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NAVIGATING THE PANDEMIC AS A RESPONSIBLE INVESTMENT BUSINESS

TEBOGO NALEDI

A MESSAGE FROM THE DIRECTOR OF INSTITUTIONAL BUSINESS

Having a positive outlook has become increasingly challenging, as the COVID-19 pandemic is spreading at an increasing rate with over 18 million global cases and over 500,000 cases in South Africa at the time of writing. This pandemic has, from a social and economic perspective, given us even deeper insights into the importance of environmental, social and governance (ESG) factors when we make investment decisions. The world is moving towards a more socially conscious and inclusive way of operating. In these dynamic times, what we know for sure is that change is the only constant and in many respects, life has become substantially more challenging. There are specific moments that remind us that financial markets operate within broader societies and this is no doubt one of them.

How do we then, as investors, participate in a proactive manner, to honestly and inwardly reflect on effecting

change to our environment? We achieve this by having honest and at times uncomfortable conversations, engaging the tough topics and deepening our commitment for change.

The COVID-19 pandemic has had a disproportionately negative impact on poor and historically disadvantaged communities. South Africa is one of the most unequal countries in the world, with the bottom 60% of households being primarily dependent on income from social grants. Our fellow citizens' need for us to be responsible stewards of the nation's savings has never been greater.

As Old Mutual, we have engaged actively to try to support our nation through this crisis. The Old Mutual Foundation set aside R50 million for emergency COVID-19 assistance focusing on education, food security and supporting municipal community care health workers. Old Mutual has also offered support to SMEs worth more than R40 million and has provided premium-free cover worth R4 billion to essential healthcare workers.

Alongside our parent, Old Mutual, we at Old Mutual Investment Group share a deep social consciousness and operate with a shared value model in delivering products and services that promote inclusion. We focus our efforts on pursuing long term risk-adjusted returns in a way that makes a difference in our clients' lives, and that builds system resilience in making the world a better place. We believe having such an approach to investing long term capital has never been more critical.

Our theme for this quarter's Fundamentals is "Navigating The Pandemic As A Responsible Investment Business" and it will cover the following insightful topics:

- **Johann Els, Chief Economist**, assesses the impact of the resurgence of capital markets and the path for a global economic recovery from the pandemic.
- **Meryl Pick, Head of Research at Old Mutual Equities**, demonstrates the importance of having a long-term investment outlook and partner. Learning from our experience in managing the oldest unit trust in South Africa through various market crashes, Meryl demonstrates that having a true long-term investment approach in equities will result in a superior outcome.
- **Ruchir Severaj, Credit Portfolio Manager** in our Liability Driven Investments boutique, unpacks the integration of responsible investing within Liability Driven Investment strategies; highlighting that responsible investing is not only limited to equity investments, but is also applicable to fixed income based strategies as well.
- **Peter Brooke, Head of MacroSolutions**, our multi-asset boutique, provides an update on long-term expected returns across various listed asset classes.
- **Jon Duncan and Robert Lewenson** from our **Responsible Investment** team highlight the importance of an investor's listed equity stewardship programme, given its ability to address company specific issues relating to ESG and effect true behavioral change in society on a range of issues, including climate change.

OUR FELLOW CITIZENS' NEED FOR US TO BE RESPONSIBLE STEWARDS OF THE NATION'S SAVINGS HAS NEVER BEEN GREATER.

- Lastly, **Kelly Joshua, Head of Education Investments** within our affiliate Old Mutual Alternative Investments, provides insights into the approaches taken by schools in order to adapt their business models given the challenges posed by the COVID-19 environment, and the long-term outlook for investors in private affordable education.

We hope you take away something meaningful from these insights and encourage you, to wear your masks, practice social distancing and wash your hands. Until next time, stay safe!

AN ECONOMIC OVERVIEW AND OUTLOOK BEYOND COVID-19

JOHANN ELS
Chief Economist



GLOBAL ECONOMY – A RECOVERY SLOWLY PLAYING OUT

At the time of writing the April report, it was relatively early in the current COVID-19 crisis with respect to infection rates and lockdowns of economies. We then warned of enormous uncertainties around infection rates, the duration of lockdowns and economic impact – uncharted territory for the global economy. I postulated that the cycle would likely be in the form of a “V” shape and while a deep downswing was expected, it would be of a relatively short duration and the recovery would likely be quite rapid as lost production is recovered. There are still significant uncertainties around the spread of the virus worldwide. While a potential second wave of infections in Asia has not yet materialised and infection rates in Europe have eased markedly, the outbreak in the US is outpacing the experience in many other countries. Similarly, the infection cycle continues almost unabated in Latin America. Nevertheless, to a large extent, the expected reopening of economies has happened from late May onwards.

There has been significant pushback around late March and early April against the view of a V-shaped cycle, but recent data has presented sufficient upside surprises that have strengthened my view that a V-shaped cycle is the most likely outcome. One of the lessons from the Global Financial Crisis (GFC) was that the cycle would likely be V-shaped – a deep recession, followed rapidly by a sharp recovery. Similar to the GFC, my main concern is around economic growth after the initial recovery (or the upleg of the “V” cycle).

While there are similarities to the GFC, there are also crucial differences – which makes this cycle even more likely to be of a shorter duration. The current crisis was the making of an exogenous shock (COVID-19), which led to lockdowns of economies – there were far fewer cyclical imbalances now than before the GFC, the financial system is in a much better shape and deleveraging should also be more moderate than during the GFC. Policy support this time around was again quick off the mark, but far more decisive and sizeable than during the GFC. Fiscal policy support was targeted more at non-financial businesses and consumers (versus more aimed at financial sector support during the GFC) and monetary policy support (apart from interest rate cuts) was also far larger in terms of quantitative easing (QE) than during the GFC. The reopening of economies should therefore lead to a far quicker recovery.

As economies reopened, employment recovered, consumer spending rebounded and production restarted. In the US, the extent of job losses during the lockdown period was truly shocking, but the recovery has already started. A total of 22.2 million jobs were lost during March and April 2020 and 7.5 million of those were recovered during May and June. This recovery will likely continue over the next few months. During the GFC, the peak-to-trough jobs cycle lasted two years from February 2008 to February 2010, during which

8.6 million jobs were lost. From February 2010, it took more than four years (to May 2014) to recover all the jobs lost. In line with the jobs recovery in the US, retail sales have already rebounded more strongly than expected.

Globally, purchasing managers’ indices (PMIs) have recovered sharply as economies reopened from China, to Europe and the US (the three most important economic areas). The Global Manufacturing PMI (as calculated by JP Morgan) fell to 39.6 in April (not as far as during the GFC, when it reached 33.8 at the low point – probably because the rolling lockdown and reopening from China to Europe, to the US did not occur at the same time, thus softening the blow) and has since recovered to 47.8 in June. While this is still below the neutral level of 50, the recovery has already been remarkable. Similarly, the services component of this global PMI fell to a low of 23.7 in April and recovered to 48.0 in June.

The bottom line is that despite the risks on both sides of the virus (renewed infection spikes versus news of potential vaccines) this cycle is largely playing out along the shape of a V. This does not mean it will be all plain sailing though. However, that is why policy support will continue to be extensive and long-lasting. Already, central banks are worried about deflation. Lower than expected readings of core inflation rates (i.e. excluding the impact of food and energy prices) will keep policymakers attuned to the need for continued expansionary policies. In the US, the underlying pace of the Federal Reserve (the Fed)’s preferred inflation measure (the core PCE deflator) has slowed sharply and more deeply than during the GFC. Another key learning from the GFC was that, despite the significant policy support, inflation continued to move lower for far longer than expected. I expect the same situation to unfold now – inflation will likely continue at a lower pace for a longer period, with more risk for deflation than inflation – keeping central banks very much alert.

Despite the unfolding recovery, there are many risks and markets could be volatile for some time – especially when deeply negative second quarter GDP data is released.

My latest growth forecasts for the main areas are:

Global growth forecasts in perspective:					
	Actual growth		Forecasts		
	2009	2019	2020	2021	2022
USA	-2.5	2.3	-5.2	3.2	2.5
China	9.4	6.1	2.0	8.5	6.0
Euro Area	-4.5	1.2	-6.2	6.3	1.5

SA ECONOMY – A TEST FOR A SUSTAINABLE RECOVERY

In South Africa, the situation is far more dire than in the rest of the world. While a deep downswing followed by a sharp recovery is also expected here (the V-shaped cycle), the sustainability of the recovery over the medium term remains in serious doubt and of deep concern. Let's explore.

The same reasoning for the "V" in the global economy applies to South Africa. The collapse in activity was followed by a rebound as the lockdown eased and activity restarted. The global recovery will also help the local economy. Similar to the global cycle, I expect a deeply negative real GDP growth number in 2020 in SA and a sizeable positive growth number next year. My concern is the outlook for the SA economy over the medium to longer term.

Having experienced sharply lower economic growth over the last decade, all the main variables that are important for foreign investors and ratings agencies – the budget balance and the debt ratio (government debt as a percentage of GDP) are the most important ones – had deteriorated substantially even before the COVID-19 crisis hit. The subsequent economic collapse and resultant impact on these variables will make it even more difficult to set the economy right.

To emphasise the dire situation, take a look at these numbers:

- **Growth:** Annual average real GDP growth over the ten years ending 2019 was only 1.7% p.a. – less than half the 3.6% growth (on the same basis) recorded in the previous ten years. Over the last five years to 2019, average annual GDP growth was even weaker – only 0.8% p.a. The situation worsened further recently, as the economy has recorded negative growth for four out of the last five quarters – and continuously since July 2019 – thus being in recession even before the onset of the current crisis.
- **Budget balance:** From 1994 onwards, lower deficits were recorded as growth picked up until a budget surplus was recorded in 2007 and 2008, at the onset of the GFC. Since then the balance has deteriorated sharply – firstly, as a result of the GFC-induced local recession, and then weaker growth and an inability to correct the deficit through more serious intervention. So, from a surplus in 2008, to a 15.7% deficit this year.
- **Debt ratio:** Thanks to the stronger growth and lower budget deficits in the late 1990s and early 2000s, the debt ratio improved to around 26% (debt as % of GDP) by 2008. Then the deterioration came along with growth and bigger deficits. Last year the debt ratio was 63.5% and it will reach 81.8% this year.

This brings us to the Supplementary Budget of June 2020 – in reaction to the economic fallout from the COVID-19 crisis. While the numbers in the Budget were truly horrific as expected, the message was clear that the attention needs to be on fiscal consolidation. While this is commendable, the consolidation targets of a primary surplus (i.e. budget balance excluding interest payments) by 2023/24 (from 11% deficit now) and a stabilisation in the debt ratio at 87.4% (also in 2023/24) will be close to impossible to achieve without growth-enhancing policy reform. Also worthy was the aim to achieve these goals largely through extra spending cutbacks, with far less emphasis on extra tax measures. Again, without growth-

enhancing policy reform this will have a deeply negative impact on the economy.

The Minister of Finance described the Budget as a "bridge" to the October Medium-Term Budget Policy Statement (MTBPS) and promised that Government "will prepare a set of far-reaching reforms" before then that "will stabilise public debt". The cynics amongst us will argue that we have heard these promises before – many times – over the last few years.

But there might be reason for slightly more optimism this time around, in terms of the planned expenditure cutbacks and promised policy reform. Firstly, the planned spending cuts of R230bn over the next two years may be somewhat easier to achieve than what we thought initially. National Treasury was able to cut spending by R100bn between the February and June Budgets alone. Slower planned spending on state-owned enterprises (SOEs) will also help. Thus, a R230bn cutback over two years might be feasible. Also, Government remains steadfast in the planned R160bn savings from the public-sector wage bill (announced in February) despite significant union pushback.

The likelihood of serious policy reform may also now be somewhat higher than previously thought. The US\$4.2bn emergency IMF loan comes with the condition that Government should stabilise the debt ratio. The threat of a full IMF structural adjustment programme in the absence of policy intervention could be the impetus needed to make unpopular decisions. The signs have become clearer recently with the President talking about a "whatever it takes" approach to policy change (also endorsed by the ANC's NEC). Thus, the promised reforms may actually come through this time. Watch this space.

On the monetary policy front, low inflation (May CPI inflation fell to 2.1%, which is below the bottom end of the SA Reserve Bank's 3% to 6% inflation target range) for longer (headline inflation is likely to remain below

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the 4.5% mid-point of the target range for the duration of the forecast horizon, i.e. through end of 2022), and very weak growth (limiting the ability to pass on cost increases) could mean more rate cuts over the next few months, on top of the 325 basis point reduction over the past year. Headline inflation could remain around or below the 4.5% mid-point of the target range for five consecutive years: 4.6% in 2018, 4.1% in 2019, 2.9% in 2020, 3.9% in 2021 and 4.5% in 2022.

As the global situation stabilises, the massive amounts of QE money in the US will also eventually lead to huge flows into EM bond and equity markets – as it happened after the GFC (the so-called risk-on trade). This should lead to a material strengthening of the rand exchange rate from later this year into next year. Thus, short-term currency moves will likely be dictated by global factors, while the rand's medium- and longer-term path will be determined by policy reform and the growth outlook.

Despite the many risks around the outlook for the SA economy there are signs that maybe, at long last, serious growth-enhancing policy change could finally be on the cards. While long overdue, time is now of the essence.



INVESTMENT EXCELLENCE THROUGH THE AGES

MERYL PICK
Head of Research, Old Mutual Equities

Imagine, for a moment, the world as it was in October 1966: Muhammad Ali is the world heavyweight champion. Jack Nicklaus has won the Masters at Augusta. The Beatles' hits are ubiquitous and Star Trek has just been piloted (though South Africa has no TV). The West is led by Lyndon B Johnson, Harold Wilson and Charles De Gaulle. Chairman Mao Zedong is at the helm of China's Communist Party. The US has been at war with Vietnam for eleven years, and in a cold war with the Soviet Union for twenty. Che Guevara is stirring up revolution in Latin America. Two years have passed since Malcolm X's death and civil rights protests rage in the US. Hendrik Verwoerd has been murdered in Parliament. Nelson Mandela is two years into imprisonment on Robben Island. Despite geopolitical tensions and social unrest, innovation and investment continue. Warren Buffett buys 5% of Disney for US\$4 million. The Space Race is in full force. Hewlett

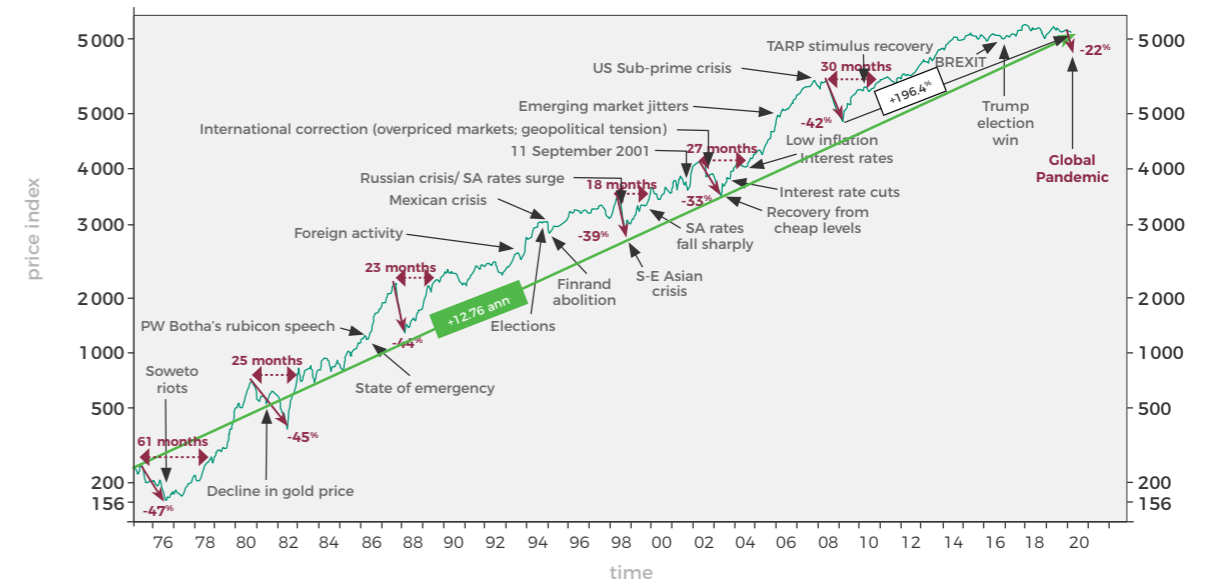
Packard is about to release its first minicomputer. The shoe company Vans is born, the Interbank Card Association (future MasterCard) has just been formed and Old Mutual is launching South Africa's first unit trust.

WE HAVE LEARNT TWO KEY LESSONS FROM NAVIGATING MARKET CRASHES SINCE 1966

The Investors' Fund has grown wealth for clients through nearly 54 years of technological breakthroughs, political turmoil and market booms and busts, delivering an inflation-beating annualised return of 15.6%. Our philosophy is to invest in businesses that trade at attractive valuations. There are two aspects to our investment process. We estimate the long-term "intrinsic value" of a business by examining in great depth the business model, the company's key drivers, its future growth prospects, its competitors, its

profitability and balance sheet health. We supplement our bottom-up research with a second aspect that seeks to independently "confirm" our fundamental assumptions. The "confirmation" factors quantitatively assess and score the quality of the company up to that point, its historical and prospective growth, and market sentiment towards the share. Diversified portfolios are carefully constructed by selecting shares that rank best on both valuation and confirmation factors, while managing overall portfolio volatility. Where valuation meets confirmation, we find our highest conviction ideas. R100 invested in October 1966 would be worth R230 000 today. We reflect on two lessons learnt from navigating several market crashes since then: 1) Catalysts are often unforeseen but cyclical is certain; and 2) Beyond fear lies the opportunity for abundant returns.

OUR PHILOSOPHY IS TO INVEST IN BUSINESSES THAT TRADE AT ATTRACTIVE VALUATIONS.

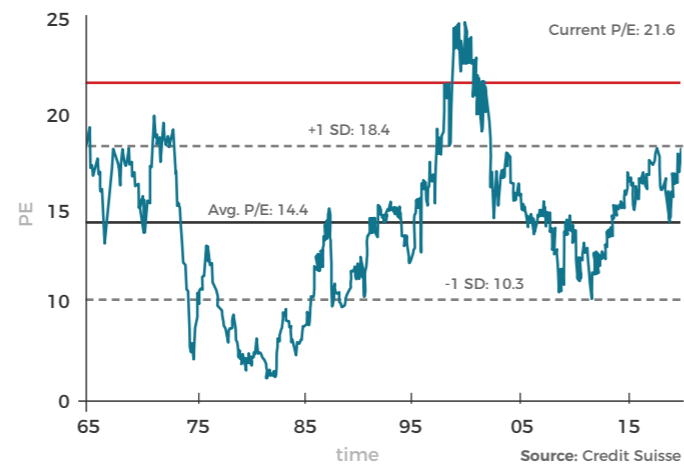


Source: Old Mutual Investment Group, Iress | Updated: 08/06/20 | FTSE/JSE All Share Price Index

Catalysts are often unforeseen but cyclical is certain. On 6 October 1973, Syria and Egypt coordinated surprise military attacks on Israel amidst the observance of Yom Kippur. The US came to Israel's aid by replenishing military supplies, triggering OPEC members to retaliate with an oil embargo. The oil price sky-rocketed and American motorists queued for hours to fill their tanks as panic set in. Against a backdrop of the Vietnam War and Nixon's

Watergate scandal, US inflation climbed into double digits and interest rates followed. Between November 1973 and March 1975, the US was in recession and global GDP slowed. By contrast, South Africa's economy held up well. The countercyclical gold price boosted exports (SA then produced more than 60% of annual gold mined globally) and national defence spending supported GDP. South Africa was relatively independent of oil imports.

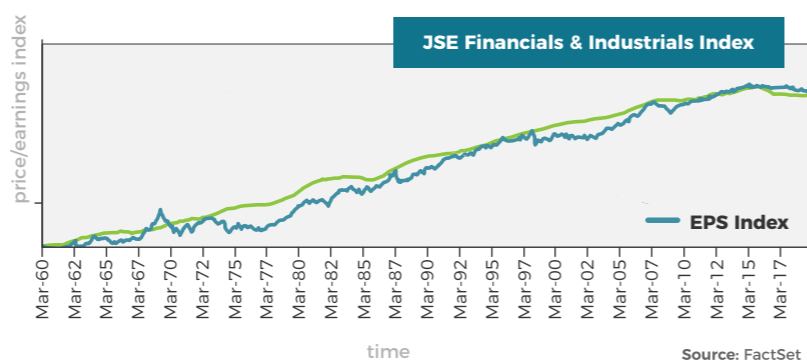
In mid-1975 the deepest and longest JSE bear market since the launch of the Investors' Fund set in, with a 47% plunge. As 1975 rolled into 1976, anti-Apartheid protests intensified, conflict with Angola persisted and the easing US recession took the shine off the gold price. Consumer and business confidence fell. During 1976 and 1977, SA suffered its worst recession up to that point since the Second World War. Relief came as stubbornly high global inflation ignited a four-year bull market in gold, starting in September 1976. The economy, and the market, clawed its way back over the next five years.



BEYOND FEAR LIES THE OPPORTUNITY FOR ABUNDANT RETURNS

The client who invested in SA equity in September 1976 surely possessed courage and imagination to see beyond the literal and figurative "blood on the streets". Three months earlier, the Soweto Uprising made headlines. Net capital flows into the country were slowing and real GDP growth was approaching zero. However, that investor's decision was rewarded with annualised returns of 44% for the next four years.

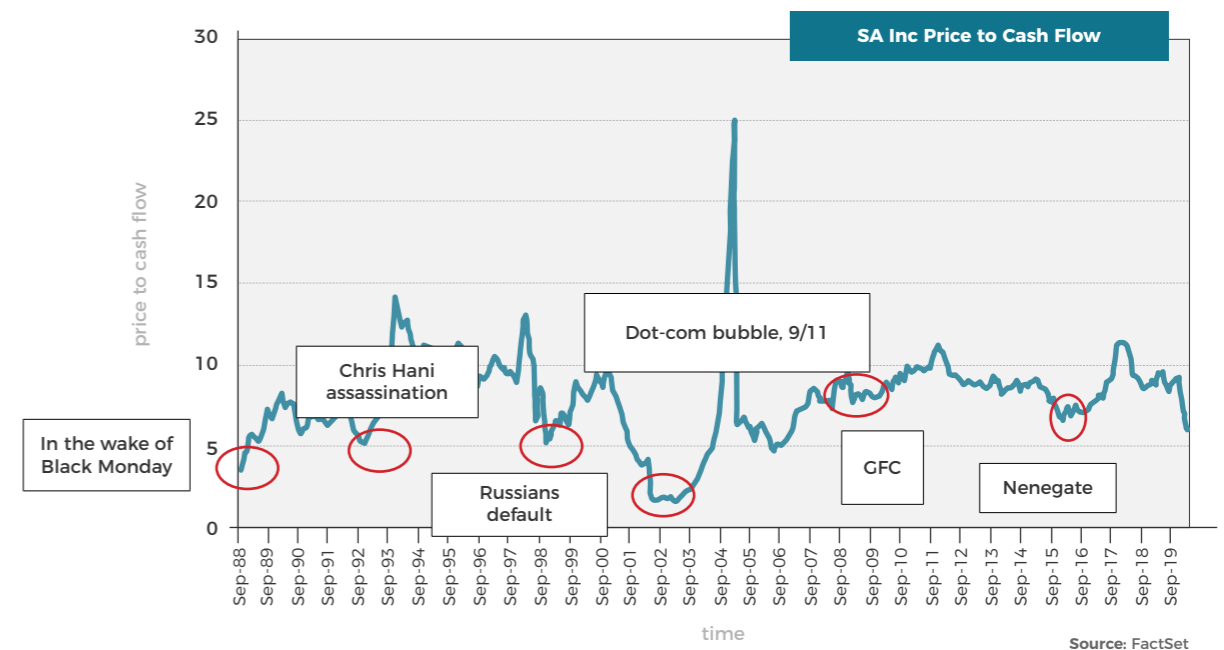
The chart below shows the JSE Financials and Industrials earnings index and price index over time. The price index is more volatile than the earnings index, falling to lower lows and rising to higher highs. This illustrates how share price movements are often amplified - positively and negatively - when investor sentiment comes into play. By contrast, earnings are driven by GDP and company strategies. Negative sentiment periodically drives market prices below what is justified by fundamentals and normalized company earnings. What follows from these low lows is a period of strong returns.



To forecast the catalysts for this cycle, one would have needed to predict a war, a quadrupling of the oil price, wild moves in the gold price, and the Soweto Uprising. However, given that the S&P 500 was trading at a high level relative to history leading up to the 1973 oil crisis, it was a matter of time before falling market returns materialised. Warren Buffett closed his investment partnership in 1969 citing the lack of attractive investment opportunities. Several "Nifty Fifty" shares (high-growth blue chip industrials) were trading at price-earning (P/E) multiples above 50. Similarly, JSE financials and industrials had enjoyed a strong run for three years. At the start of 2020, once again US multiples looked stretched and locally many JSE counters with offshore earnings looked unattractively priced. Since valuation is central to our investment philosophy we had rotated the fund into more attractively priced "SA Inc" shares such as FirstRand, ABSA and Wilson Bayly Holmes. By no means did we forecast a global pandemic, but we had positioned clients' portfolios for a lower return world. Catalysts for market crashes and subsequent recoveries are often unforeseen on the way down and the way up. The only thing that is certain is that cycles are just that, and no condition - not prosperity nor hardship, not bull markets nor bear markets - prevails infinitely.

Given the cyclical nature of markets, this pattern repeats. From October 1987 to February 1988, the Investors' Fund returned -38% as the US Black Monday Crash triggered a global bear market. Fourteen months later the fund returned 61%. In August 1998, the Investors' Fund fell 37% when Russia defaulted on its debt causing a market crash. Over the next year, returns averaged 36%. Beginning in April 2008, the Investors' Fund declined 27% over a year as the world struggled through the Global Financial Crisis. In the following year, returns averaged 46%. In March of 2020, as the COVID-19 outbreak grew into a global health and economic crisis, the Investors' Fund declined by 20% and returns have averaged -19% over the last

12 months. However, the fund is positioned in line with our philosophy of determining company valuations and seeking conviction through confirmation factors. Many of our "SA Inc" holdings are at valuation levels only reached in previous crises, as illustrated on the Price to Cash Flow chart below. History tells us that a recovery is due. Market crashes often coincide with times of tragedy and uncertainty. It is difficult to maintain a long-term perspective while living through conditions rife with despair and uncertainty. Paradoxically, it is only amidst this pervasive negativity that rare openings for great investments can exist.



WE'VE BEEN HERE BEFORE

The Investors' Fund has navigated several market crashes, with the most recent occurring in March 2020. We did not predict COVID-19 as the catalyst, but believed that the cycle was nearing its peak, particularly in offshore markets and local shares which earn most of their profits offshore. Catalysts are often unforeseen but cyclicity is certain. To prepare for a lower return environment, we positioned the fund in "SA Inc" where company valuations and confirmation factors indicated stronger future returns. As this crisis has unfolded, clients have weathered discomfoting declining returns and many investors may be tempted to withdraw from the market. However, many of our holdings are at valuation levels only reached in previous crises. History tells us that a recovery is due and that beyond fear lies the opportunity for abundant returns.

THE EVOLUTION OF RESPONSIBLE INVESTING IN LIABILITY DRIVEN INVESTMENTS

RUCHIR SEVERAJ
Credit Portfolio Manager



Friday 12 June 2020 marked 100 days since South Africa had its first confirmed case of COVID-19. Over this time, what has become abundantly clear is just how interconnected the world is. In last quarter's edition of Fundamentals, we laid out the interconnected nature of our social, biophysical and market ecosystems. The past few months have stressed this lesson: Don't neglect this interconnectivity. To think that a virus that originated in a largely unknown city of Wuhan in China could bring the entire world to its knees is inconceivable. The pandemic has also accelerated change in many ways. Famous historian and author Yuval Noah Harari's words could not be more apt, "Many short-term emergency measures will become a fixture of life. That is the nature of emergencies. They fast-forward historical processes." It has been argued that the COVID-19 pandemic represents

the watershed moment for working from home as well as under-the-skin surveillance. We believe that this pandemic could also be the watershed moment for the active incorporation of responsible investing principles into investment management.

THE CONCEPT OF RESPONSIBLE INVESTING – BEYOND JUST ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS

The United Nations Principles for Responsible Investment (UNPRI) defines responsible investment as "a strategy and practice to incorporate ESG factors in investment decisions and active ownership". While ESG investing is a term often used synonymously with sustainable investing,

socially responsible investing or mission-related investing, responsible investing is much broader. The concept of responsible investing is not based on values, ethics or morals (while this may be a consideration) but rather aims to maximise long-term risk-adjusted returns by incorporating ESG risk factors into investment decision-making and active ownership. This practice recognises that there are a host of non-financial risks that impact an investment and, to be responsible custodians of capital, investment managers need to incorporate active ownership.

ESG incorporation and active ownership can be undertaken in various ways and are informed by the type of investment being considered. For example, the different characteristics and challenges of South Africa's bond and equity markets will inform the responsible investing approach. As a boutique, Liability Driven Investments (LDI) adds value to clients' portfolios leveraging its ability to manage their liabilities by hedging interest rate and inflation risk while also providing alpha to client funds. This investment strategy typically involves the use of fixed income securities. Some of the challenges facing fixed income versus equity investors include the lack of voting rights, illiquid markets with pricing not reflecting fundamentals, and the lack of sufficient ESG coverage for issuers of debt. When incorporating responsible investing principles into our fixed income investment strategy, we consider three main focus areas: ESG Integration, Screening and Stewardship.

ESG INTEGRATION

ESG integration is the systematic and explicit inclusion of ESG factors in traditional financial analysis. Here credit analysts undertake ESG risk assessments on each investee company to identify material risks and to establish the financial implications of those risks materialising, with the aim of ascertaining the merits of the investment. This focus area is one that is most familiar across managers who consider ESG in investment decision-making and has been an integral part of LDI's investment process for many years. Where our thinking has evolved is in formalising our approach to screening, as well as being more active owners of assets through stewardship.

WHERE OUR THINKING HAS EVOLVED IS IN FORMALISING OUR APPROACH TO SCREENING, AS WELL AS BEING MORE ACTIVE OWNERS OF ASSETS THROUGH STEWARDSHIP.

SCREENING RESPONSIBLE INVESTMENTS

The practice of screening typically involves applying filters to a list of potential investments to rule issuers or specific securities in or out of contention for investment based on an investor's preferences. Examples of negative screening include avoiding issuers with complex group structures (think Steinhoff), avoiding issuers with questionable management teams, and not investing in red flag issuers as per Old Mutual's Responsible Investing Policy. Building on from this, we believe that there are opportunities for positive screening whereby investment managers develop a set of criteria to filter investments that one should target rather than avoid. Furthermore, as clients are becoming increasingly more sensitive to the impact of their investments, we believe that client-instructed screening could become more relevant in the future. One way of this manifesting would be clients specifying screening criteria in mandates to ensure that their capital is being deployed in specific ways.

The latest development in our approach to screening utilises a dynamic method whereby portfolio managers run proposed investments through a four-pillar framework before analysts perform their fundamental analysis with ESG incorporation.

This four-pillared framework is designed to consider the nuances with fixed income investing and aims to establish



the favourability of an investment from a responsible investing angle, before conducting a deep dive into the fundamentals.

- **The first pillar considers the debt type:** Is it a bond or a loan? Loans typically have stronger protections and legal terms are more negotiable than bonds. Having stronger protections and being able to add ESG-related wording to legal agreements increases the favourability of an investment from a responsible investing perspective.
- **The second pillar considers the listing status of the issuer,** as both private and public companies can issue debt. Johannesburg Stock Exchange (JSE) listed issuers tend to have significantly better disclosure than their non-listed counterparts. These companies are also more likely to adhere to voluntary guidelines like the King IV Code, which makes assessing ESG risks easier.
- **The third pillar considers the industry or sector that an issuer belongs to.** Certain sectors may be more favourable from an ESG perspective (such as renewable energy). There are also external risks that could impact entire industries; for example, the introduction of a carbon tax can be significant for issuers in the fossil fuels industry.
- **The final pillar in this framework utilises the OMIG Responsible Investing team's proprietary model to determine a quantitative ESG profile score of a**

potential investee company. Using the outcomes of all four pillars, portfolio managers can decide whether the proposed investment is favourable or not from a responsible investing perspective, and could also assist analysts by directing them to specific focus areas when conducting their fundamental analysis.

STEWARDSHIP: BE AN ACTIVE OWNER

An important component of responsible investing is active ownership or stewardship. Notwithstanding the fact that fixed income investors are not owners in the companies they invest in, they still have an important role to play in encouraging issuers to improve its ESG risk management and to develop more sustainable business practices. Actively engaging with companies on ESG risk factors is necessary to ensure that companies operate sustainably, thereby enhancing risk-adjusted returns for clients. This engagement can be undertaken on an individual basis when engaging management teams on roadshows, or in collaboration with other stakeholders in more open forums.

The Association for Savings and Investment South Africa (ASISA) has played an important role in encouraging more collaborative engagement. One of its initiatives we are supporting is improving the JSE Debt Listing Requirements, which govern listed debt instruments.

Currently, the standards of investor protection in these agreements are poor and we believe fund managers have a responsibility to improve these standards on behalf of our clients.

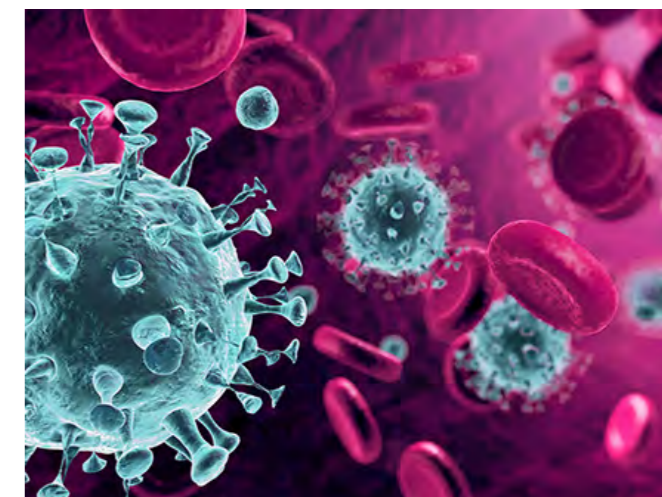
We believe that rating agencies also have a key role to play in actively incorporating ESG risks into their credit assessments and we have been in discussions with agencies to include ESG risk factors as a material part of a counterparty's rating. There is also opportunity for these agencies to publish independent ESG risk reports, since they have a unique level of access to the companies they rate. While many of these practices are present in developed markets, the rating reports on South African companies have scope for significant improvement.

We believe another important element of stewardship is actively engaging with clients on ESG factors in their portfolios. There is significant scope to improve the standard of reporting for investment mandates to include feedback to clients on the ESG risks in their portfolios and how they are being managed, as well as how their capital is contributing to building sustainable outcomes.

COVID-19 AND BEYOND

The pandemic has illustrated that responsible investing practices are no longer nice to have, but are a fundamental requirement in risk assessment. For early adopters of ESG incorporation like ourselves, the pandemic has resulted in us viewing these risk factors more holistically. The concept of an essential service will now garner more attention and aptly demonstrates the trade-offs one needs to consider when performing these assessments. For example, a company being declared as offering an essential service is positive from a revenue-generating perspective but could be negative from a social risk perspective, considering that employees may be unduly exposed to contracting the virus by continuing to work. Companies' responsiveness to external shocks has also been brought to light by the pandemic. We have seen companies repurpose themselves to be part of the solution. Examples include perfume producers making

THE PANDEMIC HAS ILLUSTRATED THAT RESPONSIBLE INVESTING PRACTICES ARE NO LONGER NICE TO HAVE, BUT ARE A FUNDAMENTAL REQUIREMENT IN RISK ASSESSMENT.



hand sanitiser, industrial companies making hygienic masks, luxury hotels becoming quarantine centres, and automotive factories producing medical devices such as ventilators.

In a world characterised by rapidly changing dynamics, we believe that companies that exhibit strong ESG profiles and are stakeholder focused, and have the appropriate structures to ensure they are agile, will likely remain resilient. As an investor, if you ignore these factors it will be at your own peril.

ASSET ALLOCATION 2020: MAINTAINING A LONG-TERM PERSPECTIVE

PETER BROOKE
HEAD OF MACROSOLUTIONS



Our long-term return expectations are updated every six months, where we step away from the daily noise and refresh our long-term strategic thinking. This includes updating our expected returns by asset class using a five-year time horizon. We focus on real returns, by way of stripping out inflation. Given that these are long term numbers, the changes are often quite small but the impact on how to allocate is large. Our bi-annual review is more important than ever as the extreme volatility in markets makes it easy to become un-anchored. A record fast crash in Q1 and a massive bull market in Q2 are enough to make anyone's head spin. We have seen unprecedented monetary and fiscal stimulus of an estimated \$US18.5 trillion, which will ensure that the world economy recovers. However, markets have already pre-empted that and we are lowering our return expectations.

LOWER RETURNS ON GROWTH ASSETS

Interestingly, we've only done two interim reviews in the last 12 years in March in 2020, when markets got too cheap; and in March in 2015 when markets got too expensive when we introduced the "low return world" theme. Our work in March this year helped us to buy equities in the crash, but as markets rebounded, the valuations have since deteriorated.

Where we were expecting a real return of 7% from SA equities in March, we've had to cut it to 6%. There are some exceptionally cheap companies in South Africa especially on a price to book basis.

Offshore, we've cut our real global equity return to 4.5% from 5.5%. This lower return is mainly driven by higher valuations in the US, while the rest of the world still offers some reasonable valuations. We are overweight to non-US equities, having bought Asia early in the crisis and, more recently, we have started adding to European equity. Europe has been a typical value trap but the degree of fiscal stimulus leads us to believe earnings will recover sharply in 2021.

We have also trimmed our real return for SA property to 6.5%. This reflects some harsh assumptions from our property specialist, Evan Robins. He assumes that property companies are forced to rebuild their balance sheets through no dividends and having to raise equity. If there isn't a need to raise as much equity, the return will be a bit better. Despite the high return from property, we prefer equity due to the better relative theme. Remember our philosophy uses a two dimensional approach with theme and price and the property sector theme is poor – disruption from e-commerce and Work-from-Home resulting in excess capacity and a loss of pricing power.

A SIGNIFICANT CHANGE IN ALLOCATING CASH

Probably the most important change, is that we've cut our expected return on SA cash to only 0.5%. As we have highlighted in recent commentary, the last five years have been very unusual in the degree of outperformance of cash relative to equity. With the slashing of local rates to levels not seen since the 1970's this will normalise over the next five years. As a result one can no longer leave money in cash and we are actively investing the cash in our portfolios. We have re-introduced a theme from nearly a decade ago "cash is trash".

SA bonds still offer an exceptional real return of 5%, which is very attractive. In a global context of aggressive central bank intervention, the yield on offer stand out like a sore thumb and we expect negative real returns from offshore cash and bonds. The steepness of our yield curve is due to our deteriorating fiscal situation and the government faces a stark choice. Either print money and lose control of the currency, or deliver much needed reform enabling South Africa to enjoy one the greatest bond bull markets in the world. It is hard to tell which path we will take as the government dithers, creating a binary risk.

REDUCED RETURN EXPECTATIONS PUT TARGETS AT RISK

Pulling these changes together, one can calculate the expected real return from a balanced fund using a passive allocation. On this basis, we would expect a real return of 4.6%, nearly a percent lower than the 5.5% we had in March. Back then we were very confident that we would hit our real return target over the next 5 years. However, now, it will be a little tougher. The unfortunate truth is that the monetary and fiscal stimulus that is being applied globally will have to be paid back in the future, which will result in lower returns. Remember that there have been more than 900 rate cuts since the Global Financial Crisis started. Offshore we are not being rewarded for this, unlike in South Africa where assets are cheaper. As a result we are overweight South African bonds to increase our chances of hitting our return targets. In addition, we own a number of local shares that have underperformed sharply in the last 12 months and we expect that these will recover. This will result in alpha or outperformance – better returns than the 6% real return expected from SA equity, enabling us to deliver a balanced fund target of 5% real.

Today, financial markets, medical health and government policy are simultaneously exhibiting extraordinary circumstances and have created an environment of extreme volatility – one where the future is even more unclear than before. In this type of environment, maintaining a long-term perspective and building diversified portfolios is crucial.

THE SYMBOLS

NEUTRAL: Real returns will be at or around the long-term historic average over the next five years; the weight in each of our portfolios is roughly equivalent to that of their benchmark, where applicable.

NEUTRAL +: Real returns will likely be at or around the long-term historic average over the next five years. However, as there may be some opportunities available for us to capture some alpha, the weight in each of our portfolios may be slightly overweight to that of their benchmark, where applicable.

+ (positive): Real returns will be above the long-term historic average over the next five years; our portfolios are overweight compared to their benchmarks, where applicable.

NEUTRAL -: Real returns will likely be at or around the long-term historic average over the next five years. However, due to prevailing negative conditions, it is likely that our portfolios may be slightly underweight compared to their benchmarks, where applicable.

- (negative): Real returns will be below the long-term historic average over the next five years; our portfolios are underweight compared to their benchmarks, where applicable.

EXPECTED LONG-TERM REAL RETURNS (JULY 2020)

	Real return	View	Comment
SA		+	SA assets offer better real returns
Equity	6.0%	+	Earnings risk to downside
Property	6.5%	Neutral	Keep the survivors
Bonds	5.0%	+	Great real return even for “junk”
Cash	0.5%	-	Cash is trash
Global		-	Still maintain some diversification
Equity	4.5%	Neutral +	Preference for non-US
Bonds	-1.5%	-	Rewardless risk
Cash	-1.5%	-	Zero rates



The end of 2019 marked a personal milestone for us, having taken responsibility for OMIG’s stewardship programme over the last five years. An important milestone such as this afforded us the opportunity to reflect on the importance of stewardship as a solution for our clients’ listed equity capabilities. We have much to be proud of – not only in terms of our stewardship with listed companies, but also our engagement with the market on key ESG issues aimed at strengthening our shareholder rights (you will find some examples of these successes in our previous annual reports).

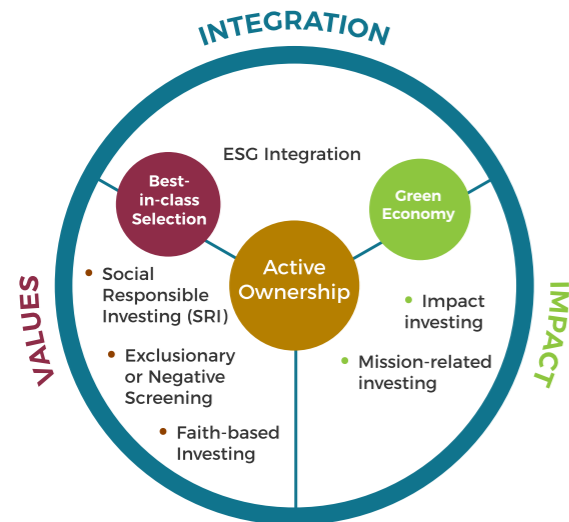
STEWARDSHIP – THE SCIENCE OF MEANINGFUL CORPORATE ENGAGEMENT

Considering the intersection between all various types of ESG investment strategy – active ownership is at the centre, regardless of the approach, as illustrated in the diagram on the following page.

OMIG’s engagement activities with companies focus on key strategy and performance issues such as: remuneration policy, climate change, audit quality, board succession, transformation, corporate governance, risk management, privacy and data security, to name a few. In 2019 alone, we interacted with 31 companies on 93 material ESG issues.

No matter what ESG strategy is employed, stewardship is central to delivering long-term outcomes. Globally, we have seen an increasing number of large asset owners consolidate their stewardship activities to ensure a consistent outcome. South Africa is no different and we expect more active investors, bigger societal voice and stronger legislative enforcement to support greater demand for stewardship services.

APPLYING SUSTAINABILITY TO INVESTMENTS



... WE WILL WORK
TIRELESSLY TO
BRING MANY MORE
ENGAGEMENTS TO A
SUCCESSFUL CLOSE...

to an experienced OMIG team that actively stewards assets in a consistent and transparent manner for scalable impact. Portfolio level reporting is enhanced in order to meet FSCA requirements in terms of the recently published Guidance Notice 1 of 2019. In addition, our listed equity stewardship clients are able to evidence their commitment to responsible investment practices.

THE MAGNITUDE OF THE TOTAL OPPORTUNITY FOR STEWARDSHIP

The global investment ecosystem represents US\$91 trillion, of which currently about a third (at US\$31 trillion) is managed in some form of ESG strategy, as of this year. Therefore, there is still a great opportunity to develop stewardship practices on a global scale. With approximately R300 billion in listed equity under management and recent additions of third party stewardship capital via our listed equity stewardship service, we are excited by the potential opportunity our listed equity stewardship service has to effect real change and impact in the South African market and beyond.

Looking ahead, we will work tirelessly to bring many more engagements to a successful close and allow all our listed equity clients to receive the benefit of a stronger market system, better investment performance and more voices heard on material ESG issues that impact their portfolios.

WHY SHOULD INVESTORS CARE ABOUT STEWARDSHIP AND WHAT SOLUTION DOES OMIG OFFER?

We see more and more evidence from eminent researchers showing increased performance from successful stewardship activities that are collaborative – with a domestic lead engager and global supporting investors, and with participation from large pension funds/long-term capital entities (Dimson, Karakas and Li, 2015 and 2020). In addition, practising effective stewardship empowers clients to take action in respect of key ESG issues affecting their listed equity holdings. The benefit of doing so is lowering the ESG risk in their portfolio and driving positive change, both at a company level and in supporting the development of long-term market resilience.

With these benefits in mind, we have recently launched our Listed Equity Stewardship service to “crowd in” like-minded collaborative engagement participants, making the industry-competitive stewardship service at OMIG an agent of change on the part of corporates in collaboration with other asset managers for overall change in the market. The benefits enjoyed by clients therefore include access



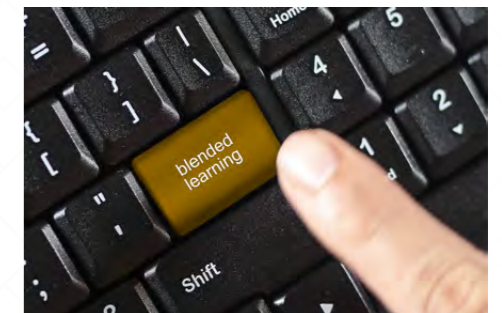
**Q&A – COVID-19:
A CATALYST FOR
INNOVATION
IN EDUCATION
INVESTMENT**

KELLY JOSHUA
Head of Education Investments

The COVID-19 pandemic hit South Africa on 1 March 2020 and two weeks later President Cyril Ramaphosa announced the closure of schools from the 18th March 2020.

It is without a doubt that the COVID-19 pandemic has and will continue to have a significant adverse impact on the economic and social development in the country. As impact investors into education, we particularly endeavour to further align our investment objectives to resolving the country’s education shortfalls at scale, using innovation and technology in the education space, long after the pandemic has passed.

We speak to Kelly Joshua, OMAI Head of Education Investments, to share her insights on the key themes relating to how innovative thinking has been critical in ensuring that no learner is left behind throughout the COVID storm.



WHILE COVID-19 HAS RESULTED IN SOME NEGATIVE SETBACKS, IT HAS FORCED OUR SCHOOLS TO SWIFTLY ADAPT BEYOND WHAT THEY THOUGHT WAS POSSIBLE IN A SHORT SPACE IN TIME

What do you see as the key themes that have emerged in education as a result of COVID-19?

At a high level, COVID-19 has acted as a catalyst in fast-tracking blended learning, especially in the affordable independent schools market. While COVID-19 has resulted in some negative setbacks, it has forced our schools to swiftly adapt beyond what they thought was possible in a short space in time. While ensuring that the schools uphold their contract in delivering quality education is critical for learners, it is also necessary for the financial livelihood of the independent education sector school operators to continually provide a service that parents value and are willing to pay for.

In the three months that COVID-19 has taken hold of our society, one of the key themes has been the realisation that, if done correctly, a blended learning strategy can enhance the learning experience and is not that complicated to implement.

Another development has been the launch of new online schooling products, such as that recently introduced by Curro. Although we are seeing similar models being launched, the reality is that it is still costly (varying between R3 000 – R5 000 pm excluding internet costs) for the

affordable segment of the market. However, online schools coupled with tech education certainly offer areas of opportunity worth exploring within affordable parameters.

With that said, the case for investing in physical school buildings still holds – especially in the short to medium term and especially within the affordable market context. The purpose of schools goes beyond academics. It serves as a platform for learners to develop holistically, equipping them with the necessary skills to be functioning members of society as well as honing their talents, be it in art, culture or sport.

Schools further serve the lower-income communities with an essential service, especially in households where both parents are required to work and it is not safe or possible to leave a child at home to facilitate schooling without supervision.

With this view and supported by the recent announcement by the UK Prime Minister, of a ten-year transformative school rebuilding programme, we believe that in SA, the right balance between investing in physical and digital education infrastructure is imperative.

Within your portfolio, what practical innovations have been implemented in schools ranging from middle-income to lower-income schools that may have been less technologically enabled?

Practically, all our school operators have implemented some form of remote learning. For certain schools that had adopted a blended learning model prior to the pandemic, older learners had access to devices which made the transition significantly easier. These schools quickly set up a virtual classroom with Google Classroom and utilised this to load daily tasks and interact with learners.

With the uncertainty around learner access to devices, WhatsApp became the app of choice given its low data usage and certain providers not charging for data usage on the app. Teachers were able to set up working groups and send videos, links and pdf documents for parents and learners.



Schools shared reworked timetables with parents so that they were aware of when their children had to be online and what was required of them. In most schools, teachers availed themselves until six in the evening to address learner queries. Although challenging, teachers need to be commended for trying to find ways to engage learners during this difficult time.

Once lockdown restrictions were lifted and management teams were allowed to go back to schools, schools had begun printing learning packs for parents to pick up from the school, if they did not have access to a device or could not afford data.

In addition, the teachers have been sharing the Department of Basic Education provision of online resources, applications and radio as well as television broadcast lessons. In order to ensure that teachers can engage in remote learning and schools are supporting teachers with data bundles.

Can you share some of the various ways in which you have extended support to the schools during the various levels of lockdown?

Since the pandemic first hit, there has been constant and robust engagement with school operators as well as parents. While there is continued uncertainty around how schools will operate for the remainder of the year, all our schools have successfully managed to implement the necessary work-from-home protocols and various distance learning programmes.

Not all school groups going into lockdown had a blended learning strategy in place. Management teams were forced to adapt quickly and initially it felt like they were all feeling their way through the dark. In order to facilitate a more efficient way of adapting to the change in landscape, the Schools Fund created a platform for management teams to share information with one another. The sharing of lessons learnt, tools and best practice to enable learners to continue learning remotely has proven to be invaluable.

From the outset, the Fund and school operators took a stance that we would try our best to avoid any cutting back on salaries or staff during this period. Other costs

are constantly being evaluated in terms of necessity to ensure that cash is reserved where possible. The Fund has taken the view that it is most important to ensure that our schools continue to operate and therefore has undertaken to assist each entity in the most appropriate way should cash flow shortfalls arise.

How have the learners coped with this new environment and what measures are the schools putting in place to prepare for the opening of schools to all learners?

The uncertainty around the virus, continued schooling and the necessary safety protocols that have been implemented, has created a lot of anxiety amongst learners.

All schools in the portfolio adhere to the national health and safety protocols to ensure the protection of learners and staff to the best of their ability. Schools have implemented daily temperature checks for everyone entering the campus; isolation facilities for learners/staff with high temperature readings; compulsory protective gear for all learners and staff; two sanitisers in each classroom; disinfecting each classroom regularly; class splits to maintain social distancing requirements; and identifying teachers, parents, learners and guardians with pre-existing conditions and discouraging them from returning to school. Some of the larger schools have ensured that there is a trained nurse on site to assist with the screening as these additional tasks are very difficult to expect teachers to do in addition to teaching. Schools have also engaged psychologists on a contract basis to potentially assist learners dealing with loss and anxiety during this period.

Being independent schools, our schools were flexible enough to adjust their timetables and put in place all the necessary health and safety measures to enable them to receive learners ahead of the phasing-in prescribed to government schools. The portfolio schools had planned to receive all grades by the 6th of July 2020. Schools have also been understanding of those learners who have not opted to return to school out of health concerns.

Distance learning is continuing in all schools indefinitely. For the younger learners and those constrained by access to devices and data, schools have printed learning packs that parents have to pick up and return on either a weekly or bi-weekly basis.

The Fund is very proud of the learners who have managed to innovate during this difficult period. One of our Grade 9 learners at Canaan College in Umlazi township, Durban, took it upon herself to start her own business of manufacturing and selling face masks in her community. In the first two months, she has managed to sell over 200 masks, excellently encompassing the school's teaching motto See, Think and Innovate.

Can you share insight into some of the relief programmes and initiatives that are in place or planned to be implemented to assist vulnerable parents and pupils?

Parents have felt the pain as a result of COVID-19, especially in the lower-income households where many cases of salary and job cuts have been experienced. We have taken the decision to avoid discounting school fees, but instead deal with the inability to pay school fees on a case-by-case basis. All our operators have developed payment plans for struggling parents, effectively stretching the balance of the outstanding fees over the remainder of the year, in addition to initiating their own relief programmes to aid struggling parents. Some examples include Royals Schools, who have set up a Relief Fund to assist parents through donations and food vouchers.

If anything, COVID-19 has further highlighted the inequality in our society. More affluent schools and learners have been able to easily switch to online learning, while the majority of our country's learner population either do not have access to devices and/or cannot afford data.

Within the Schools Fund we have tried to find ways to improve access within our schools.

Our BASA school in Protea Glen Soweto purchased tablets for Grade 11 and 12 learners to enable them to have devices to facilitate distance learning, given the crucial

nature of the grades. The BASA school services lower-income households and access to devices was a major stumbling block for learners during lockdown. Even with schools open, due to social distancing requirements, not all Grade 11 learners are at school for the full five-day week. On their days at home they are now able to participate more easily in blended learning. Two Oceans Academy in Grassy Park Cape Town has taken the same action as BASA, but due to the size of the school being a third of BASA, they have managed to purchase devices for the entire school and pre-loaded them with content. Many of these learners had no choice but to use cellphones previously. This became complicated if there was more than one learner in the household and if parents had to return to work and take their cellphones with them.

The Fund itself is trying to leverage off the Old Mutual platform to negotiate reduced data costs for our learners with all major service providers.

In conclusion, due to the negative impact of COVID-19 on the financial health of the working population, there is likely to be an increase in demand for affordable quality education through a potential downward migration into the affordable space.

With our second education fund, EduFund, having a mandate that extends across tertiary education, skills training and ancillary education services, we are also encouraged to capitalise on new innovative investment opportunities emerging in education. We have seen continued interest from investors and we continue to communicate and engage them on the developments in the education investing sector, which has proven to be resilient and has demonstrated its ability to innovate through the pandemic. We anticipate that this will lead to the unlocking of new investment opportunities that aim to deliver commercial as well as sustainable returns for our investors and the communities we operate in.

MARKET INDICATORS

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index	3.9	17.3	7.7	-3.3
FTSE/JSE Resources Index	3.9	14.1	8.8	12.4
FTSE/JSE Industrial Index	5.2	9.7	8.3	4.0
FTSE/JSE Financial Index	8.7	11.2	4.2	-34.5
FTSE/JSE SA Quoted Property Index	16.0	6.3	13.4	-40.0
ALBI BEASSA Bond Index			-1.2	2.8
STeFI Money Market Index			0.4	6.9
MSCI World Index (R)			1.2	27.4
MSCI World Index (\$)			2.7	3.4

* Total return index percentage change.

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US\$	June-20	17.35	14.10
Rand/UK Pound	June-20	21.52	17.89
Rand/Euro	June-20	19.50	16.03
Rand/Aus\$	June-20	11.98	9.89
Commodity Prices			
Gold Price (\$)	June-20	1772.9	1409.1
Gold Price (R)	June-20	30646.7	19917.8
Oil Price (\$)	June-20	41.3	64.4
Interest Rates			
Prime Overdraft	June-20	7.3%	10.3%
3-Month NCD Rate	June-20	3.9%	7.1%
R186 Long-bond Yield	June-20	7.7%	8.1%
Inflation			
CPI (y-o-y)	April-20	3.0%	4.4%
Real Economy			
GDP Growth (y-o-y)	March-20	-0.3%	0.0%
HCE Growth (y-o-y)	March-20	1.2%	0.7%
Household Consumption Expenditure (HCE) Growth (y-o-y)	March-20	-5.8%	-2.8%
Gross Fixed Capital Formation (GFCF) Growth (y-o-y)	March-20	-5.6%	0.9%
Manufacturing Production (y-o-y) (seasonally adjusted)	April-20	-48.6%	4.5%
Balance of Payments			
Trade Balance (cumulative 12-month)	May-20	\$15.9	\$1.7
Current Account (% of GDP)	March-20	1.3%	-3.0%
Forex Reserves (incl. gold)	May-20	\$922.7	\$709.4

Sources: JSE, Iris, I-Net

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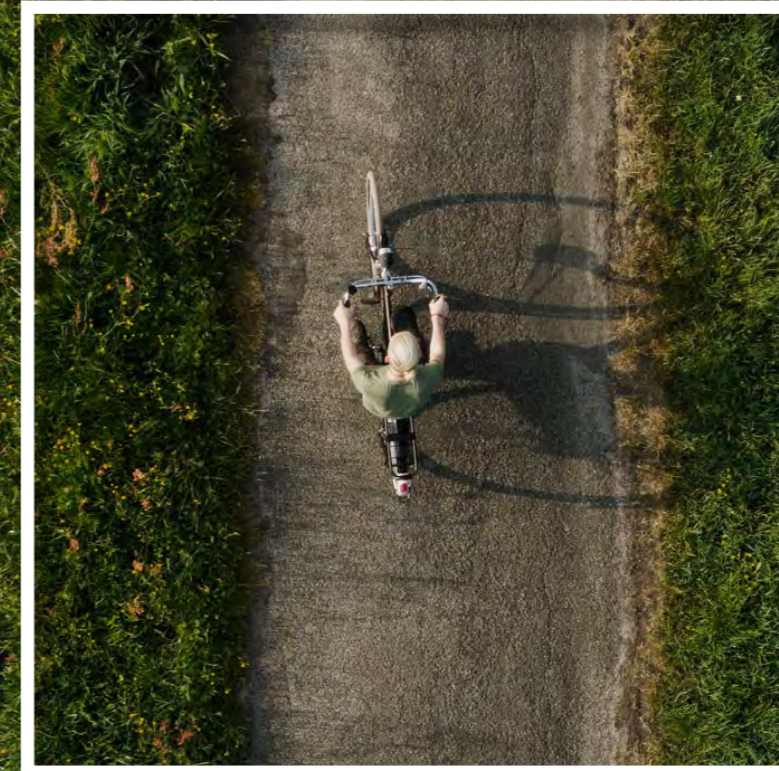
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HOW DO WE MAKE A POSITIVE IMPACT ON THE FUTURE?

AT OLD MUTUAL INVESTMENT GROUP WE LIKE TO THINK WE HAVE AT LEAST SOME OF THE ANSWERS



INVESTMENT GROUP