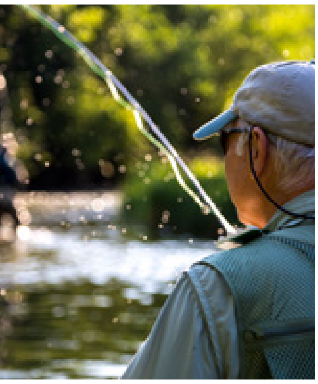
Report to Wealth Associates Investors

1st Quarter 2017

WEALTH ASSOCIATES
ASSET MANAGEMENT

Independence. Continuity. Value.




1 2016 IN HINDSIGHT... A CAUSE FOR MEANINGFUL REFLECTION. WHAT MIGHT 2017 HOLD IN STORE?

At the outset, we can certainly say 2016 was all about the journey – quite a tumultuous one at that. We lost a number of cultural icons, including David Bowie, Prince, Muhammad Ali, Mandoza, Leonard Cohen and George Michael. We lived through mass shootings, terrorist attacks and we still have the situation in Syria. We saw natural disasters – such as the earthquakes in both Italy and Indonesia, as well as Hurricane Matthew in the US and the devastating drought in South Africa.

POLITICS INFLUENCED OUR EXPERIENCE IN 2016

Politics played a major role in our experience of 2016, both locally and globally, and in developed and emerging markets. Events such as Brexit and the Trump presidency immediately spring to mind. Locally, we'll remember the Constitutional Court finding on the Public Protector's report into the President's private homestead in Nkandla, the local government elections, #FeesMustFall, #ZuptaMustFall and the report into state capture.

The world of sport didn't disappoint either, from Leicester winning the English Premier League football, to Ireland's rugby team beating the All Blacks – and of course Italy beating the Springboks.

To be sure, 2016 was a year in which the frequency of low-probability events was in fact very high. With the benefit of hindsight, it's fair to say many of us experienced 2016 as being a lot more intense than usual. But was this necessarily the case? Various media houses were quick to declare 2016 as the worst year ever. It seemed to dethrone prior worst years, 2015, whichever those had been. This doesn't bode well if extrapolated into 2017, but it does point to a trend, especially regarding how we experience things. People suffer from a number of cognitive biases and tend to remember recent and bad events most vividly. It therefore becomes difficult to maintain perspective.

THE MARKETS IN 2016

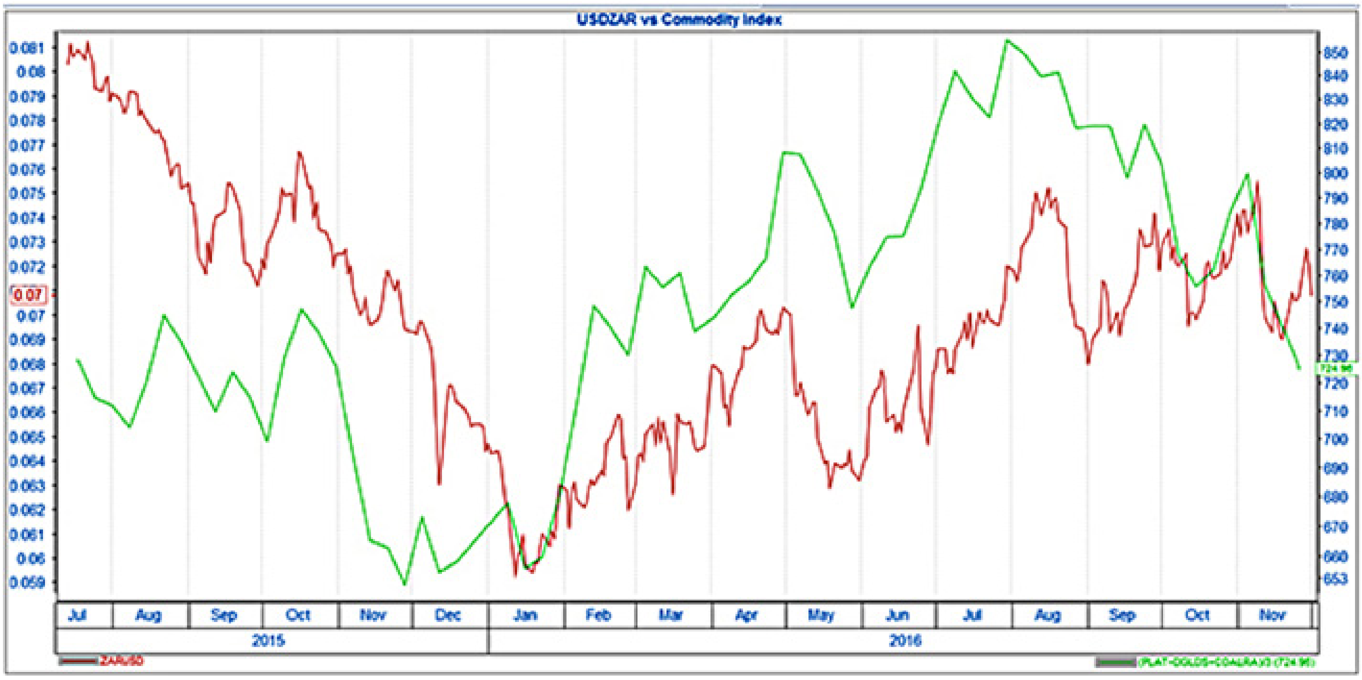
South African investors will remember 2016 as difficult year for risky assets, defined as equity and property. The JSE All Share returned 2.63%, while the SWIX managing to deliver 4.13%. Property fared somewhat better, returning 10.20% for the year. Comparing these returns to headline inflation (6.34%), only property managed to deliver positive real returns. If you invested offshore you would not have been better off. In rand terms the S&P 500 delivered -1.19%, the FTSE 100 was down 11.90%, and the Japanese Topix returned -11.08% for the year. Overall the MSCI World and MSCI ACWI were also down -5.12% and -4.81% respectively (in rand terms). So much for the vocal SA and ZAR detractors.

Rand appreciation played a major role in investment performance during 2016. The rand reached some of its lowest levels in January 2016, only to recover strongly and appreciate around 11%, 26% and 14% against the US dollar, British pound and the Euro respectively. This detracted from the performances of offshore assets, but also had a meaningful impact on rand-hedge stocks as well as listed property counters, specifically those with material UK exposure. Therefore, funds that were exposed to these counters as well as making full use of their 25% direct offshore exposure, would have had a particularly difficult 2016. Such funds tended to have held very negative views on the South African economic and political environment, and while the events of 2016 have certainly vindicated their views in many ways, these events didn't materialise in investment performance.

THE INFLUENCE OF WORLD MARKETS

The rand strength during 2016 was once again a confirmation of the continued impact of major central banks around the world, as well as investors' search for yield. In February, Federal Reserve Chair Janet Yellen told the US Congress that increased volatility in world financial markets could threaten the recovery in US growth, a point she repeated in her rather dovish statement at the March Federal Open Market Committee meeting. Expectations of further rate hikes were tempered and investors turned to higher-yielding emerging markets, bringing with them capital flows and consequent emerging market currency appreciation.

In SA, however, foreigners were persistent net sellers of both our equities and bonds. But we have a commodity-reliant economy and therefore our currency is closely related to commodity prices. Commodities made a strong recovery during 2016 as concerns over Chinese growth subsided and we consequently saw our currency strengthen along with other major commodity exporters.



The graph above shows the relationship of the rand-dollar exchange rate (red line) to a basket of commodities (green line) that we export. It's also a very useful reminder that while we become fixated on political events, larger, more fundamental forces are at play regarding our currency.

Locally, an asset class that did do well during 2016 was SA Bonds, and more specifically, longer-duration bonds. The BEASSA 12 Year Index returned 17.43% followed by the 7-12 Year Index at 15.37% and the 3-7 Year Index that returned 13.41% for the year. These bonds were sold off heavily during December 2015, with the firing of then Finance Minister Nhlanhla Nene – testament to negative events and sentiment creating huge opportunities for those investors who were able to keep their wits about them. Cash returned 7.37%, a positive real return, and when one considers the additional option value of this asset class, it would have been quite attractive to hold during 2016.

Last year was a particularly difficult year for larger capitalisation shares, which delivered -1.60%. However, small- and mid-cap stocks delivered strong returns, returning 21% and 27% respectively. In particular, the basic resources category was a significant contributor to returns in terms of mid-cap stocks.

From a style perspective, value outperformed in 2016, followed by quality, growth and momentum stocks, which returned 17.15%, 3.72%, -3.63% and -13.31% respectively.

In summary, funds with high exposure to fixed-income instruments, resources, mid and small caps and that were also long on the SA rand with little offshore exposure, therefore tended to outperform their peers during 2016.

However, despite all of the terrible things that did happen during 2016 and the future uncertainty created by political rhetoric and commentary both locally and internationally, it is a somewhat moot point as to whether 2016 was the worst year. To be somewhat academic and philosophical, consider that the second law of thermodynamics states that with the passage of time, entropy (the degree of disorder or randomness of a system) increases. There was abundant evidence of this last year with pollsters getting the Brexit and Trump election results wrong and locally with infighting within the ruling party resulting in uncertainty on the policy front.

IMPLICATIONS FOR YOUR INVESTMENTS?

Having a specific term financial plan, periodically reviewing it and sticking to it will help you avoid much of the noise and pitfalls out there. Avoiding excessive tactical calls in terms of asset classes, sectors or styles is another useful habit if you're not a professional investor with a vast amount of relevant information at your disposal. Leave the asset allocation and style allocation calls to the investment managers. This, together with building a well-diversified portfolio with your financial adviser, will go a long way in successfully navigating 2017 and the years beyond.

2 LOCAL MARKET
1 YEAR ASSET CLASS RETURNS (1JAN 2002 to 31DEC 2016)

The matrix below illustrates the variability of returns from 1 year to the next in the different asset classes.

Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	5 Year return	10 Year return	15 Year return
SA Real Estate 16.5%	SA Real Estate 32.5%	SA Equity 41.2%	SA Real Estate 42.5%	SA Equity 36.7%	SA Real Estate 21.4%	SA Bonds 16.1%	SA Equity 27.2%	SA Real Estate 24.1%	Foreign Equity 11.5%	SA Real Estate 31.5%	Foreign Equity 52.2%	SA Real Estate 25.1%	Foreign Equity 29.1%	SA Bonds 12.8%	Foreign Equity 19.3%	SA Real Estate 13.9%	SA Real Estate 19.0%
A Bonds 15.4%	SA Equity 24.2%	SA Real Estate 34.2%	SA Equity 36.9%	Foreign Equity 31.0%	SA Equity 17.6%	SA Cash 11.9%	SA Real Estate 12.5%	SA Equity 18.5%	SA Bonds 8.5%	SA Equity 20.0%	SA Equity 19.4%	Diversified 12.4%	SA Real Estate 10.8%	SA Cash 7.4%	SA Real Estate 16.1%	Diversified 9.7%	SA Equity 14.7%
SA Cash 11.2%	SA Bonds 16.9%	Diversified 19.0%	Diversified 24.0%	SA Real Estate 25.8%	Diversified 11.7%	SA CPI 10.3%	Diversified 10.8%	SA Bonds 14.7%	SA Real Estate 7.6%	Foreign Equity 18.6%	Diversified 17.4%	Foreign Equity 11.9%	Diversified 9.1%	SA CPI 6.7%	Diversified 12.2%	SA Equity 8.8%	Diversified 9.7%
SA CPI 10.8%	Diversified 16.7%	SA Bonds 14.1%	Foreign Equity 23.3%	Diversified 21.3%	SA Cash 9.5%	Diversified -4.5%	SA Cash 9.1%	Diversified 12.3%	Diversified 7.3%	Diversified 18.2%	SA Real Estate 9.2%	SA Equity 10.3%	SA Cash 6.4%	SA Real Estate 5.8%	SA Equity 10.5%	Foreign Equity 8.5%	SA Bonds 9.3%
A Equity 2.8%	SA Cash 11.8%	SA Cash 7.7%	SA Bonds 10.4%	SA Cash 7.3%	SA CPI 8.6%	SA Real Estate -4.5%	SA CPI 6.3%	SA Cash 6.9%	SA CPI 6.1%	SA Bonds 15.4%	SA CPI 5.4%	SA Bonds 9.0%	SA CPI 5.2%	Diversified 4.3%	SA Bonds 7.0%	SA Bonds 7.8%	SA Cash 7.8%
iversified 1.5%	SA CPI 4.0%	SA CPI 4.3%	SA Cash 6.9%	SA Bonds 5.5%	Foreign Equity 6.2%	SA Equity -22.9%	Foreign Equity 5.2%	SA CPI 3.5%	SA Cash 5.5%	SA CPI 5.7%	SA Cash 5.1%	SA Cash 5.8%	SA Equity 1.0%	SA Equity 3.1%	SA Cash 6.0%	SA Cash 7.3%	SA CPI 6.1%
Foreign Equity -38.3%	Foreign Equity -2.0%	Foreign Equity -2.2%	SA CPI 4.0%	SA CPI 5.0%	SA Bonds 4.0%	Foreign Equity -23.0%	SA Bonds -0.1%	Foreign Equity -2.5%	SA Equity 3.3%	SA Cash 5.4%	SA Bonds 1.1%	SA CPI 5.3%	SA Bonds -2.0%	Foreign Equity -7.4%	SA CPI 5.7%	SA CPI 6.3%	Foreign Equity 5.3%

versified returns are calculated using the sectors weighted evenly at 20%.

Sources: MacroSolutions, Morningstar, Category returns

The balance of 2017 promises to be an interesting year, with the following big political events on the horizon, all likely to increase market volatility:

- The playout of the balance of Donald Trump's first 100 days in the office as US President
- Dutch elections on March 15th, where there is the potential for the Netherlands voting in Geert Wilders and his hard-right Freedom Party, which favours leaving the EU and a ban on the Quran
- 31st March – May's deadline for invoking Article 50 and the start of the exit negotiations with the EU
- French presidential elections in April / May, where far-right candidate Marine Le Pen of the National Front (which favours exiting the EU), has a good chance of reaching the second round of elections. Whilst statistics indicate that she has a slim chance of being elected, roughly 60% of support for French candidates favours right wing oriented policies.
- May – Iran's presidential race where hardliners seek to challenge reformist Hassan Rouhani, which together with Trump's hostility could potentially scupper the existing Iranian nuclear deal
- Autumn – China's Communist Party Congress where leader Xi Jinping, already the most powerful Chinese leader since Mao Zedong, is likely to further extend his influences
- September – October: Germany's election where Angela Merkel, a bastion of stability in Europe, faces challenges in seeking her fourth terms and where the anti-euro, anti-immigrant Alternative for Germany will be trying to enter parliament
- Locally, the ANC elective conference and the political jostling that will ensue will most certainly provide some interesting and sometimes painful headlines
- Throughout the year – constant speculation on when the next Fed rate rise will be and how many of them there will be this year.

Looking at the above list, it's easy to be apprehensive, but the lesson of 2016 for investors is that it is possible to make good returns even in volatile years. When markets have performed poorly during a previous period, the probability of outperformance in the next period is significantly increased. Looking back even further, where positive returns where achieved in 16 out of 18 years (89% of the time), the lesson is even clear: every year, whilst the possibility of a market selloff exists, the odds are very much in investors' favour. The natural inclination of investors in growth assets after a period of poor to negative performance is to rotate out of the growth assets into cash. This is generally the worst possible thing that long term investors can do as they will often miss out on the impressive returns which often follow.

Material in this article courtesy of Francis Marais (Senior research and Investment analyst at SIM, and Brendan de Jongh (Investment analyst at PortfolioMetrix)

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