Robert Cowen Investments

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Newsletter

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The Family Office

You are welcome to pass this newsletter on to friends who may wish to learn more about investment.

To be added to our email, contact alan@rcinv.co.za

"Lack of money is the root of all evil." ~ George Bernard Shaw

"The buck stops with the guy who signs the cheques." ~ Rupert Murdoch

RCI MET Flexible Fund – closed February at 379.40, 2.03% down for the month but 2.02% higher than 12 months ago. The JSE Top 40 fell 0.60% for the month but down 7.12% versus a year ago. Mining shares had a strong run so, as we had none, we underperformed. In March we added a bit of mining not because we believe the fundamentals have really changed but because momentum in the mining share prices have turned up. See more inside.

Visit our website: www.rcinv.co.za for back copies of the newsletter, background information, etc.

The US stock market turned up and we are happy about that as we increased offshore investments into top quality shares.

The JSE has had a strong run in the past few weeks. Our safe, boring banks are up 20% since late January but we did not have much in mining shares, some of which are up by 50% in a month! We do not like the longer-term outlook for metal prices so we don't have much invested in mining. This may result in some short term underperformance but the risk/reward relationship of mining is currently not good enough to tempt us into much investment in this.

How does the budget affect your investment strategy? Our new employee, Andrew Lawson, has summarised it for you: ALMOST NO CHANGE TO STRATEGY. The conduit principle allowing trusts to distribute capital gains and income to beneficiaries was under threat last year but this principal has been confirmed. Although capital gains tax rates have risen, one can choose to pay 32% tax in trust on capital gains or to distribute it to beneficiaries with a maximum rate of 16%, and, with judicious use of grandchildren, spouses, etc., one can probably get that rate down to less than 8% in many cases. Will this budget be enough to prevent a downgrade of the county's credit rating? We expected higher marginal tax rates, and although we did not expect the ANC to do it, we think an increase in VAT would have reduced the tax deficits. Thus, although a downgrade may have been deferred, the long term outlook for mining is poor and we expect a downgrade within two years.

Ross has written an interesting article on the increased spending of the US consumers thanks to their savings at the petrol pump. 80% of the saving is spent on restaurants and food. At some point, this spending will spread into durable goods.

The American market has stopped falling

Last month we wrote that the US economy was continuing to improve slowly but steadily so shares should stop falling.

The American SP 500 index stopped falling

On the 15th of February 2016, we called the bottom in the US market (marked by the up arrow) and since then it has risen 7%. Ok, we were both lucky and smart! Prices are still at the level of 15 months ago and with slow growth expected this year, we are expecting only another 5% growth in 2016. Not so good in dollars but how will it be in rand? Some think the rand has weakened too rapidly but we fear a number of things:

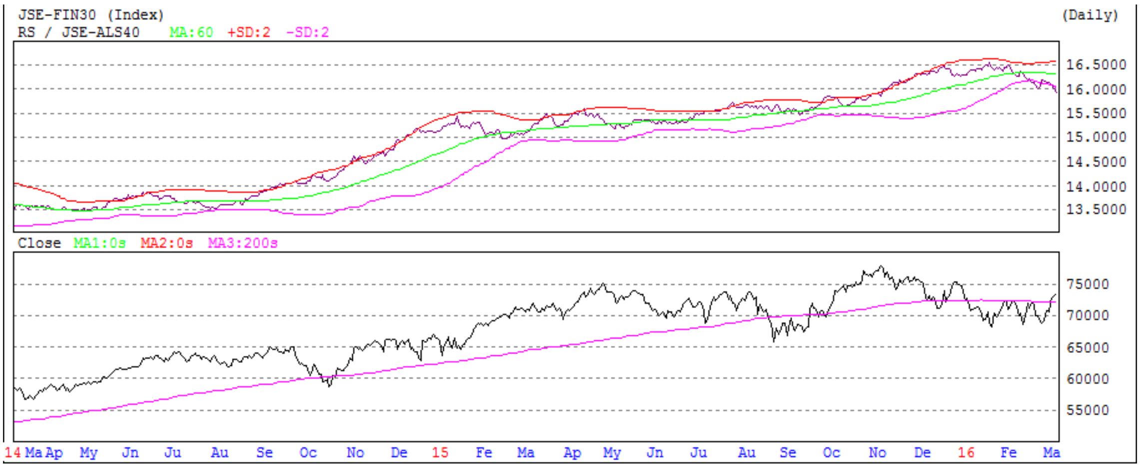
1. Although some metal prices are turning up again, South Africa's main exports viz. iron ore, coal and platinum, remain under pressure with extra supply of iron ore coming from new mines in Australia and South America. We think that any price relief will be short lived and expect the US dollar prices to be lower by year end.
2. If the metal prices remain weak, the rand will need to drop, otherwise our mines will start making big losses and be forced to close when they run out of money. If they close, the rand will come under intense pressure and a lot of people will be out of a job!
3. The risk of a country downgrade within the next 12 months is significant. Although interest rates and the currency already appear to be discounting it, there is likely to be a short term spike – rates should shoot up and then settle down again while the rand could get worse than 17 to the dollar. As usual, markets are likely to overshoot.
4. Our other exports, such as agricultural products, will be under pressure from the drought. Car exports might be helped by the weak rand but there is an almost equal import bill for every car we export. Gold production is now so low as to be almost irrelevant (except in jobs provided). Tourism is slowly recovering from a shotgun blast to the foot over visas. That said, tourism is likely to be our bright spot in the economy over the next few years but it is hard to invest in it directly.

South African markets

The JSE has performed strongly over the last two weeks, including the first few days in March and is now well above the lows of January.

But much of the action has been in the mining shares …

We don't want to invest much in the miners because their outlook is questionable so if they rise strongly, we will underperform in the short term. In the bottom of the two graphs below, the Financial and Industrial Index (where we are mostly invested) shows a much smaller bounce in February than in the graph above.



The top graph above shows the relative performance of the Financial and Industrial Top 30 versus the Overall Top 40 Index. Over two years, it has risen from 13.5 to 16.5, so an outperformance of close to 20%. However, in the past two months, it has dropped from 16.5 to 16 as miners have risen more. In the short-term, underperformance of the Financial and Industrial Index may occur for a few months but, over the longer term, we do not believe that the outlook for metal prices is good enough for miners to do well. We fear that 20% of mines will have to go insolvent to restore the imbalance between oversupply and demand and we are worried that quite a few South African mines may be casualties. If the rand falls enough, the useful lives of our mines will be prolonged. The risks are too high for us to invest in most miners. We prefer the safe, steady route of good quality financial and industrials with highly predictable earnings supported by good dividends that are unlikely to be cut.

Mining shares have turned around in the last few weeks but do the fundamentals support this? We feel that metal prices are very low and will remain low (although a short term spike is always possible) as Chinese demand should remain muted yet new supply is still coming on stream. We will not invest much in mining before the mines prove that profits are rising steadily. Maybe that will be a bit late as share prices often rise in anticipation of a rise in metal prices but we are not in the business of risking your money on a "hunch". We would rather have most of your portfolio invested in companies with highly predictable earnings – and preferably offshore with the current uncertainties dogging the SA economy and the rand!

Thus, it is not just about how much money can be made, it is also about avoiding losses when things don't turn out as expected or hoped for. We love that trite saying "Probability is the only certainty in investments".

Coronation Asset Management showed an interesting table in their "summer 2016" 'Corospondent' review. They showed that if different fund managers performed similarly overall, it was the manager who performed the best in a down market, who had the best long-term performance. This is what we aspire to, to lose less in down markets and to show good long-term growth in your portfolios. What happens in a month, or even three or six months is largely irrelevant. What happens over five years – that is what is important.

http://www.coronation.com/Assets/za/Personal/Publications/Corospondent/2016/January/Corospondent-January-2016-Retail.pdf

"The importance of avoiding negative returns and focusing on long-term cumulative performance.

The following table shows a hypothetical case study in which the market delivers a cumulative return of only 6% over five years. In the first scenario, 'steady fund manager' delivers the holy grail: consistent outperformance of 4% every single year.

HYPOTHETICAL COMPARISON OF FUND MANAGERS

	Year 1	Year 2	Year 3	Year 4	Year 5	Average alpha	Arithmetic average	Cumulative return
Market return	(50%)	40%	15%	15%	15%	-	7%	6%
Steady manager	(46%)	44%	19%	19%	19%	4%	11%	31%
Lumpy manager	(40%)	35%	25%	10%	25%	4%	11%	39%
Bear market manager	(30%)	40%	15%	15%	15%	4%	11%	49%

Source: Coronation

In the second scenario, 'lumpy fund manager' delivers the same aggregate alpha over the five years (20%), but its performance is lumpier. In the third scenario, 'bear market manager' delivers the same aggregate alpha, but does it all in the first year (which happens to be the only down year in the period). In the performance assessment process our brains are wired to:

- weigh recent performance more heavily than earlier performance;
- penalise losses more heavily than gains; and
- appreciate alpha that is more steady than lumpy.

The entire field of behavioural finance is devoted to analysing these flaws in our reasoning process. Suffice to say that the evolutionary process did not equip homo sapiens to manage capital over multi-decade periods! We are just too guilty of instant gratification and loss aversion (we put two to two- and-a-half times the weight on a rand loss as on the same rand gain!).

Over the full period, the steady manager delivered a compelling return of 31%, the lumpy manager did even better with 39% and the bear market manager did best with 49%. These outcomes are fascinating. All three managers delivered the same aggregate outperformance over the period (20%) and yet the final outcomes for their clients are so very different. Not only are the outcomes materially different from one another, but they are also at odds with what we intuitively would have expected (because our brains don't easily compute compound returns).

They demonstrate that as much as we desire consistent alpha year in and year out, it was the steady manager that ultimately delivered the lowest value-add. The steady manager was beaten by the 'inconsistent' manager whose alpha was lumpier. And the manager who did best was the one that delivered in a down year and then delivered no alpha for the next four years.

This case study talks to some of the pitfalls in assessing investment performance. We instinctively place too much emphasis on recent performance as well as the consistency of alpha, and we don't give enough credit to managers who can preserve value in downmarkets."

Thus we might summarise our investment goal as to make you a very acceptable return at a reduced risk. If we avoid some of the falls, we don't have to outperform in risky markets.

No significant changes to your financial structures due to the Budget

Higher capital gains tax rates but conduit principle of trusts confirmed

By Andrew Lawson

After all the turmoil in the treasury ministry over the last few months, the much awaited budget was delivered. While there are some encouraging points, Minister Gordhan failed to deliver anything dramatic as many in the press were expecting. What are the main aspects relevant to the majority of our clients? Nothing significant has changed, so please don't worry!

With regards the structuring of trusts, both local and offshore, nothing has currently changed. The conduit principle of being able to distribute income in trusts to beneficiaries with lower tax rates remains. While it was discussed that donations to trusts could be reviewed to include the growth from loans in the donor's estate, and to regard loans to trusts as donations, these ideas are still to be considered and no actual determinations have been made. We think this will be impractical and do not expect any meaningful change. We are confident that should any changes be made, there will still be ways to limit the tax liability.

Unchanged: Offshore assets invested in your own name in shares in the US (and some other places) result in you becoming liable for estate duty on these shares in the US on death at a rate of 40% compared to 20% in South Africa, and cannot, as in South Africa be delayed by leaving them to your spouse. And you might need to pay estate duty tax a second time when your spouse dies! Offshore trusts are therefore the preferred method to limit this liability. Alternatively, move the investments to our offshore fund, and then there will be no foreign estate duty.

Changed: Capital gains tax has increased for individuals and special trusts. The old formula was to include 33.3% of the capital gain in your taxable income. This has now increased to 40%. This means the effective maximum capital gain tax rate for individuals and special trusts will increase from 13.7% to 16.4%. For companies and ordinary trusts the inclusion rate of capital gains has increased from 66.6% to 80% resulting in the tax payable rising from 18.6% to 22.4%. However, maximum effective rate will normally be much less if the gain is distributed between beneficiaries with lower tax rates such as spouses and grandchildren. This does not mean that the gain has to be paid out. It effectively becomes a tax free loan from the beneficiary to the trust, repayable at the trustees' discretion.

Transfer duties will be raised from 11% to 13% on property sales above R10 million, but if this is indeed applicable, then you should be able to afford the increase!

On a general note, the budget speech needed to reaffirm government's commitment to close the gap between income and expenditure. A R25 billion saving over 3 years in the government's expense bill was mooted but unfortunately, we will believe this only if it is achieved. The desire to address corruption and lower the government wage bill is commendable. There was also some discussion over strengthening the cooperation between government and the business sector, who might become possible equity partners in some of our failing state owned organisations. However nothing concrete was tabled.

Avoiding a credit downgrade for South Africa

For the time being this budget should, hopefully, keep the ratings agencies at bay, and prevent them from downgrading our government bonds to junk status. Countries, just as companies and people do, have a credit rating and ours has been getting steadily worse.

However, as RCI has been warning for the past four years, it is as if everyone can see the cliff approaching but no one is doing anything about it. With the fall in metal prices, our exports have declined and the cliff looms ever closer!

Unfortunately, we do not believe metal prices will turn around in the next few years so our expectation is that a downgrade will occur, sooner or later. This is likely to weaken the rand and cause interest rates to rise, as well as impact on economic growth.

The usual sin tax increases were not unexpected. The new sugar tax will impact on those with a sweet tooth, and the tyre tax will have a small impact on the cost of driving your vehicle. These are, however, not significant to our clients.

While we did not expect VAT to be increased as it is not politically expedient, it was probably warranted. There was no change in the company, trust or individual tax rates.

All in all, the government rhetoric appeared positive in trying to avoid a ratings downgrade, and to encourage economic development. Talk is cheap but 'money buys the whiskey'. It remains to be seen how well the government will implement its rhetoric in a very tough economic climate.

What have Americans been doing with their savings from the low oil price?

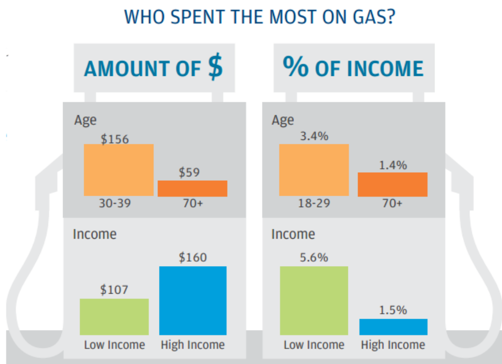
By Ross McConnochie

At some point they will start spending more of this money on durable goods which will get the US economy moving forward faster.

Morgan Stanley produced a report in October last year based on credit card data of 25 million Americans. The average American household was expected to save about $700 in 2015 of which they were spending roughly 80% of that extra money, as opposed to paying down debt. Consumers are spending their money on experiences rather than goods. Air travel, restaurants and hotels are the main beneficiaries of the low oil price.

Below is a summary of their findings:

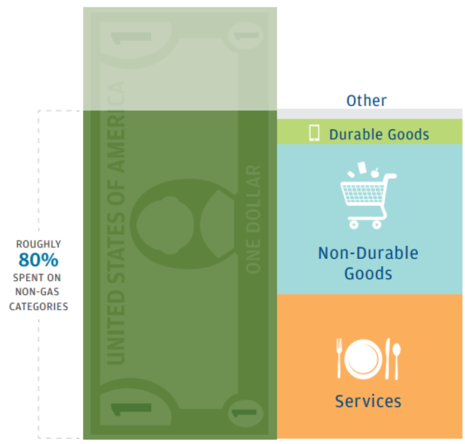
Finding 1: Gas spending and the savings associated with gas price declines varied dramatically among U.S. individuals. Some people continued to use the same amount of fuel and thus saved money whilst others took advantage of the low fuel prices by purchasing more and travelling more.



Finding 2: People in the South and Midwest spent more on gas and saw larger increases in disposable income when gas prices declined relative to those on the East and West coasts. This is likely due to the concentration of people in cities and the use of public transport. The Western states tend to have cities that are spread out over larger spaces.

Finding 3: Savings at the gas pump represented more than 1% of monthly income for low-income individuals and disproportionately impacted younger Americans. Although gas spending was highest among men, 30–49 year-olds, and high-income earners, spending on gas represented a larger share of income for men, 18–29 year-olds and low-income earners than other individuals as a whole. This figure would likely approach 2% if gas prices stay near the January 2016 lows.

One of the reasons why the boost from cheap oil may have gone unnoticed is that Gas spending represents less than 5% of consumer spending, so the impact from lower prices was small in absolute dollar terms and easily overshadowed by other economic forces.



Finding 4: For every dollar less spent at the gas pump, individuals spent roughly 80 cents on other things. Almost 20% of the gas savings were spent at restaurants, but department stores, entertainment, electronics and appliances also saw significant gains. Americans tended to spend their savings on experiences as opposed to paying down debt. We see further evidence of this in record car sales in the 4th quarter of 2015.

This boost to other categories of consumer spending could be here to stay if gas prices remain low as predicted. On the other hand, a substantial increase in gas prices might proportionately dampen consumer spend in these categories, if the response to gas price increases is symmetrical with the response to gas price decreases.

The combination of low oil prices and low US unemployment levels put the American consumer in an excellent position to spend and we have finally seen evidence of this in the recent US inflation figures. The data shows that the USA is slowly improving and is therefore the best investment location for offshore investments.

Editor: This article reflects the benefit to consumers of the oil price decline. There is a large additional benefit to each company which must make a delivery or pay for shipping. These extra profits result is greater earnings, larger dividends and additional spending by companies.

U.S. Consumer Spending Rose in January by Most in Eight Months

From the Fuller Treacy Money letter of 27 February 2017

Here is the opening of this informative report from Bloomberg News
http://pbn.com/US-consumer-spending-rose-in-January-by-most-in-eight-months,112434?print=1

WASHINGTON - Consumer purchases climbed in January by the most in eight months, fueled by faster earnings growth and indicating the biggest part of the U.S. economy gained momentum at the start of 2016.

The 0.5 percent advance followed a 0.1 percent gain the prior month, a Commerce Department report showed Friday. The January figure exceeded the 0.3 percent median forecast in a Bloomberg survey. Incomes also climbed 0.5 percent, more than projected. The Federal Reserve's preferred measure of inflation rose by the most since October 2014.

Steady hiring, cheap gasoline, and rising home values are powering Americans' ability to boost spending, which accounts for almost 70 percent of the economy. Households are broadening out purchases beyond big-ticket items such as cars and houses, which bodes well at a time when manufacturing is weak.

"It's a very positive story for consumers," Scott Brown, chief economist at Raymond James Financial Inc. in St. Petersburg, Fla., said before the report. "They've got job growth, wage growth and low fuel prices. Spending will be strong enough to carry the economy through this year and avoid a recession."

A separate report from the Commerce Department, also issued Friday, showed gross domestic product expanded at a revised 1 percent annualized rate in the fourth quarter, faster than the previously reported 0.7 percent advance and reflecting a higher value of business inventories.

David Fuller's view

One month's economic data can be misleading and it is also subject to revision. Nevertheless, this is encouraging data following the worst January on Wall Street for a very long time. It provides initial evidence that the US stock market is experiencing no more than a cyclical bear market within an overall secular upward trend.

Climate change, fertility and girls' education

From the Fuller Treacy Money letter of 27 February 2017

This article by Homi Kharas for the Brookings Institute may be of interest to subscribers. Here is a section:
http://www.brookings.edu/blogs/future-development/posts/2016/02/16-climate-change-fertility-girls-education-kharas

Would it really make that much difference to global carbon emissions if there are fewer people? Yes. In the United States, for example, the carbon emissions of a single person is about 20 times the reductions that each of us might be expected to achieve by being more conscious of our carbon footprint, switching to electric cars and using LED lightbulbs.

Does education really make that much of a difference to fertility rates, compared to other possible explanatory variables? Yes. Look at the graphs below, taken from the World Bank, to see how dramatic the difference is in some selected countries. The difference between 0 years of schooling and 12 years is almost 4 to 5 children per woman. While trends are for women to have lower fertility over time (perhaps through access to family planning) at each education level, the main driver of overall fertility reduction is clearly the change in proportions of women at each education level.

Eoin Treacy's view

Sometimes the answer to a difficult question is just staring you right in the face. Offering girls the same access to education as boys has had transformative effects on developed economies. In fact since it is women who tend to work in factories in the developing world, it is hardly an overstatement that allowing women to pursue careers is a primary enabling factor in economic development.

Sea Levels Are Rising Faster Than They Have in 2,800 Years

From the Fuller Treacy Money letter of 24 February 2016

Here is the opening of this unsettling scientific report from CBC News:
http://www.cbc.ca/news/technology/sea-level-rise-1.2951884

Sea levels on Earth are rising several times faster than they have in the past 2,800 years and are accelerating because of human-caused global warming, according to new studies.

An international team of scientists dug into two dozen locations across the globe, including a salt marsh and coastal wetland in Newfoundland, to chart gently rising and falling seas over centuries and millennia. Until the 1880s and the world's industrialization, the fastest seas rose was about three to four centimetres (1 to 1.5 inches) a century, plus or minus a bit. During that time global sea level really didn't get much higher or lower than eight centimetres (three inches) above or below the 2,000-year average.

But in the 20th century the world's seas rose 14 centimetres (5.5 inches). Since 1993 the rate has soared to 30 centimetres (a foot) per century. And two different studies published Monday in the journal Proceedings of the National Academy of Sciences, said by 2100 that the world's oceans will rise between 28 to 131 centimetres (11 to 52 inches), depending on how much heat-trapping gas Earth's industries and vehicles expel.

David Fuller's view

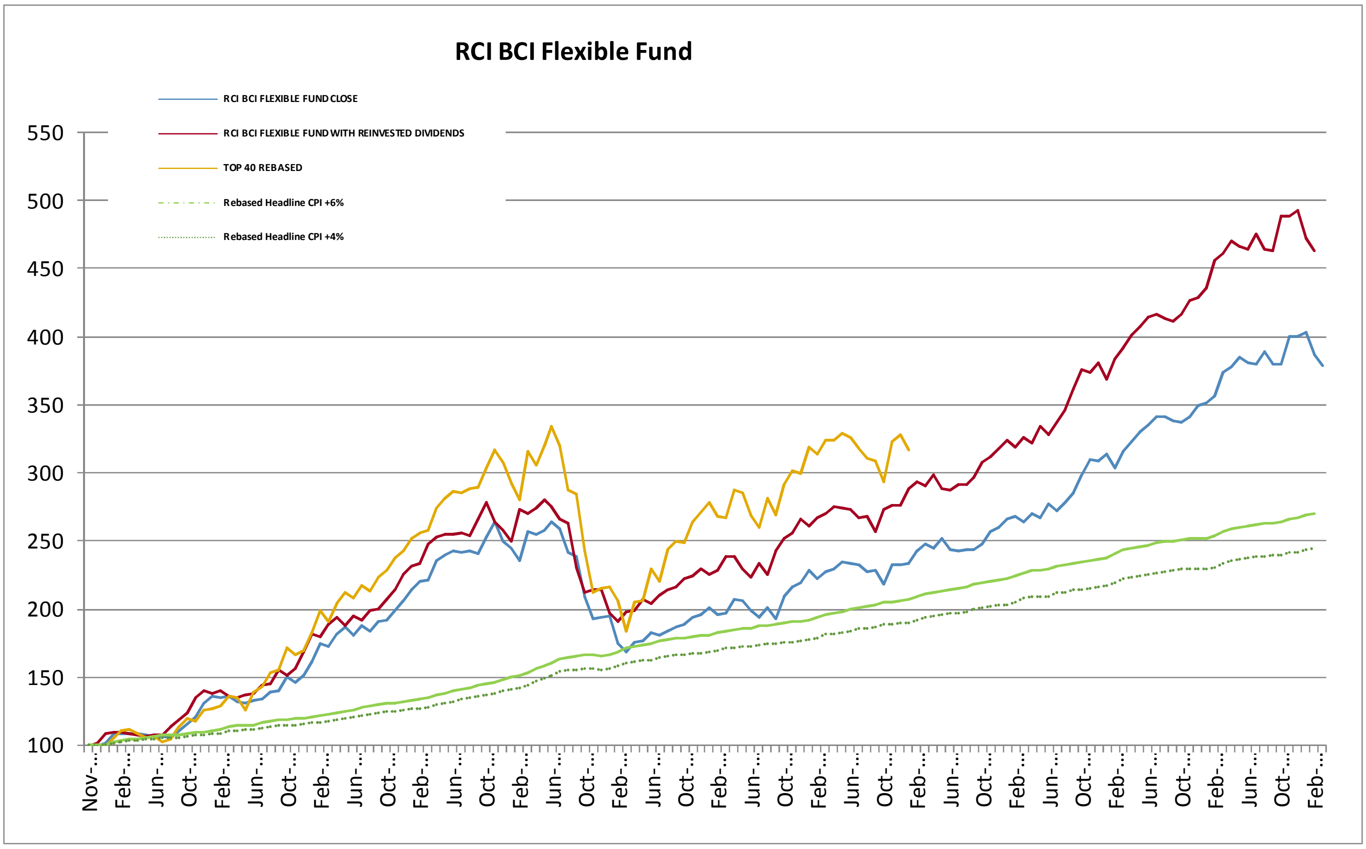
Most of us do not want to believe this because it is too frightening. However, it makes sense to me that the climate is warming and I see more evidence to confirm rather than refute this view. I hope I am wrong or that technology provides a solution, because the long-term economic consequences of rising sea levels are appalling.

(See also: *Bill Gates Q&A on Climate Change: 'We Need a Miracle'* – This is an excellent article and video, in my opinion.) http://www.bloomberg.com/news/articles/2016-02-23/bill-gates-q-a-on-climate-change-we-need-a-miracle

RCI BCI Flexible Fund – Only up 2% over 12 months but the JSE overall was down 7%. We try to ensure that you lose less in tough times

Please contact Maggie on 011 706 1420 for any help on your unit trusts.

RCI BCI Flexible Fund dropped 2.03% for February closing at 379.40c per unit. The JSE top 40 fell 0.60% for February so we underperformed this month as we had no mining shares which leapt spectacularly. We have added a few mining shares in early March, not because we are convinced that the fundamentals of miners have improved but to try to ride the momentum. Not much importance should be placed on the performance over a month. Over a year the Overall Index is down 7.12% but our fund is up 2.02%. That is almost a 10% outperformance which makes us happy. Our goal is to double every five years.



Unit trust has flexibility – happy to take small amounts

The unit trust has the flexibility to buy and sell shares and to change weightings more frequently than in an individual portfolio. We are happy to take small amounts into the unit trust (from R500 per month or lump sums of R3000). As you will not pay commission to any agents there is no cost to get in and out of our fund. On selling, the amount you receive back will depend on our performance.

Collective Investment Schemes in Securities (Unit Trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to the future. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from the company/scheme. Commission and incentives may be paid and if so, would be included in the overall costs. The portfolio is registered under the license of Boutique Collective Investments, a member of the Association for Savings & Investment SA. Forward pricing is used. More details are contained in a fact sheet that is available on request.

To conclude

The FEAR of January appears to have passed. Life goes on and the reality of eating, drinking and living reassumes its importance in peoples' minds. Minister Gordhan finishes his budget speech and suddenly people stop worrying about economics and politics …….. until the next time.

Investors normally overreact and it is hard to be a 'majority of one'. To buy when others are selling is not easy. To sell when the prices reach ridiculous levels is not easy. It was difficult to sell EOH shares at R170 during 2015 and hard to buy them back under R125 in 2016. What helps is to understand the share well and it is much easier to make decisions on companies with highly predictable earnings streams.

IF you can rely on the company to produce predictable earnings and to pay reliable dividends then "all" you have to focus on is getting the price right. If you buy cyclical shares or mining shares it is much harder to value them as the earnings can fall or rise drastically. An interesting article we read postulated that Warren Buffett is so good because he stuck to companies with slow technological change. Thus all knowledge built up on the share snowballs – continues to accumulate. Whereas, if you buy a share where the technology changes rapidly e.g. Nokia or Ericsson or Blackberry, they might be overwhelmed by changes and then every bit of knowledge you have built up on them is wasted!

Thus the saying 'too soon old and too late smart" can be mitigated by not having to relearn the lessons of history too often. Finding out what works in a low-risk manner and becoming expert in it is a safer and often more rewarding (but more boring) method of wealth accumulation.

We aim to be the best family office in South Africa.

Thank you for being our clients

Best regards

Di and Alan