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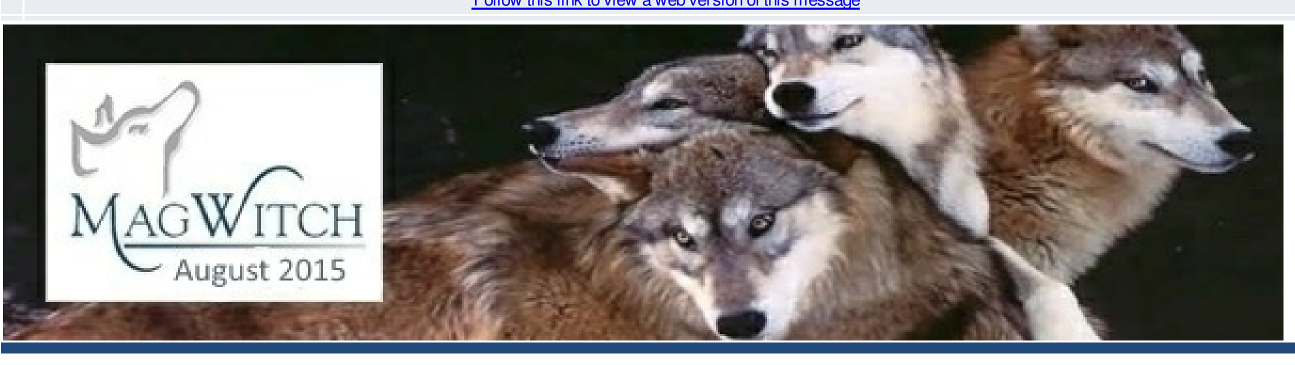


Dear

August 2015 was a stressful month for investors. Global concerns around a slowing Chinese economy resulted in a “risk-off” approach as investments moved to developed economies and defensive assets. The China situation is an interesting one as their economic reports often lack substance and the world has to rely on the reported economic data without being able to interrogate the underlying assumptions. The reported numbers have for the most part always been positive and demonstrating that the Chinese economy is growing at a far quicker pace than the rest of the world. The move by China during August 2015 to devalue the Yuan has changed this picture. The devaluation of their currency has been done to stimulate growth and to make Chinese manufacturing and exports more competitive.

The gold price had a strong month as some investors looked to move their investments into the “safer” physical asset. The JSE Alsi lost 4% during the month which meant that it was one of the better performing exchanges in the world, as most stock exchanges lost more than 6%. This can be attributed to the sideways move of the JSE Alsi over the last 12 months whilst other stock exchanges had shown some growth. The rest of the world effectively had more profit to give up.

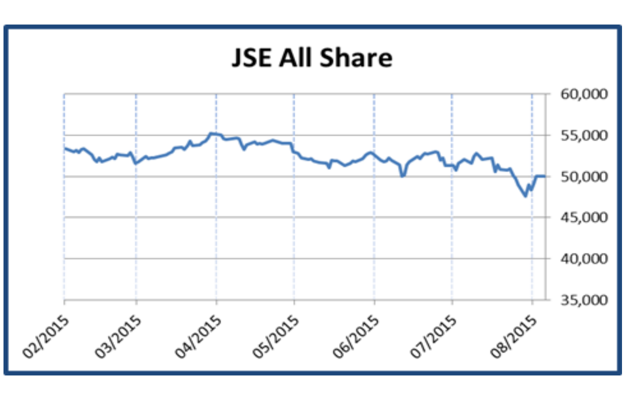
The Rand came under severe pressure in the month with investors reducing risk and moving out of emerging markets. The Rand traded at record lows during the month against all major currencies. The weaker currency will hopefully increase competitiveness of South African exports although it is important to note that all emerging market currencies had a very poor month.

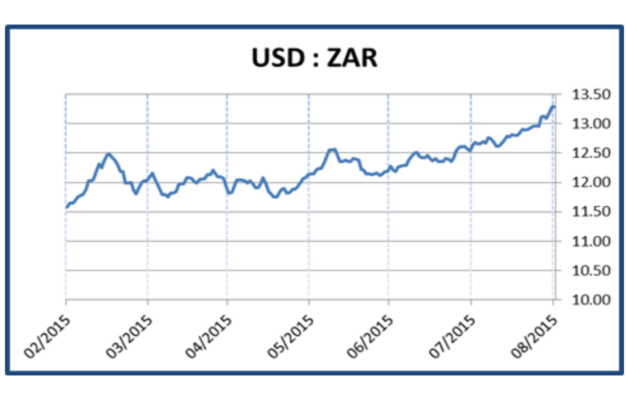
South Africa’s GDP report for the 2nd quarter of 2015 showed that the economy had contracted by 1.3% during this period. The biggest contributor was a huge decline in agriculture as South Africa is experiencing their worst drought since 1992. CPI increased slightly to 5% year on year. This number is expected to increase above the upper limit of inflation targeting (6%) before the end of the year as a weaker Rand, higher maize prices, higher electricity tariffs and higher fuel prices affect the price of the basket of goods. The high inflation and low growth does create an interesting conundrum for The Reserve Bank. The normal response to higher inflation would be to increase interest rates but any interest rate hike is going to have a negative impact on growth. The challenge for the government is to stimulate growth through other measures. The one area that would have the biggest impact would be labour reform but given our current unemployment levels this would be far away.

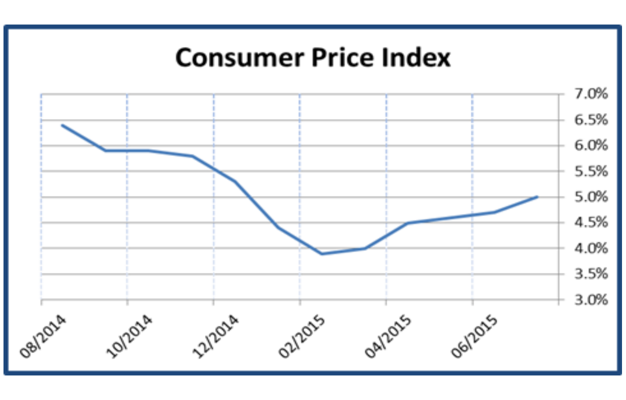
The current sell-off has created a few more opportunities for investors and asset managers and short term volatility is often to the benefit of the long term investor if they manage to invest in periods of weakness.

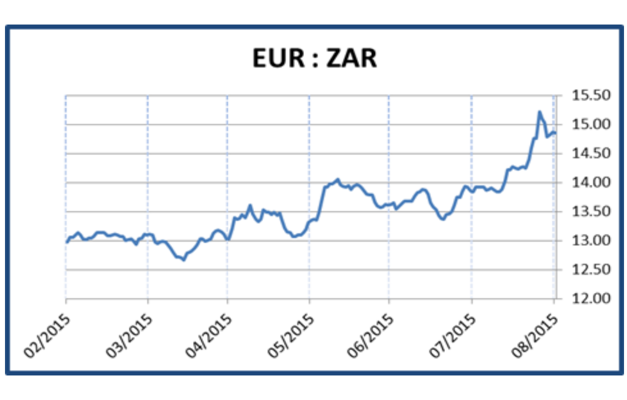
Magwitch Securities

MARKET INFORMATION









FINANCIAL PRODUCT IN FOCUS

INVESTMENT STRATEGIES

In our financial product in focus this month we look at the different investment strategies employed by asset managers. We will select a company that is listed on the JSE to demonstrate the attributes the asset manager will be looking at in each of these strategies. It is important to understand the investment strategy of the asset managers in order to know how the investments will perform in different cycles.

Value and Growth Investing

The traditional classification of investment strategies was that the strategy was either a value investment strategy or a growth investment strategy. This assumed that the investor would invest for one of two reasons.

The value investor would only invest in companies where the share price was significantly less than the intrinsic value of the company. When the price exceeds the intrinsic value the value investor may decide to exit the investment. Benjamin Graham is often cited as the forefather of value investing and his book, The Intelligent Investor, is a fantastic read for people looking to increase their financial knowledge. Value investors also often look at financial ratios, the most commonly used is probably the Price-Earnings (PE) ratio. They also compare shares in the same sector and try to determine which share is the most attractive.

The growth investor would only invest into companies where that company exhibited above average growth when compared to its peers. The growth investor looks at different financial ratios compared to the value investor and may not be concerned at all about the company’s PE ratio.

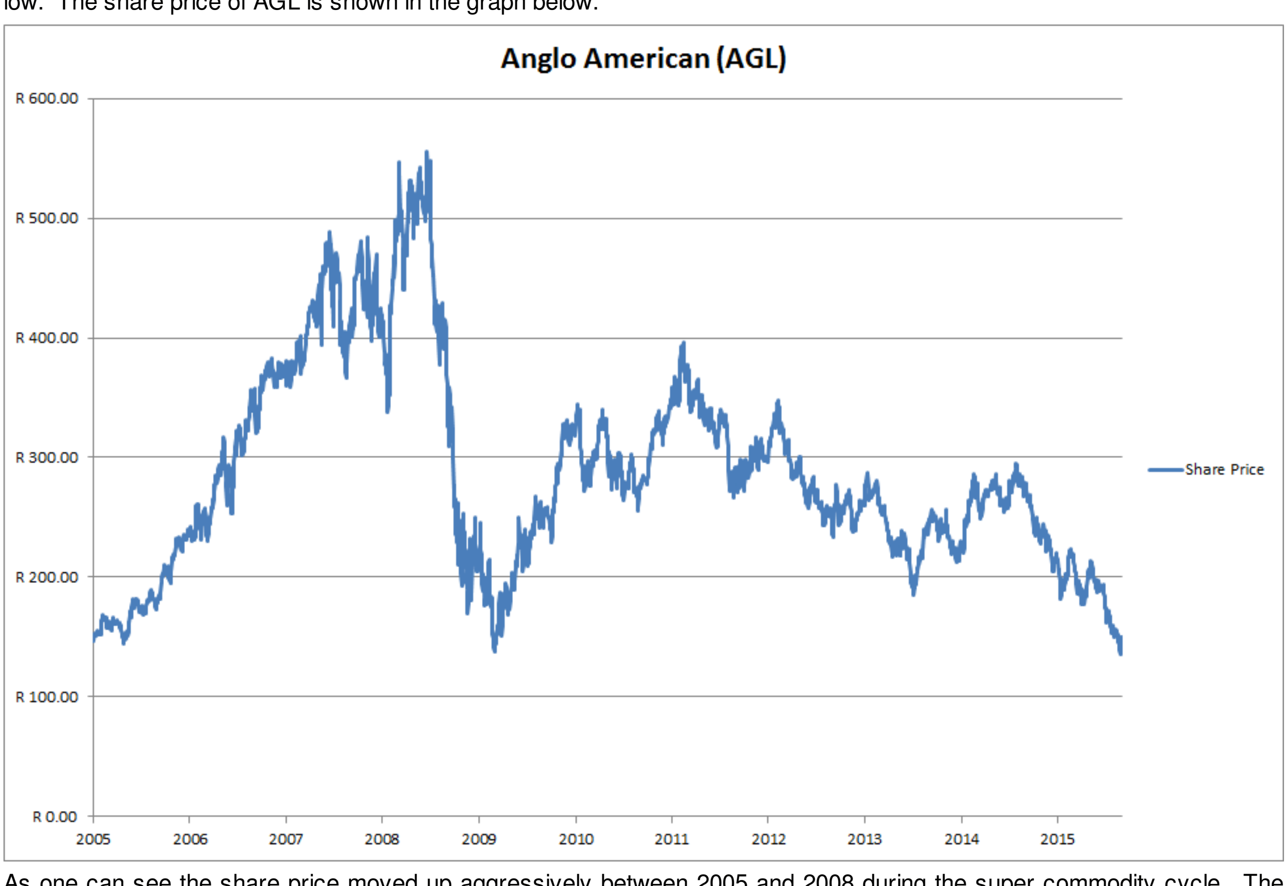
The problem with this traditional classification is that it ignores the fact that investors only invest when they feel that the share price is trading at less than it is worth, and thus any investment must have an upside potential to a higher intrinsic value. Even if an investor is investing in a growth company they will still need to determine an intrinsic value of the investment as they would only invest where they feel the company is worth more than they are paying. This classification shortcoming has led to a whole new set of definitions.

Contrarian Investing

Contrarian Investing is an investment strategy that is characterized by doing the opposite to the prevailing sentiment of the time. The contrarian investor believes that negative market sentiment may cause the share price to be well below its intrinsic value due to an exaggeration of its associated risks. Similarly positive sentiment will cause a share price to run up to well above its intrinsic value. They believe that these market inefficiencies create opportunity for above average returns.

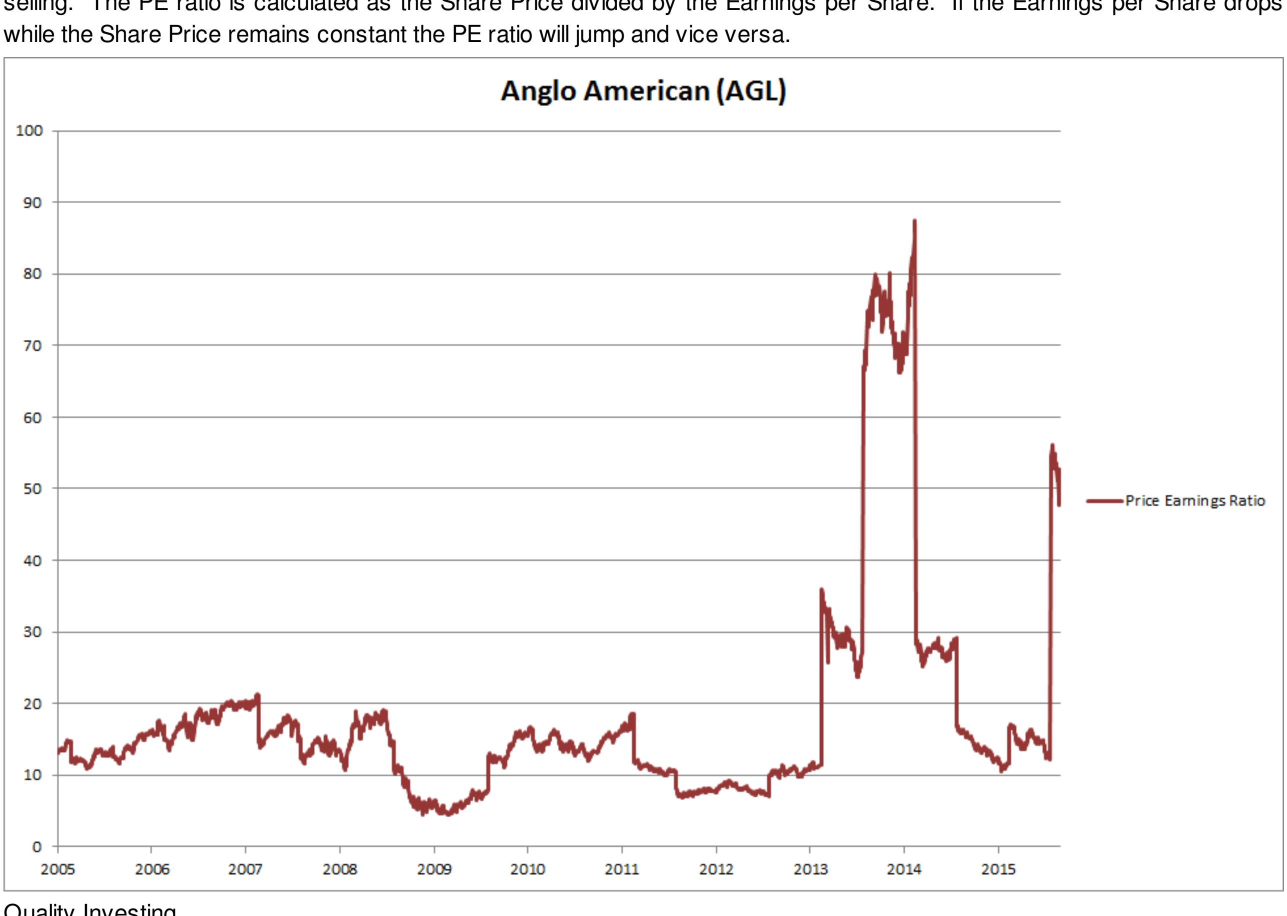
The contrarian investor is effectively swimming against the tide and they look for companies that are out of favour with the market in general.

In the current market a contrarian investor may consider a company like Anglo American (AGL) which is trading at a decade low. The share price of AGL is shown in the graph below.



As one can see the share price moved up aggressively between 2005 and 2008 during the super commodity cycle. The contrarian investor would have been avoiding the company during that period and would have felt justified when the commodity cycle came to a swift halt during the Global Financial Crisis. After a brief recovery to 2011 AGL has been consistently sold and would appeal more to a contrarian investor who believes that the selloff has been overdone. A contrarian investor in AGL would believe that commodity prices will increase in the medium term and thus the company will deliver higher profits than is currently expected by the market.

A contrarian investor may not be that interested in PE ratios as often it is negative news that causes the negative market sentiment. In the Graph below one can see the volatility of the AGL PE ratio with the PE ratio jumping up every time AGL reported lower earnings. If one compares the two graphs you would see that the negative news resulted in additional selling. The PE ratio is calculated as the Share Price divided by the Earnings per Share. If the Earnings per Share drops while the Share Price remains constant the PE ratio will jump and vice versa.

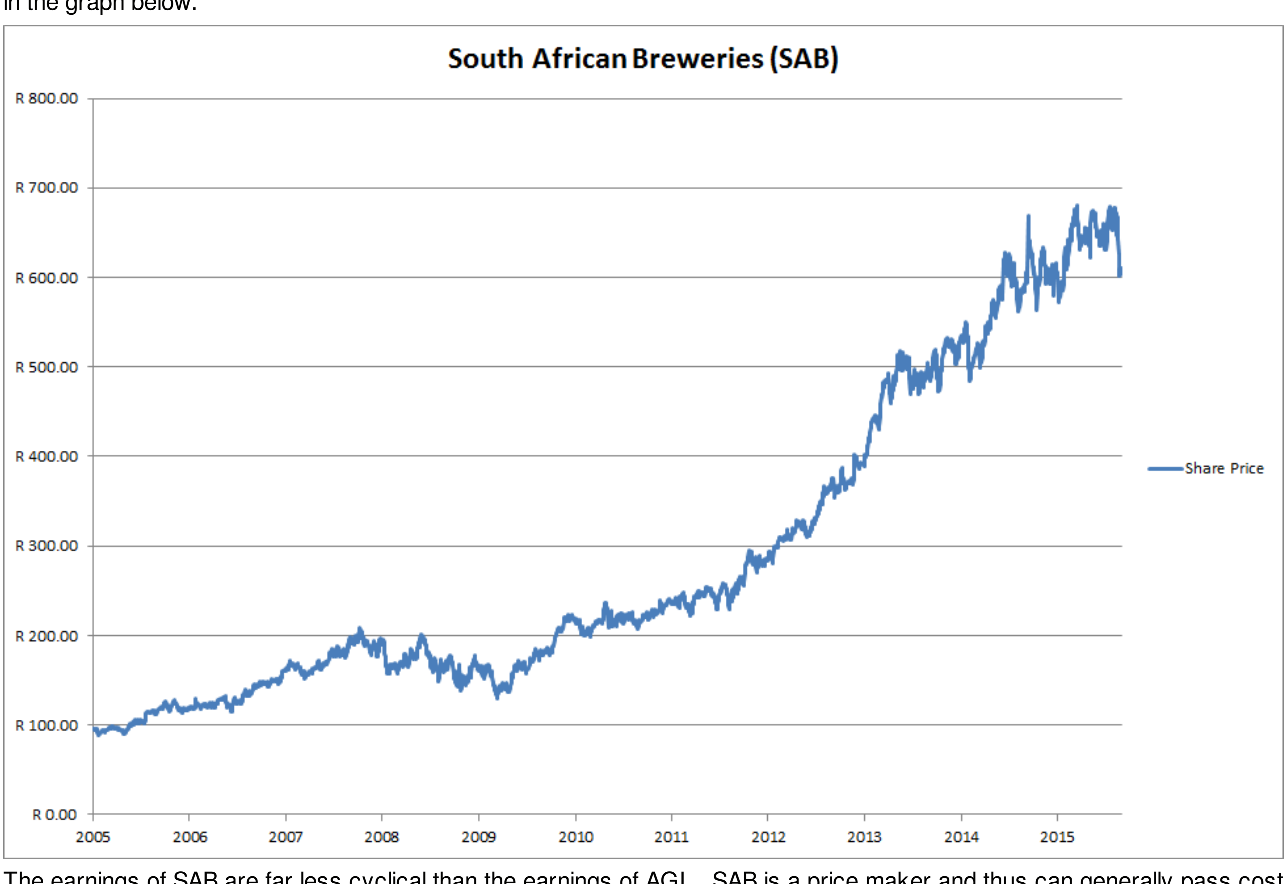


Quality Investing

The quality investor will only invest in companies that they deem to be of high quality. They seek to invest in market leaders who have high barriers for competitors to enter the market. The quality investor will also look at softer issues like the experience of the management of the company and their future plans.

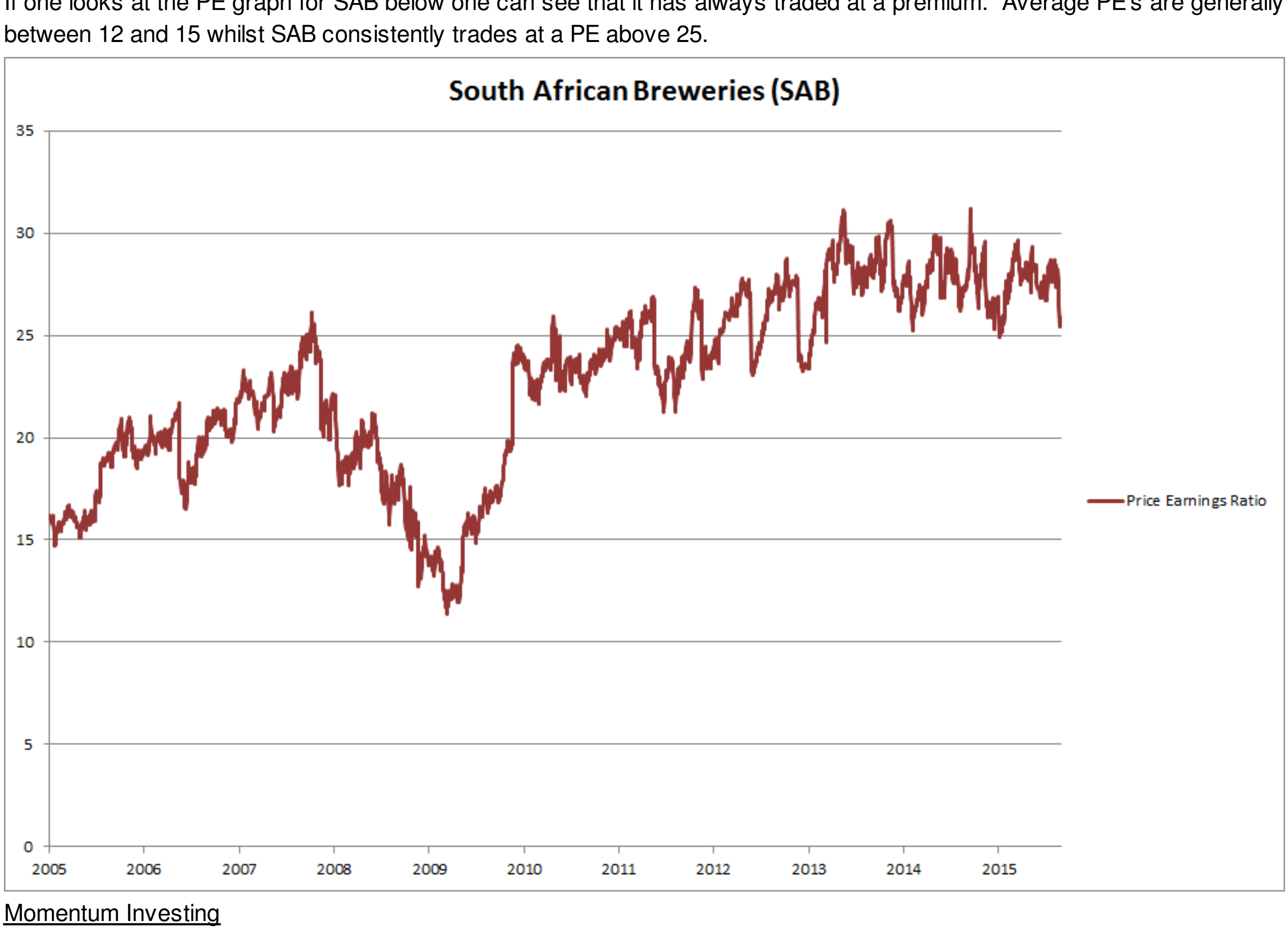
A good example of what many consider a quality company is South African Breweries (SAB). SAB are the world’s second biggest brewery and dominate the local market. Due to their product range and the volumes that they produce they are a very cost efficient producer and can afford to undercut competition if required – a good example would be the beer war between SAB and Luyt Lager during the 1970’s.

A quality share is more sought after as earnings are more consistent. The quality investor would generally be happy to pay a premium for this consistency of earnings and growth. The share price movement of SAB over the last 10 years is shown in the graph below.



The earnings of SAB are far less cyclical than the earnings of AGL. SAB is a price maker and thus can generally pass cost increases on to the consumer. AGL are different in that the price that they sell at is generally beyond their influence and is subject to market forces. This defensive nature of SAB can be seen in that the share price didn’t come off to the same extent as AGL during the Global Financial Crisis.

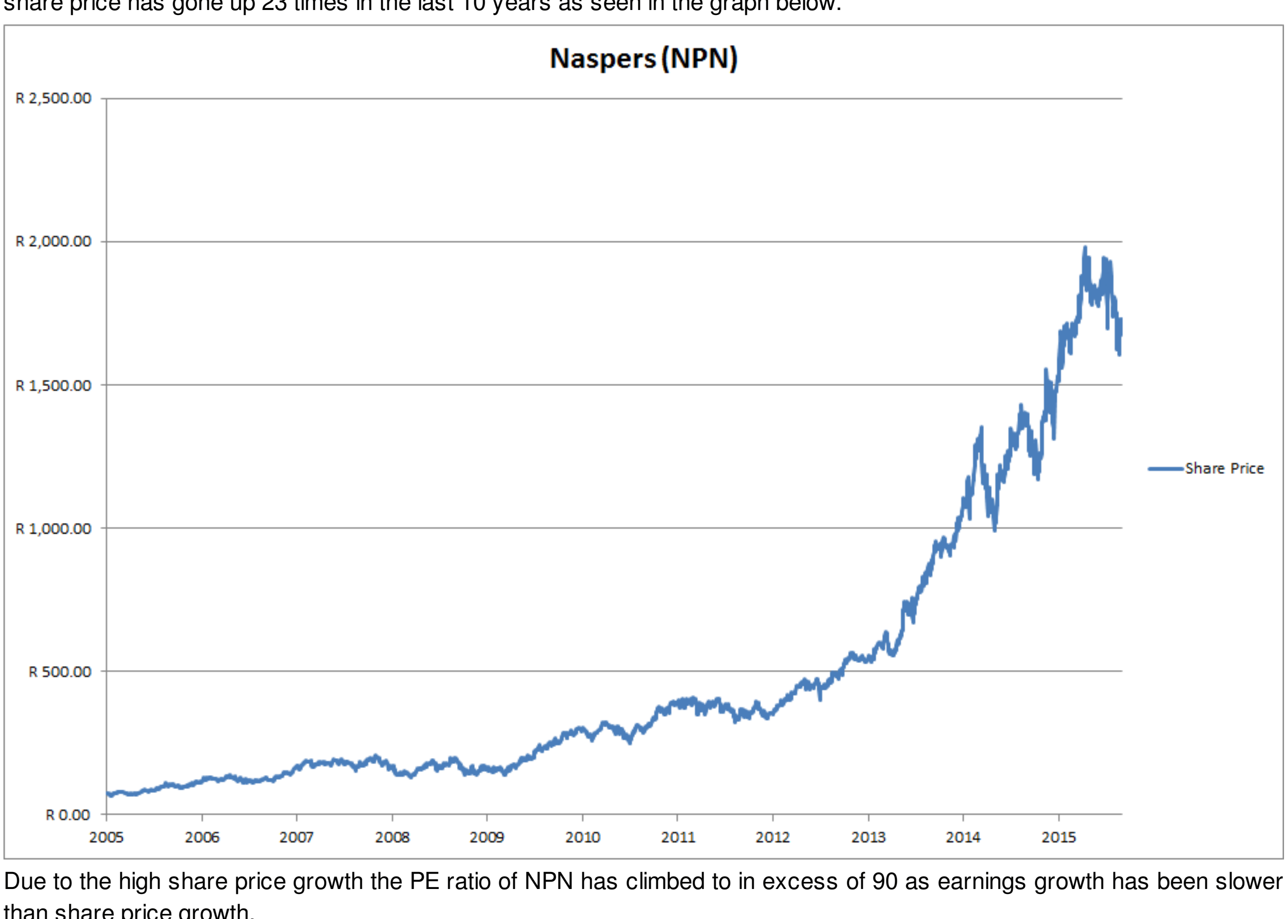
If one looks at the PE graph for SAB below one can see that it has always traded at a premium. Average PE’s are generally between 12 and 15 whilst SAB consistently trades at a PE above 25.



Momentum Investing

The momentum investor is the complete opposite of the contrarian investor. The momentum investor will look at the top performing shares and invest in those shares. They believe that market sentiment is the biggest factor in future performance.

The local share that has shown the biggest momentum over the last few years is Naspers (NPN). A large portion of NPN’s earnings is derived from an internet gaming company that is part of the ever increasing social media phenomenon. Investors in NPN believe that the internet will continue to have more innovation and penetration of untapped markets. The share price has gone up 23 times in the last 10 years as seen in the graph below.



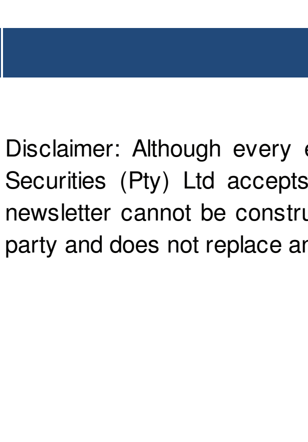
Due to the high share price growth the PE ratio of NPN has climbed to in excess of 90 as earnings growth has been slower than share price growth.

Conclusion

There are a number of different investment strategies and the asset managers perform differently in the various investment cycles. There isn’t a right or wrong investment strategy as it is more important to invest in companies that are going to give you long term returns, whether it is the quality share like SAB or a current underperformer such as AGL. The top asset managers seem to have a higher percentage of correct stock picking calls no matter which strategy they adopt.

At Magwitch we like to blend asset managers that have different investment strategies to remove some of the volatility in the investment return. We generally pair asset managers that have a lower correlation to one another. This should help smooth out the returns for our clients making the investment experience to be a lot less stressful. A well-diversified portfolio often eliminates the effects of any underperformance of one specific investment strategy. If you would like to know what investment strategy a particular asset manager favours Magwitch would be very happy to assist.

ABOUT MAGWITCH



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