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SLOWING GLOBAL GROWTH SEES CENTRAL BANKS SLIDE BACK INTO EASY MONETARY POLICY

JOHANN ELS | CHIEF ECONOMIST

ABOUT THE AUTHOR

As Chief Economist, Johann is responsible for all local and global macroeconomic research. Specific focus areas include the rand, inflation, interest rates and fiscal matters.



GLOBAL ECONOMY: CENTRAL BANKS TAKE A WAIT-AND-SEE APPROACH

During the past quarter, one of the common threads in the global economy was the sustained easing in global financial conditions – thanks largely to the US Federal Reserve Board (Fed)’s so-called “policy pivot” and policy easing in China. The US Fed dropped its tightening bias at its first meeting of the year and increasingly talked about being more patient regarding policy tightening. Worries about slowing growth, subdued inflation, global trade wars and slower global growth conditions played a big role in this shift in thinking.

At its March policy meeting, the US Fed indicated (by way of its so-called dot plot) that the members of the Federal Open Market Committee (FOMC) expect interest rates to remain unchanged throughout 2019. It also announced a tapering of its balance sheet normalisation (meaning that the reversal of quantitative easing, or QE, will be slowed) from May onwards, and that it will be halted by September. This will be an important factor in a better outlook for emerging markets, which have been under pressure while QE has been reversed.

The US Fed’s easier policy stance is also promoting a broader easing in global monetary policy.

KEY TAKEOUTS



- POLICYMAKERS STEP AWAY FROM MONETARY TIGHTENING
- US FED’S U-TURN ON QE IS GOOD FOR EMERGING MARKETS
- SA GROWTH OUTLOOK IS IMPROVING (IF THE LIGHTS STAY ON)
- MOODY’S DEFERS SA RATINGS DECISION
- LIMITED PRICING POWER WILL KEEP CPI LOW

Meanwhile, China has continued on the easing path that was started last year. More policy easing is likely on the way should growth not stabilise and rebound soon.

RATE FREEZE WILL LEAD TO A WEAKER DOLLAR

All of the above has been in line with my base-case view for the world economy: slower, but better balanced and more synchronised growth (that is, slower US growth and better growth elsewhere, including the euro area and China) and a slower interest rate hiking cycle in the US (it now seems as if rates might actually stay flat, or even be lowered). Under these circumstances, the US dollar is likely to weaken. The environment for emerging markets should improve from that of 2018, when the global economy was “unbalanced” (strong US growth and weaker growth elsewhere) and higher US rates led to a strong US dollar.

The biggest risk to this view is probably sustained weak euro-area growth. While the region remained relatively weak during most of the first quarter of this year, recent signals have been slightly more positive, with some of the forward-looking indicators starting to stabilise.

Some recession risk (globally and in the US) remains, but improved conditions have lessened the probability – as most of the potential negatives have eased. Trade talks between the US and China have been ongoing and the latest news suggests that there might be a deal in the offing within the next month or so. Brexit has been an ongoing soap opera, but it seems that there is at least a willingness to try and prevent a no-deal exit.

OUTLOOK FOR THE GLOBAL ECONOMY

I remain of the opinion that recession risk is still low and that growth rotation from the US to elsewhere should mean better balanced and more synchronised growth – albeit at a somewhat slower pace than in 2018. With the US rate hiking cycle seemingly having come to an end, I expect a weaker US dollar during 2019 (this has been the outstanding item in terms of my expectations for the year). The US dollar could potentially weaken towards US\$1.25 to US\$1.30 per euro by year-end from

a level of US\$1.12 at the time of writing. This will be a far better environment for emerging markets in general, and South Africa in particular.

SA ECONOMY: WINDS OF CHANGE FAN EMBERS OF OPTIMISM

It has been an eventful start to the year for South Africa. While most attention was focused on issues around economic growth, the annual budget, credit ratings, politics and the upcoming elections, the South African Reserve Bank (SARB)’s policy shift and the inflation rate also played a prominent part in the economic discussion.

Before I discuss this in a bit more detail, I want to reiterate that I am still convinced that the South Africa of the next few years will likely be a significant improvement on the SA of the past five years. The “winds of change” investment theme is alive and well. While there has been lots of uncertainty, risks and volatility, it is a big part of my job to try to look through the current volatility and uncertainty towards the medium and longer term. I have seen more and more signs of the headwinds that have been holding us back dying down and even turning into tailwinds pushing us forward.

I still expect the election outcome to be conducive to accelerated policy reform, and the resultant return of confidence, and a better outlook for the economy. Combined with the global environment sketched above, this could lead to a substantial strengthening of the rand exchange rate.

Probably the biggest event thus far this year was the annual Budget in February. This was again a disappointment, as the budget deficit ratio, the debt ratio and the expenditure ceiling were all higher than expected. The two main factors behind this were continued slow economic growth and the cost of the Eskom bailout package. While the Budget was disappointing in terms of the numbers, the Eskom support was viewed as positive. President Ramaphosa already announced in the State of the Nation Address that Eskom would be split into separate companies, and the Budget spelled out the financial aid to Eskom. On a positive note, Government will not take on any of

Eskom's debt, but will rather give financial support over the next 10 years. Encouragingly, this will partly be financed from cutbacks in public sector wage spending. The appointment of a Chief Reorganisation Officer to oversee Eskom's separation process was also a welcome step.

Economic data at the start of the year was rather weak, confidence remains at dismal levels and the latest forward-looking indicators (the Purchasing Managers' Index and the Reserve Bank's leading indicator index) suggest downside risk. However, a slow cyclical economic recovery should gather some pace after the elections in May. Economic growth could lift somewhat from the 0.7% recorded in 2018 to 1.5% in 2019. The risk here is extended and severe load shedding that could dampen growth.

Despite risk emanating from load shedding, weak growth, the fiscal position and weak state-owned enterprises, ratings agency Moody's kept the outlook on SA's investment grade debt unchanged. In all likelihood, it will reassess the economy and policies after the May elections.

Inflation continued to surprise on the downside over the past several months. From a high of 5.2% year on year in November 2018, inflation reached 4.5% in March this year. While recent cost increases (electricity, petrol etc.) will place upward pressure on inflation, there is very little second-round pressure coming through in

this weak economy. I maintain that the current circumstances are very deflationary as there is virtually no room to pass on cost increases to consumers. My inflation forecast for this year (4.4%) is now below last year's average (4.6%). For 2020, I forecast inflation of 4.7%. If this plays out, it would be the lowest three-year average inflation rate in many decades.

In fact, should downside growth risk increase and inflation continue to decelerate, an interest rate cut(s) could come back on the cards. This brings me to the SARB's own policy pivot, which was so much larger than the US Fed's, as discussed above. The SARB has gone from a rate hike in November to a much more dovish stance in the past two policy meetings. To some extent, it was assisted by the Fed's pivot and (late last year/early this year) by a lower oil price, but to a large extent the SARB might have been too focused on potential risks that did not materialise.

OUTLOOK FOR THE SA ECONOMY

A better global environment, including an improved environment for emerging economies, should help SA this year. A good election outcome and improved post-election confidence will also help. I expect growth to slowly gather pace in the second half of the year and inflation to remain subdued. A case could be made for an interest rate cut should growth and inflation continue on the downside. For now, I expect a strong rand later this year and flat interest rates.





GLOBAL BONDS SIGNAL INVESTOR CONCERNS

FUTUREGROWTH INTEREST RATE TEAM



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Broad-based weak economic data, coupled with a very muted inflation backdrop, forced some of the world's major central banks to abandon intentions of future policy tightening. Fragile market sentiment went into a tailspin following the US Federal Reserve (Fed) signalling no further interest rate increases for the remainder of this year. It further announced that the current central bank balance sheet runoff will end in September. This announcement was close on the heels of the European Central Bank (ECB) which, earlier in March, reiterated a cautious monetary policy stance and restarted a crisis-era bank lending programme in response to a raft of underwhelming eurozone economic data.

NEGATIVE YIELDS MAKE A COMEBACK

The major global bond markets had already entered a bull trend in November last year, in response to a muted economic growth outlook. Even so, the recent changes in policy stance from two of the world's major central banks forced yields even lower, as investors rushed to the perceived safety of government bonds. In the eurozone, the rally forced the yield of the 10-year German Bund into negative territory for the first time in three years. However, this rush to safety comes at a perplexing price: investors who bought at the negative yield are guaranteed a nominal loss should they hold the bonds to maturity. In the US, the 10-year Treasury yield reached its lowest level since December 2017,

as it decreased sharply to 2.41% at the end of March. This is a very significant 83 basis points below the high of 3.24% recorded in October last year.

These global developments present somewhat of a dilemma for emerging markets. On the one hand, the weaker global growth outlook bodes poorly for vulnerable, small and open economies like South Africa – specifically from an economic growth and a balance of payments perspective. Moreover, in the case of South Africa, downside risk to an already anaemic growth outlook is of particular concern, considering the fragile state of South Africa's government finances. On the other hand, an ease in global monetary policy in a benign inflation environment often



leads to lower global bond yields, while also holding the promise of an improved growth outlook as a result of policy stimulation. Typically, it is the latter that investors tend to focus on and this time was no different: foreign buying interest in domestic bonds during the quarter amounted to a net R9 billion. This lent much-needed support to our bond market and the non-resident share of total marketable rand-denominated RSA government debt stabilised at just above 38% – albeit still well below the peak of 43% reached in March 2018.

Even though the short-term correlation between the rand exchange rate and the local bond market has weakened considerably in recent times (as a result of a substantial breakdown between local currency movements and inflation), it remains difficult for a bond bull rally to be sustained in the presence of significant rand weakness/volatility. Although the rand/US dollar exchange rate is back at end-2018 levels, the intra-quarter range of R13.25/US\$ to R14.65/US\$ made it one of the world's most volatile currencies so far this year. Nervousness around Moody's biannual scheduled credit ratings review for South Africa and contagion from the volatile Turkish lira (amid concerns of the central bank supporting the currency) were some of the noisy negative developments that largely contributed to recent volatility.

KEY TAKEOUTS



- LOW GLOBAL YIELDS BOOST APPEAL FOR SA BONDS
- MOODY'S DEFERS ITS SOVEREIGN RATINGS DECISION
- A HIGHLY VOLATILE RAND MAKES A BOND RALLY UNSUSTAINABLE
- GLOBAL GROWTH CONCERNS COULD TRAP YIELDS AT LOW LEVELS

DEBT CEILING BREACHED TO SAVE ESKOM

Local bond market investors paid close attention to the tabling of this year's National Budget – particularly the extraordinary fiscal support to Eskom. R69 billion is budgeted over the medium-term expenditure framework (MTEF) as a “provisional allocation” for reconfiguring the entity, which is to be transferred as a cash injection of R23 billion a year over a three-year period. This allocation negates the benefit of departmental expenditure constraint in the 2018/19 fiscal year and ultimately results in the lifting of the previously sacrosanct expenditure ceiling by R16 billion over the next three years. The net effect of this extraordinary fiscal support for Eskom is a wider budget deficit over the MTEF – budgeted to peak at -4.5% of GDP in 2019/20. As a result, the gross debt-to-GDP profile is now expected to peak in excess of 60% in 2023/24. To us, this clearly points to sustained fiscal slippage with no near-term prospect of urgent consolidation. Using the phrase “going over the fiscal cliff” is arguably melodramatic, but it is difficult to simply brush this risk aside, especially considering the fundamental challenges to persistent anaemic economic growth.

While the fiscal situation remains perilous, the conservative South African Reserve Bank (SARB) continued to receive welcomed news on the inflation front. The rate of inflation at both consumer and producer levels continued to drift lower – in line with the Bank's stated intention of keeping inflation around the mid-point of its target range of 3% - 6%. Even though our forecasts suggest that the inflation cycle has bottomed, the outlook remains relatively benign, primarily the result of weak domestic economic activity and a slowing global growth backdrop. The combination of benign inflation, low economic growth and global monetary policy easing assisted the SARB in retaining a neutral policy stance at its March Monetary Policy Committee (MPC) meeting.

During the first quarter of this year, the yield of the benchmark R186 (maturity 2026) was bound to a relatively narrow range of 8.60% to 8.94%, especially considering the developments described above. As mentioned, foreign investors provided some support. Another supportive factor is the real yield of almost 4% offered by longer-dated nominal bonds. On a comparative basis, SA nominal bonds also appear

relatively attractive against its emerging market peer group. From a risk perspective, domestic nominal bonds are already trading at a sub-investment sovereign credit rating level.

In contrast, inflation-linked bond yields came under renewed upward pressure. The combination of sharply lower inflation, a benign inflation outlook and the fragile fiscal situation did the inflation-linked market no favours. Following a brief respite in January, real yields continued to drift higher. The yield of the medium-dated R197 (maturity 2023) increased from 2.90% at the end of 2018 to 3.17% at the end of March 2019, its weakest level since November last year. The real yield curve slope also steepened as long-dated real yields increased more than those of shorter-dated bonds.

The impact of the above developments on market returns was mixed. The net decrease in medium- and long-dated nominal bond yields during the quarter resulted in the ASSA JSE All Bond Index (ALBI) rendering a solid total return of 3.8% for the first three months of the year. This was significantly higher than both cash (1.7%) and the JSE Inflation-linked Government Bond Index (IGOV), which returned a mere 0.5%.

GLOBAL GROWTH UNCERTAINLY KEEPS YIELDS LOW

At a global level, the shift from quantitative easing to tightening has stalled and, in some cases, even reversed due to fears of a global growth slowdown. Even so, we are of the view that authorities are prepared to respond relatively quickly and, in certain instances, are already taking steps to avoid a broad-based collapse in economic growth. Global bond yields and, more specifically, the US Treasury market, have already responded as if an easing cycle has commenced. Our view is somewhat different in the sense that, although we agree with the risks of a global growth slowdown, the risk of collapse is small enough to argue in favour of higher bond yields and steeper curves from current levels. However, given the level of uncertainty about the growth outlook, yields may be trapped at the lower levels for a while.

Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and the lack of fiscal consolidation – or more specifically, Government's rising debt burden as a consequence of the lack of fiscal consolidation.

This debt burden continues to threaten the country's sovereign risk profile and places pressure on domestic funding costs. In addition, the risk of a failed economic recovery has certainly not dissipated. Even when accounting for the rebound in GDP of 2.6% and 1.4% in the third and fourth quarters of 2018, respectively, the underlying economy remains structurally weak, with growth for the 2018 calendar year an uninspiring 0.8%. A weak economy calls into question the quality of tax revenue collections and the health of the tax base, which, in turn, keep the risk of a budget deficit overrun at elevated levels. The financial burden of poorly managed state-owned enterprises on state finances has now reached a point where the delivery of a credible National Budget was near impossible in the absence of substantial remedial action. The proverbial chickens (mainly in the form of Eskom) have come home to roost and this required more than the usual liquidity provision. Addressing solvency is an entirely different matter – requiring more than simply kicking the can down the road via more liquidity bailouts.

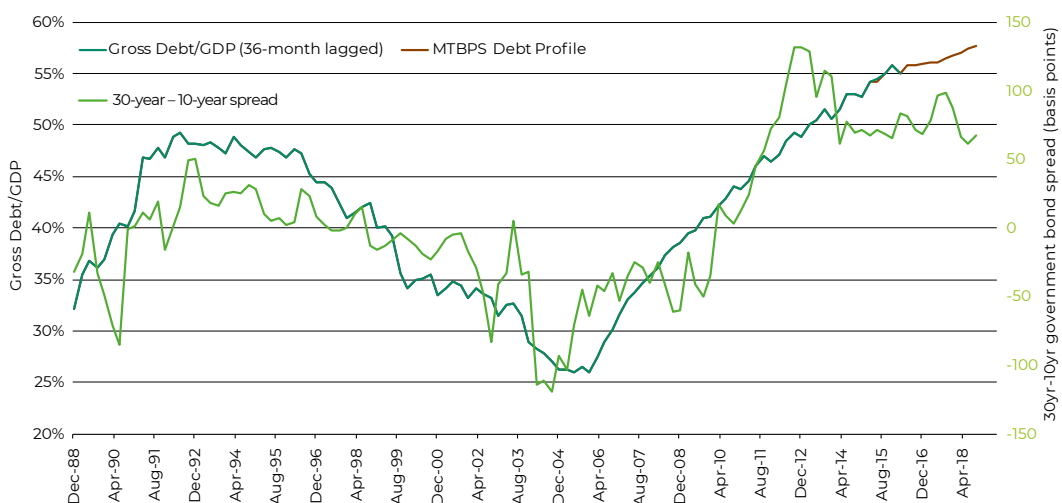
On the monetary policy front, we maintain our view that, following the repo rate increase in November 2018, the SARB will remain hostage to the opposing

forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of the strong disinflationary environment. For now, this suggests a stable policy path combined with a central bank that will keep warning of their response to the threat of higher inflation outcomes. The underlying domestic disinflationary trend and the risks to the global growth outlook should not be ignored. On balance, the risk to the stable repo rate outlook is still skewed to the upside, but our base case remains for a stable repo rate.

The recent bull rally, combined with renewed concerns about the fiscal state, convinced us to reduce risk into bouts of market strength. In doing that, we endeavour to strike a balance between avoiding capital loss (in the case of a market sell-off) and losing out on the accrual offered by a steeply sloped yield curve. We have also considered the fact that nominal bonds are currently trading at an attractive real yield of around 4%. So, while our broad interest rate investment strategy remains defensive, the modified duration variance of -0.60 is still some way off the maximum allowed position of -1.0. Real yields have retraced sufficiently to entice us to close some of our underweight positions.

OUTSTANDING GOVERNMENT GROSS DEBT (EXPRESSED AS A RATIO TO GDP) AND THE SLOPE OF THE NOMINAL BOND YIELD CURVE (EXPRESSED BY THE YIELD SPREAD BETWEEN THE 10- AND 30-YEAR POINTS ON THE CURVE)

Government's deteriorating gross debt to GDP ratio severely limits the extent to which long-dated nominal bond yields may decrease on a sustainable basis.



Sources: National Treasury, Futuregrowth



IAN WOODLEY | PORTFOLIO MANAGER

MINING OUTPERFORMS DESPITE SLOWING GLOBAL GROWTH

Traditionally, the threat of a trade war between the world's two largest economies and an economic slowdown, at least partially induced by that threat, would have investors running for the mining sector exit door. However, the mining sector has comfortably outperformed both the financial and industrial sectors of the JSE over the past 12 months. In fact, the platinum group metals (PGM) sector was the best performing sector on the JSE, up 116% over the period.

In the South African context, this could be ascribed to the fact that although the global economy is forecast to slow, with the OECD projecting GDP growth of 3.3% in 2019 and 3.4% in 2020, it is still easily above any projections for the South African economy over the same time period. Nevertheless, a similar profile of outperformance can also be seen when comparing the mining sector performance in the UK and Australia. There is obviously something else going on here.

In my view, there are two specific events to consider, and then one general observation.

ABOUT THE AUTHOR

Ian is the analyst responsible for the diversified mining companies and the non-mining sectors, such as construction and forestry & paper. He is the portfolio manager of the Old Mutual Mining and Resources Fund.



KEY TAKEOUTS



- PMGS BENEFIT FROM CLIMATE CHANGE TARGETS
- COMMODITY SHORTAGES ARE DRIVING PRICES HIGHER
- MINERS ARE TAKING A CAUTIOUS APPROACH TO CAPEX
- FUTURE SUCCESS DEPENDS ON COMMUNITY ENGAGEMENT

1. AUTOMAKERS DRIVE DEMAND

Following the discovery that Volkswagen (and subsequently most of the other car companies) was manipulating its emission test results – the so-called “Dieselgate” scandal – the car companies have come under increasing pressure to actually meet the emission standards of the territories where they sell cars. Compliance is being enforced using real-world tests, backed up by some fairly hefty fines for those companies that fail to meet the standards. With



a fast-approaching deadline (2021) to meet these targets, and therefore limited time to do research into alternative methods of reaching these standards, the car companies are being forced to make do with what they know. What they know is that increasing the amount of platinum group metals (PGMs) in the coatings of autocatalysts in the cars' exhausts will work to reduce the overall emissions. This has particularly benefited the palladium and rhodium markets. The palladium market has been operating in a deficit for a number of years now – the deficit being supplied from stockpiles that were unsubstantiated, but obviously large to begin with. These stockpiles have been steadily eroded and the market is becoming increasingly tight, as seen in the market price for palladium running away over the past 12 months. Rhodium has also benefited from the same dynamic. While the platinum price has been left behind somewhat, the degree of interchangeability of the PGMs offers hope that the runaway palladium price will force some manufacturers to look at platinum as an alternative.

2. DAM DISASTER LEADS TO SHORTAGE

The other specific event was the collapse of the Brumadinho tailings dam in Brazil used to store mine by-products, and which claimed the lives of hundreds of people. In addition to taking out the production directly tied to the dam, the increased scrutiny of Vale's environmental practices (and a lack of faith in some of the results) has led to substantial reductions in supply to the international iron ore market. The price has benefited accordingly, as no other producer is able to make up that production shortfall in the short term. In addition, some cyclone activity around the major exporting Australian ports also gave the price a bit of a push, emphasising just how tight the market has become.

In general terms, commodity markets are still benefiting from the unusual amount of restraint that has been shown by the major mining houses over the past three to four years. Despite the markets turning positive in 2016, there hasn't yet been the gut-wrenching splurge of activity and capital expenditure on new projects that traditionally follows the change in the cycle. This relative

restraint has led to most metal markets being relatively tight, with prices well supported by the fundamentals. In effect, this has allowed markets to see through the current uncertainty about US-China trade relations. Although there have been more announcements in the second half of 2018 – notably Anglo American's new copper project underway in Quellaveco, Peru – the new metal will not impact on market conditions for a few years and markets are likely to remain tight.

Looking ahead, provided global economic activity is maintained at a reasonable rate, market tightness should be sufficient for commodity prices to be stronger than seen during 2018. However, the economic outlook is clouded by a number of issues, including: What will be the outcome of the trade wars? Is China slowing down structurally? Can the US continue to grow after the tax stimulus seen last year? What impact will Brexit have on Europe?

Longer term, when the politics have been bedded down successfully, the market should adjust to the tighter supply side and, provided demand continues at a reasonable level, there is every expectation that another major upcycle is probable, albeit not at “super cycle” type levels.

SOCIAL LICENCE TO OPERATE

This is a phrase oft used by the mining sector and brought into focus for the general investing public following the collapse of the Brumadinho tailings dam

earlier this year. The failure of Vale to engineer a sufficiently robust structure, despite (reportedly) prior warnings, led to the disaster. Notwithstanding the obvious and horrific consequences of this failure, the social licence to operate incorporates more than just being a safe operator.

Mining companies can get regulatory permission to operate by fulfilling their statutory requirements, but a “social licence” is a more abstruse concept. Essentially, it means getting the approval from the local, regional and national stakeholders to build and operate in their area. There is no pre-assigned checklist of issues that can be addressed, although common concerns will exist. Issues that frequently emerge are jobs for the local community (both directly and indirectly), ensuring that environmental issues will be addressed and the ethics, transparency and accountability around any operation.

A process of engagement and discussion with all stakeholders should be followed so that impediments to the success of an operation can be debated, with major concerns aired and discussions initiated. Importantly, this is not to say that mining companies should give in to every request, but points of concern should be talked through. Where the communities' requests are reasonable, measures should be taken to accommodate them; when these requests are unreasonable, it should be explained why this is so.





THE PRIVATE SECTOR'S ROLE IN SA'S EDUCATION CHALLENGES

ZOM CHIZURA | HEAD OF IMPACT FUNDS

ABOUT THE AUTHOR

Zom is responsible for Old Mutual's Impact Funds, which invest in affordable housing, schools, retirement accommodation and SMME financing. Previously, he was Chief Executive of Old Mutual West Africa.

For us, as one of the largest private alternative investment managers in Africa, responsibility for our country meeting its potential does not just lie with the state. The President, in his State of the Nation Address, and Finance Minister Mboweni, in his Budget Speech, both recognised the increased role of the private sector in our economy. Indeed, there is much that the private sector can do to alleviate the pressure on Treasury when it comes to the funding of urgent requirements across the economic spectrum. For us, none is more important than education. To borrow from Kofi Annan, a Nobel Peace Prize recipient: "Knowledge is power. Information is liberating. Education is the premise of progress, in every society, in every family."

We believe by working in partnership with Government, independent education providers can play a greater role to secure additional investment to improve education.



KEY TAKEOUTS



- INVESTING IN AFFORDABLE, QUALITY EDUCATION FOR CHILDREN FROM LESS ADVANTAGED COMMUNITIES
- PUPILS ARE INDEPENDENTLY TESTED TO ASSESS LITERACY AND NUMERACY LEVELS
- PARTNERSHIP WITH GOVERNMENT AND INDEPENDENT PROVIDERS IS KEY

THE STATE OF OUR CLASSROOMS

When the 2018 national matric results were published in January, they showed a small overall improvement in pass rates, rising from 75.1% in 2017 to 78.2% for 2018. While the headline figures looked encouraging, a significant amount of investment is still required to further improve the nation's education system and here both Government and the private sector have to be involved.

South African classroom sizes are growing ever larger as our country's population rapidly expands. Today, many primary school class sizes are around 45 learners, and in some places nearer 50, which is putting even more strain on a system that is on an improvement trajectory. However, what was clear from Minister Tito Mboweni's Budget Speech earlier this year is that the country has no surplus money to allocate towards improving both standards in and access to basic education while it copes with the repercussions of a shrinking economy and directs resources at other urgent areas of need.

This begs the question: how do we address the need for increased investment in education when there simply aren't readily available extra funds to improve the quality and access to education?

AN INDEPENDENT SOLUTION?

Currently, there are many excellent school operators in the independent sector which are state regulated although privately governed. Their schooling is often geared around particular religious principles or learning philosophies and many cater for parents with generous budgets. There is an increasing need for improvement in not only the quality of schools, but also for affordability and access for so many less privileged children across the country. This is where we believe the private sector can truly offer value in South Africa's ongoing education investment challenge.

This is where we are focused. The schools we invest in through the Schools and Education Investment Impact Fund of South Africa (Schools Fund) provide quality, affordable and accessible education for children from less advantaged communities. Indeed, over a third of our students are from the very toughest backgrounds in the country, including many from single parent households.

Our schools are consistently producing very encouraging matric and bachelor pass rates. For example, last year our schools collectively achieved matric results of 94.5% and

bachelor pass rates of 50.2%, which compares favourably with the national bachelor pass rate average of 28.7%.

It's important to add that the schools we fund cater for a student's rounded development, addressing their individual vocational, sporting, artistic and other talents as well as their academic achievements. And each school is different, reflecting the direction set by the principal and board of governors. But one thing the schools we fund have in common is strong leadership and very clear standards and expectations of student performance.

WHAT THE REPORT CARD SAYS

The Schools Fund will only back a school if its directors, principal and governors are 100% dedicated to the success of the school as an institution and have the right corporate governance structures in place to ensure it happens.

We are firm believers in reliable information and collect data to ensure we know how each school we fund is performing. To do this, each school is tested by an independent body to ascertain levels of performance and measure progress. In addition, at the end of each phase, i.e. grades three, six and nine, learners are externally tested separately on the core skills of literacy and numeracy. Only by regularly measuring and understanding educational attainment levels can we improve them.

Although we have a common approach to improving literacy and numeracy across all our schools, many choose their own areas of academic focus. For example, some of our schools teach classes on robotics, coding and IT, while other schools have chosen to engage their pupils in Maths and Science Olympiads. Some students have a strong interest in running their own businesses after matriculation or university, resulting in our schools developing courses devoted to entrepreneurship.

There are great opportunities for South Africa's independent school sector, and we believe we and other private investors have a role in the sector's success. This is particularly vital while the country's education budget is under such stress.

We know there are no quick fixes. A new school can take years before it becomes a stable, mature institution. But with vision and leadership, public and independent schools together can provide the education that meets the needs of the country and makes the most of South Africa's young, growing and resourceful population.



SEARCHING FOR ALPHA THROUGH ESG

WALEED HENDRICKS | ESG INVESTMENT ANALYST

ABOUT THE AUTHOR

Waleed is responsible for ESG quantitative research and analysis, the development of ESG Investment tools and integrating ESG factors into our stock selection and portfolio construction processes.



KEY TAKEOUTS



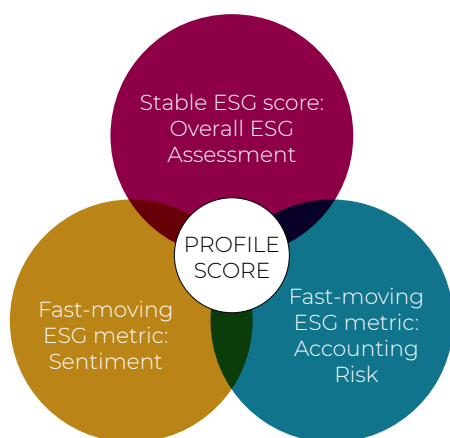
- SUSTAINABILITY IS RESHAPING THE INVESTMENT LANDSCAPE
- OUR BESPOKE ESG RISK SCREENING MODEL ASSESSES LONG-TERM RETURNS
- THE FOCUS IS ON PORTFOLIOS WITH BETTER-RATED ESG PROFILES

We have always contended that investing in a portfolio of companies that rate well based on environmental, social and governance (ESG) factors need not result in sacrificing returns. In fact, empirical research shows that carefully considering these factors can lead to superior returns and that there are intuitive explanations for this. To gather our own evidence, and to enhance both our ESG quantitative research process and risk screening across markets, we developed a proprietary ESG Risk Screening Model using external data vendors¹ to assess long-term investment risk and opportunities associated with a company.

CREATING THE ESG RISK SCREENING MODEL

To gain insights into the sustainability practices of any company and, consequently, its long-term investment returns, we need adequate ESG data. And ESG data has a temporal dimension, meaning that some ESG data is long-lived while other ESG data points are short-lived in nature. Looking at the short- and long-term data sources independently has both pros and cons. We believe the optimal approach to assessing long-term investment risk associated with a company requires combining the short- and long-term ESG data sets into a single metric.

Our proprietary ESG Risk Screening Model is a blend of the long-term ESG risk profile of a company, which is derived from analysing a company's risks and opportunities that arise from ESG factors that may not be captured by conventional financial analysis of a company¹, and the faster, more short-term ESG news flow on potential controversies and accounting risks. Additionally, we developed a one-year ESG Profile Momentum score to capture changes in the ESG profile of a company, investor sentiment and price behaviour.



THE QUANTITATIVE RESEARCH

Our research hypothesis was that the better-rated ESG companies should outperform both the lower-rated ESG companies and the benchmark over time, and therefore incorporating ESG factors when investing across all markets can lead to superior returns.

Using our model, each underlying ESG metric was individually tested for volatility and performance attributes as the basis for ensuring the optimal weighting when blending the metrics. To account for the different ESG methodologies, statistical measures were used for calculating each metric separately to ensure standardisation when combining the scores.

While we conducted the research globally across various markets, this article only focuses on the MSCI All Country World Index (ACWI) and the MSCI Emerging Markets (EM) Index.

We applied our proprietary ESG Risk Screening Model to the above indices' constituents from 30 June 2015 to 31 January 2019. We used this period as we only had consistent accounting risk measures from June 2015.

The constituents in the aforementioned indices were ranked into quintiles from the highest performing companies within the index (Quintile 1) to worst (Quintile 5) per our proprietary model and ranked relative to their peers. Each quintile basket of stocks was equal weighted and rebalanced monthly.

THE FINDINGS

The summary table on the following page shows the key elements of the attribution analysis on the MSCI ACWI Index (developed and emerging markets). The attribution analysis evaluates and compares the performance of each quintile portfolio (best to worst rated per our proprietary ESG model) within the MSCI ACWI Index. The attribution analysis by our proprietary ESG Risk Screening Model provided compelling support for our hypothesis. As you can see, there is an almost ordinal distribution in cumulative returns from quintile 1 through to quintile 5. This means that if you invested in the quintile 1 portfolio, which is our best measure in terms of ESG for the research period, you would have had a 25.96% return, which is an active return of 6.84%. However, if you invested in the quintile 5 portfolio you would have had a return of 10.86%, which underperformed the benchmark by -8.25% and the quintile 1 portfolio by -15.1%. Very interesting to note is that the quintile 1 portfolio also outperformed the MSCI ACWI ESG Leaders Index (MSCI best-in-class ESG index) over the time period by 3.52%. I must point out that certain risk control measures, such as tracking error and sector neutrality, are not discussed in this article, given that the main focus is to highlight the ESG alpha signal of our proprietary risk screening model.

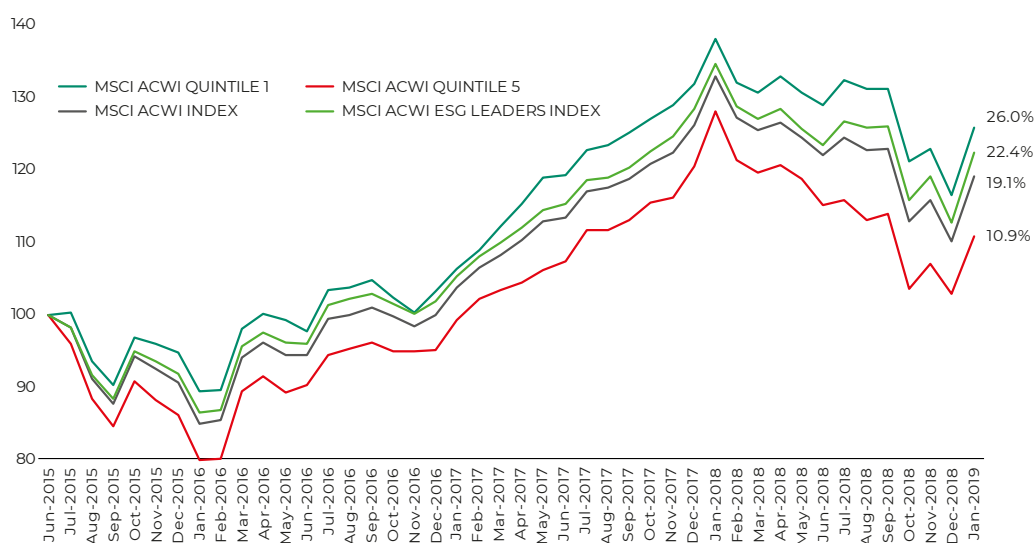
¹ MSCI Inc., which is a global provider of equity, fixed income, hedge fund stock market indices and multi-asset portfolio analysis tools.

If you look at the second last row in the table labelled “ESG profile specific factor”, you will see that quintile 1 profile specific factor return of 1.85% compares with quintile 5, which is at -2.08%. The ESG profile specific factor is the residual source of return that is not explained by the common traditional factors, which in this case is the ESG profile score from our risk model, as this is the only additional factor we introduced. This evidence gives us conviction in our model, as this is attributable to the quality of the ESG profile scores in each quintile portfolio. What is noteworthy is that the ESG specific factor for quintiles 4 and 5 is negative, which implies that poorer rated ESG companies lead to lower returns when aggregated with other sources of returns from common factors.

MSCI ALL COUNTRY WORLD INDEX (ACWI) PROPRIETARY PROFILE SCORE ATTRIBUTION (CUMULATIVE RETURNS IN US\$)

SOURCE OF RETURN	ACWI QUINTILE 1	ACWI QUINTILE 2	ACWI QUINTILE 3	ACWI QUINTILE 4	ACWI QUINTILE 5	MSCI ACWI ESG LEADERS INDEX
Cumulative return	25.96%	22.31%	22.99%	14.07%	10.86%	22.44%
MSCI ACWI Benchmark cumulative return	19.12%	19.12%	19.12%	19.12%	19.12%	19.12%
Total active return	6.84%	3.20%	3.87%	-5.05%	-8.25%	3.33%
Residual	9.02%	3.23%	3.35%	-5.89%	-9.00%	2.74%
Common factor	7.16%	1.63%	2.16%	-3.61%	-6.92%	1.45%
Industry	0.24%	-0.43%	0.35%	-0.23%	0.05%	-0.92%
Country	5.07%	1.54%	1.42%	-2.79%	-4.95%	2.21%
ESG profile specific factor	1.85%	1.60%	1.19%	-2.27%	-2.08%	1.29%
Currency	-2.17%	-0.03%	0.52%	0.84%	0.75%	0.59%

MSCI ACWI PERFORMANCE (CUMULATIVE RETURNS IN US\$)



Sources: MSCI, Old Mutual Investment Group | Time series: 30 June 2015 – 31 January 2019

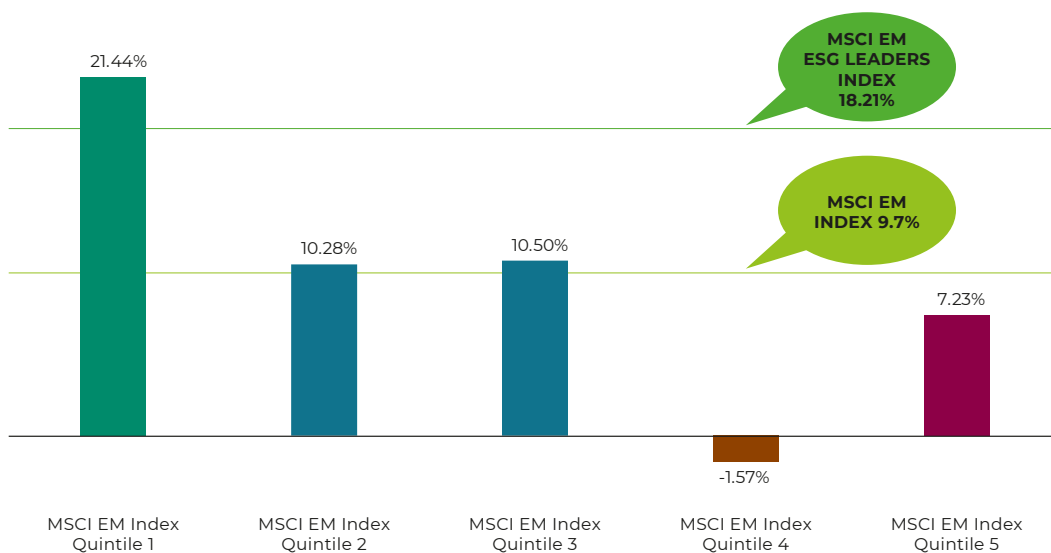
To ensure our research was relevant to South Africa, we also tested the performance in emerging markets. The constituents in the MSCI EM Index were also ranked into quintiles from highest performing companies to worst per our proprietary ESG Risk Screening Model and each quintile basket of stocks was equal weighted and rebalanced monthly. And as can be seen in the chart below, the quintile 1 portfolio outperformed

its peers, the MSCI EM Index and the MSCI EM ESG Leaders Index.

During the period under assessment, companies with higher ESG profile scores per our proprietary ESG Risk Screening Model outperformed their peers and the benchmark (MSCI EM Index). Our quintile 1 portfolio (which is our best measure in terms of ESG) outperformed the MSCI EM ESG Leaders Index. The quintile 1 portfolio had a return of

21.44%, outperforming the MSCI EM Index by 11.74% and the MSCI EM ESG Leaders Index by 3.22%. The quintile 1 portfolio specific factor attribution is 7.02%, which is attributable to the better quality ESG rated companies per our Proprietary ESG Risk Model.

MSCI EMERGING MARKET INDEX PERFORMANCE (CUMULATIVE RETURNS IN US\$)



Sources: : MSCI, Old Mutual Investment Group | Time series: 30 June 2015 – 31 January 2019

CONCLUSION

Sustainability is a macro-thematic trend that is reshaping the competitive landscape. Companies that are able to respond to this trend early on, will reap the benefits of stronger growth prospects, enhanced operating efficiencies, stronger social licence to operate, enhanced staff retention, lower cost of capital and, ultimately, a stronger and more sustainable competitive advantage. They will also reduce operational risk and be positioned towards more sustainable growth, ensuring improved financial performance. And for investors searching for alpha, greater emphasis will have to be placed on portfolios whose ESG profile is better rated.



BUILDING INFORMED SOLUTIONS

SOME THINGS ARE WORTH REPEATING

GRAHAM TUCKER | PORTFOLIO MANAGER

ABOUT THE AUTHOR

Graham is responsible for a range of balanced funds. He is also a quantitative strategist, risk manager and a member of the asset allocation team.

2018 was a difficult year for investors, especially those in equities and listed property. This is particularly evident when comparing the asset class returns in 2017 to those of 2018 – SA Equity and SA Property went from the top of the performance rankings to being the two worst performing asset classes.

While increased volatility is unsettling for investors, it is the very motivation behind us developing the LONG-TERM PERSPECTIVES yearbook. The 89 years of data that informs the content of the yearbook shows the muted impact short-term returns have when viewed through a long-term lens. In scrutinising the long-term performance and behaviour of a range of the asset classes, we developed a set of key lessons that informs our investment process and the way we build our solutions. While you may well be familiar with most of these lessons, the profound impact they can have on an investment portfolio is worth reconsidering.

LESSON 1

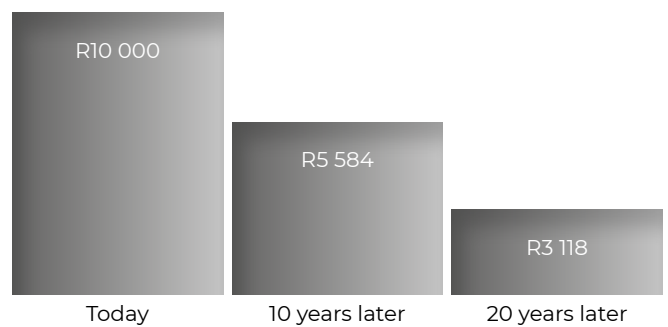
INFLATION IS YOUR ENEMY

REALITY: Many investors suffer from “inflation illusion” as they don’t notice how destructive inflation can be over time.

LESSON: We need to look at long-term investment returns in “real” terms, stripping out the impact of inflation.

INFLATION ERODES SPENDING POWER

Take a look at what a 6% inflation rate effectively does to your money.





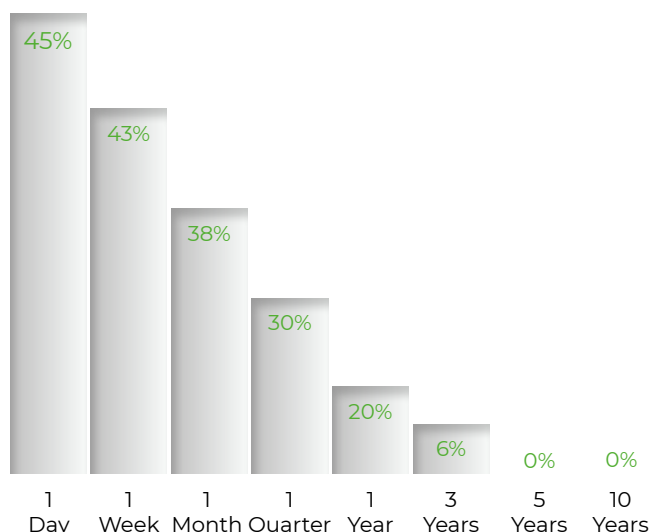
LESSON 2

TIME IS YOUR FRIEND

REALITY: The main reason why investors prefer cash to equities is the fear of losing money.

LESSON: The best way to manage the risk of losing money is to remain invested in equities for longer. As soon as you extend your holding period for more than three years, past performance of SA equities shows that the chance of losing money becomes negligible.

PROBABILITY OF NEGATIVE RETURNS OVER DIFFERENT TIME PERIODS



1 day and 1 week: Rolling total returns for SA equity, June 1995 – December 2018
 1 month to 10 years: Rolling returns for SA equity, January 1960 – December 2018

LESSON 3

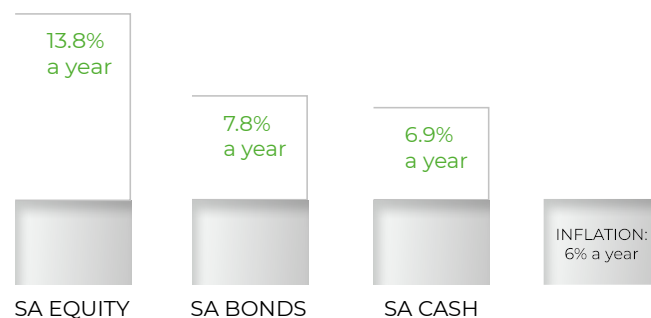
YOU NEED EQUITIES

REALITY: Many investors will not retire with enough money.

LESSON: We need the higher long-term returns from equities to grow our wealth. This is particularly important in a world where people are living longer.

PERFORMANCE OVER 89 YEARS

(Nominal Returns from December 1929 to December 2018)



LESSON 4

CASH IS TRASH

REALITY: A bank deposit exposes you to minimal risk, but there's a price to be paid for that security.

LESSON: Cash does not significantly increase your real wealth over time. Over 94 years, cash has an after-inflation return of just 1% a year. It is better to own shares in the bank than to leave your money there.

TIME NEEDED TO DOUBLE YOUR MONEY

Using each asset class's long-term average returns, this is how long it will take to double your REAL investment value.



LESSON 5

COMPOUNDING IS A POWERFUL WEALTH GENERATOR

REALITY: Money needs time to benefit from the full potential of compounding growth.

LESSON: Start saving as soon as you can, leave it for as long as you can, and let compounding do the work for you. And tick the dividend reinvest box on your investment application form to maximise your growth.

GROWING YOUR WEALTH OVER TIME

Using the long-term nominal average return of 13.8% a year, look at what happens when a lump sum is invested in SA equities over time.



LESSON 6

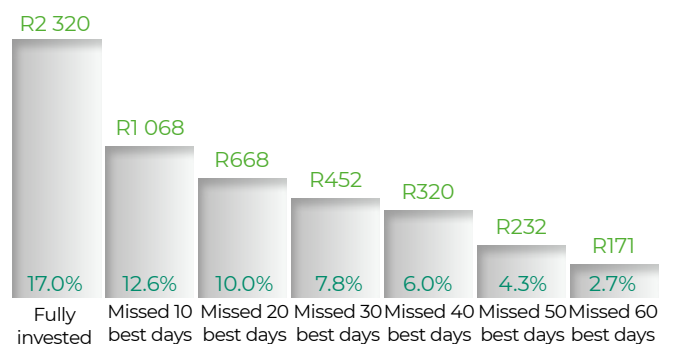
HIGH PRICE OF MISSING OUT

REALITY: Short-term volatility can often lead to investors selling their investments at the worst time – as almost all of the 10 best days on the JSE occurred after bad news or during uncertain times.

LESSON: Sitting on the sidelines and missing those good days can be detrimental to your savings. The only thing you can control is to have a well-considered plan and to stick to that plan. It is the best way of ensuring you have a secure retirement.

THE HIGH PRICE OF MISSING OUT

The performance of R100 invested in the FTSE/JSE All Share Index (June 1997 to December 2018)



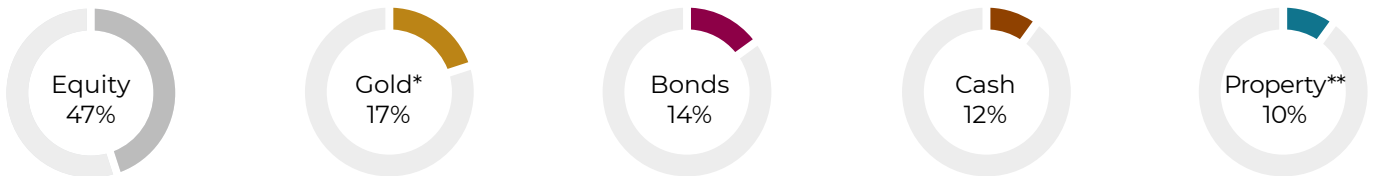
LESSON 7

DON'T PUT ALL YOUR EGGS IN ONE BASKET

REALITY: Equities may have been the best performing asset class since 1929, but cash was the best performer for 11 of those 89 years and listed property for 9 years...

LESSON: Diversification is the one free lunch in investments; use it. That is because it pays to invest across different asset classes.

PERCENTAGE OF TIME AS THE YEAR'S BEST PERFORMING LOCAL ASSET CLASS (1930 – 2018)



* since 1967 ** since 1980

LESSON 8

ACTIVE ALLOCATION ADDS VALUE

REALITY: Asset classes have distinct secular or long-term periods of under- and outperformance.

LESSON: Active asset allocation is a vital tool in delivering superior returns.

UNDERSTAND THAT MARKETS MOVE IN CYCLES



LISTED PROPERTY went nowhere for 15 years, before becoming the best performing asset class for the next 20.



SA BONDS delivered a negative real return for 40 years, before delivering a great return over the last 30 years.

The analysis that informs these lessons and shapes the principles that have contributed to the success of our multi-asset class funds, is explained in more detail in our Long-Term Perspectives 2019 yearbook. This yearbook, now in its sixth edition, is available at www.oldmutualinvest.com.



MARKET INDICATORS

AS AT 31 MARCH 2019

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index			1.6	5.0
FTSE/JSE Resources Index			4.7	41.6
FTSE/JSE Industrial Index			2.9	-3.7
FTSE/JSE Financial Index			-4.0	-5.8
FTSE/JSE SA Quoted Property Index			-1.5	-5.7
ALBI BEASSA Bond Index			1.3	3.5
STeFI Money Market Index			0.6	7.3
MSCI World Index (R)			4.0	27.3
MSCI World Index (\$)			1.4	4.6

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US\$	March-19	14.49	11.82
Rand/UK Pound	March-19	18.90	16.61
Rand/Euro	March-19	16.26	14.59
Rand/Aus\$	March-19	10.28	9.09
Commodity Prices			
Gold Price (\$)	March-19	1291.9	1325.0
Gold Price (R)	March-19	18772.0	15667.6
Oil Price (\$)	March-19	67.6	69.4
Interest Rates			
Prime Overdraft	March-19	10.3%	10.0%
3-Month NCD Rate	March-19	7.1%	6.9%
R186 Long-bond Yield	March-19	8.6%	8.0%
Inflation			
CPI (y-o-y)	February-19	4.1%	4.0%
Real Economy			
GDP Growth (y-o-y)	December-18	0.2%	2.2%
HCE Growth (y-o-y)	December-18	1.2%	2.7%
Household Consumption Expenditure (HCE) Growth (y-o-y)	December-18	-4.1%	1.9%
Gross Fixed Capital Formation (GFCF) Growth (y-o-y)	January-19	0.1%	1.2%
Manufacturing Production (y-o-y) (seasonally adjusted)			
Balance of Payments			
Trade Balance (cumulative 12-month)	February-19	\$4.0	-\$0.6
Current Account (% of GDP)	December-18	-2.2%	-2.7%
Forex Reserves (incl. gold)	February-19	\$709.5	\$588.1

Sources: JSE, Iris, I-Net

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