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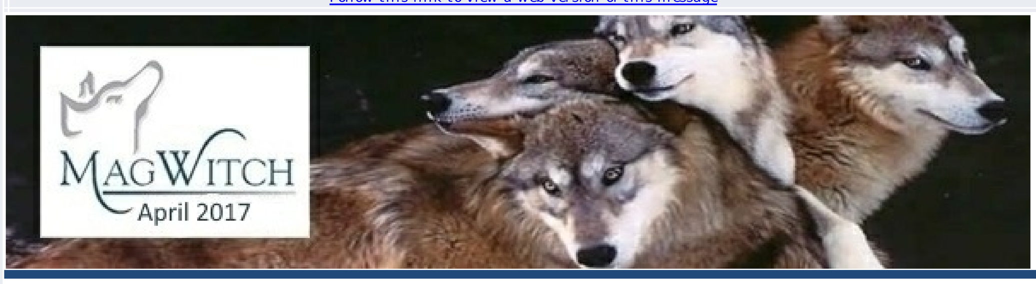


Dear

The ratings downgrade that everyone was eager to try avoid finally happened in April 2017. The cabinet reshuffle that happened on the 31st March was not an April Fool's joke but rather the straw that broke the camel's back as two of the three large rating agencies, S&P and Fitch, downgraded South Africa's sovereign credit rating to junk status. Unfortunately at this stage it is not apparent whether the political leaders wish to acknowledge the long term implications of the downgrade. The move to junk status is moving the country ever closer to an economic crisis which will be detrimental to all citizens, whether rich or poor.

In order to compensate lenders for the "increased" credit risk the lenders will require a higher interest return when South Africa borrows funds. This increased cost of borrowing for South Africa is going to put additional strain on an already stretched budget. Debt servicing costs are already the single biggest expenditure item in the South African budget and this cost would increase dramatically from the existing R169 billion per year level. South Africa currently owes R2.2 trillion to lenders which is just over half the annual GDP of the country.

The ratings downgrade weighed negatively on the currency during the first half of the month as the Rand continued to weaken. This changed halfway through the month when emerging market risk appetite improved and investors starting to move investments back into the Rand and Rand denominated assets. The currency remains volatile and although buoyant in the short term one needs to remember the longer term implications of the ratings downgrade.

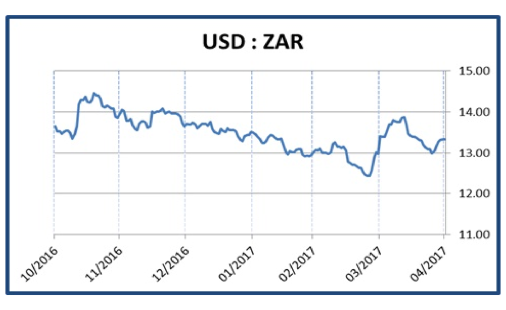
The stock market benefited from the currency movements and the large multinational industrials and Rand hedges benefited from the weakening Rand. The largest share on the JSE, Naspers representing 16% of the JSE, finished the month at a record high, boosting the overall return of the market due to its large representation in all indices.

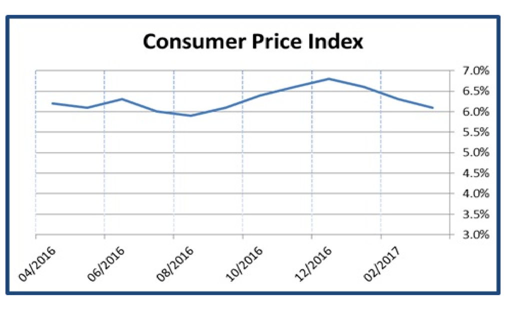
Inflation improved slightly to 6.1% year on year. A lower oil price and stronger pre-reshuffle Rand led to a fuel price drop during the month which benefited consumers across the board. The forecast for inflation remains benign with inflation expected to drop back within the target band within the next few months. Continued improvement will be dependent on Rand strength and given the negatives in place over the longer term this does not look great.

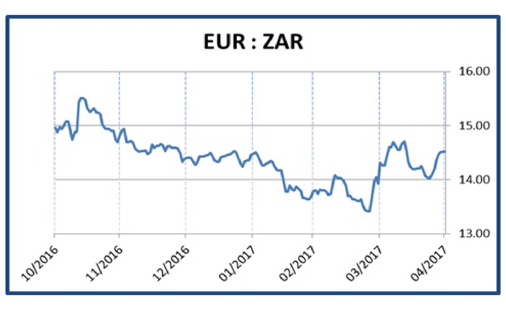
The biggest positive in the month was the ruling by the Western Cape High Court that the proposed nuclear deal was both unlawful and unconstitutional. We were very concerned that an unaffordable nuclear deal would be pushed through by the government, even though it isn't needed and would only be implemented to benefit those individuals directly involved in the deal. It would have no benefit to users of electricity as there is currently sufficient capacity and it wouldn't benefit the taxpayers who would be left to fit the bill over a number of generations. Whilst the ruling doesn't mean that we won't be going nuclear it does mean that more public participation will be required for any deal to be signed off.

Magwitch Securities

MARKET INFORMATION







FINANCIAL VIEW

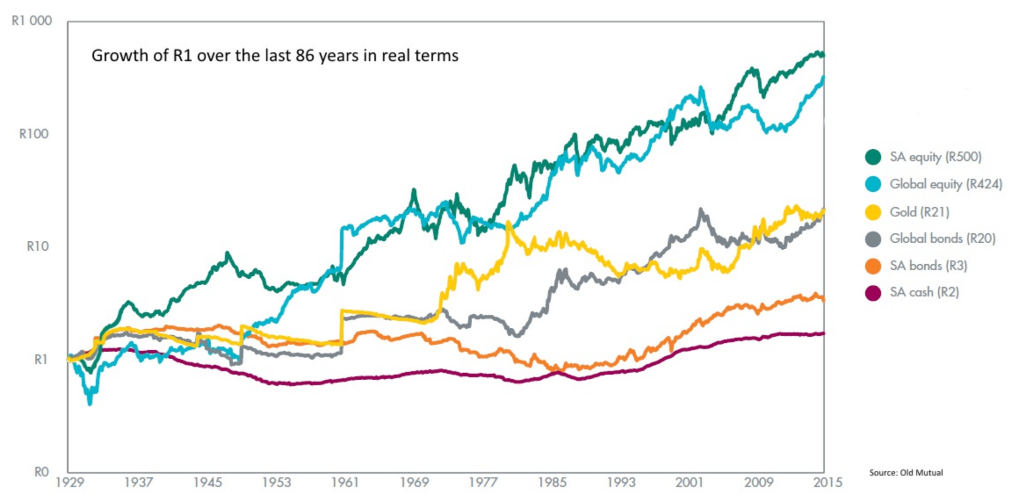
<u>THE VOLATILITY OF STOCK MARKET RETURNS</u>

This month marks twenty-four months since our stock market, the JSE, reached its record high. On the 24th April 2015 the JSE All Share Index reached its all-time high of 55 355 points. In the subsequent twenty-four months we haven't come close to matching those levels resulting in equities delivering the lowest returns as an asset class over this period. In our financial view this month we demonstrate why equities remain the preferred investment choice even though they carry greater risk and volatility.

The Argument for Equities

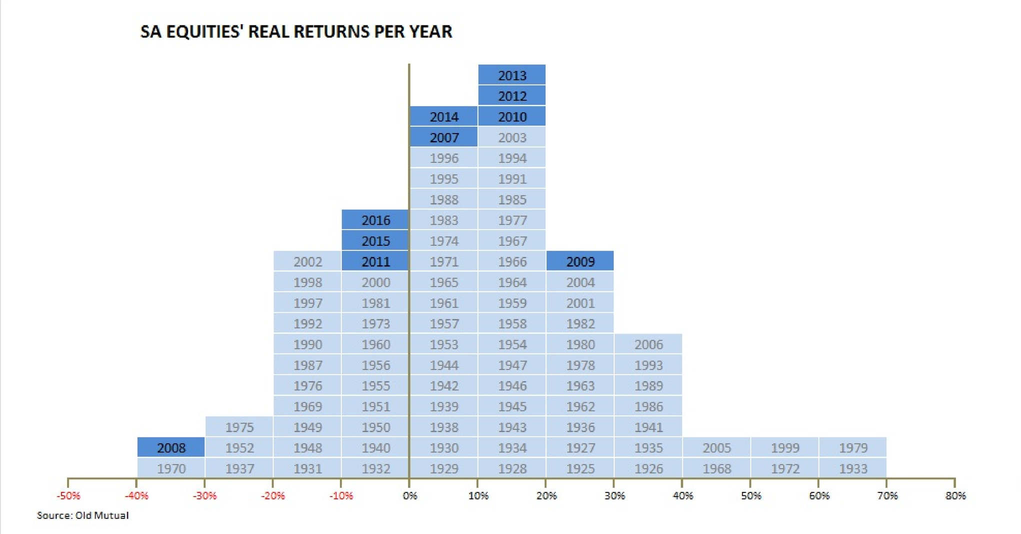
When investing in equities on the JSE you are buying a shareholding in a listed company. You are therefore as a shareholder an owner of the company, benefiting both from any dividend declarations and long term growth in the share price of the company. Equities are often the best protection against inflation as a company will need to make a profit and move up their selling price of their products when faced with increasing costs. This means that their earnings should go up, in turn pushing their share price up.

This can be demonstrated with the following graphic. It removes the effect of inflation by looking at the compounded real return of different asset classes over the long term and shows real returns earned on each asset class since 1929.



If one had invested in cash over the full 86 year period your purchasing power would have only doubled. For many years, especially after the Second World War the return on a cash investment was lower than inflation and thus holding money in your bank resulted in you getting poorer. The benefit of investing in cash though is that the line is smooth as it has no volatility. Alternatively an investment in equities would have increased your purchasing power by 500 times, demonstrating that over the longer term shares are the best protection against inflation. The downside is that the green line is a lot more volatile than the other asset classes.

In one had to summarise the returns utilised in the above chart on an annual basis you will see that equity investments on an annual basis will produce a real return and outperform inflation 2/3rds of the time.



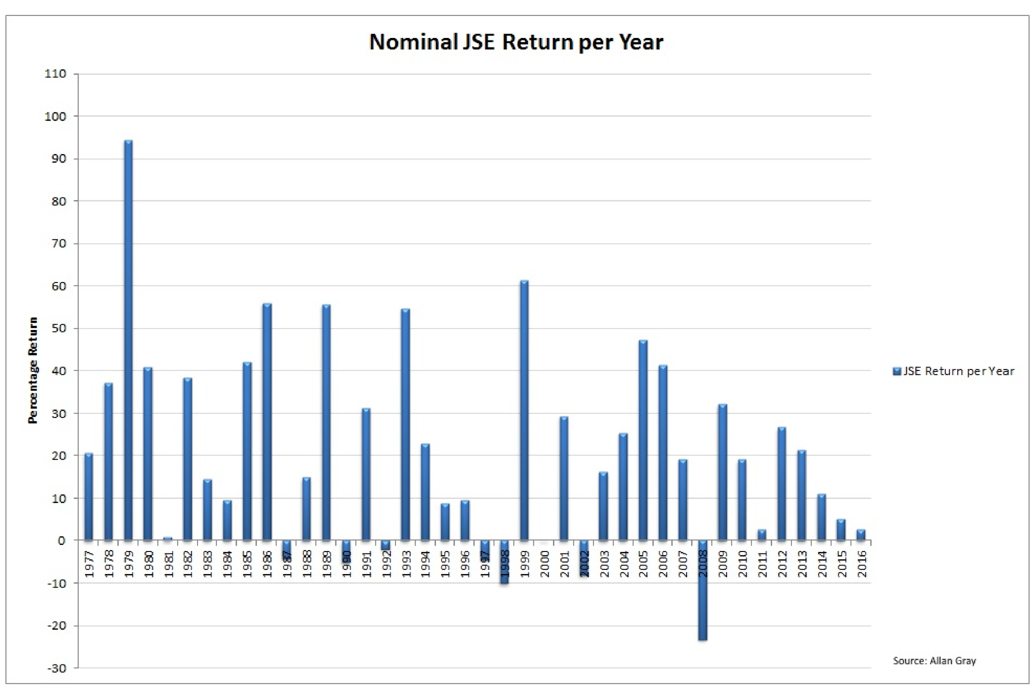
The Volatility of Equity Returns

The most widespread measure of risk in investing is to look at certain volatility ratios. Therefore in the investing world volatility means risk and we know that risk is required to generate a higher return. It therefore is logical that equities being the highest returning asset class would also come with the highest volatility.

This volatility is driven by two large factors. The first is a logical factor and is determined by the fortunes of the company that you are invested in. If they increase their earnings they should be able to increase dividend payouts and their share price should also increase. The converse would also apply if they went through tough periods due to economic cycles, competition or product/service deficiencies.

The second factor creating volatility in equity returns is anything but logical but an emotional factor. Market sentiment is the biggest contributor to market volatility. Investors tend to behave like sheep and trade in a herd, hence the saying - "the trend is your friend". When prices are moving up everyone tries to get a stake, forcing the price even higher. Often the sentiment is that the investment is a one way bet and it cannot fail. Investors appear to believe that the prices will rise forever, without looking back at history and acknowledging that the market overall tends to revert back to its long term averages or the mean.

A graph of the JSE performance over the last 40 years demonstrates this volatility via the plotting of returns achieved each year.



You will notice that there isn't any clear pattern in the annual returns. A poor year may be followed by another poor year and a good year such as 1999 may happen in isolation (the Dot Com boom and subsequent crash). The large loss in 2008 was as a result of the Global Financial Crisis, the second worst market crash worldwide and the worst market crash in South Africa's history.

Over the last 40 years only 7 were negative (18%) however 15 years delivered returns that were either negative or single digit returns (38%). It is the balance of the years, or the majority, which ensure that the stock market has a long term average return in excess of 15% per annum.

The biggest mistake investors make is jumping out of the stock market after a poor year, only to miss out in the good years that may follow. The average return of the five years after the Global Financial Crisis was significantly higher than the long term average return.

Conclusion

Any long term investor needs an appropriate exposure to equities to deliver long term wealth. One however has to accept that these investments do come with a high degree of volatility. If you have any investment in listed shares you need to understand the risks that come with that investment and always remember why you entered into the investment. Short term volatility shouldn't impact your long term investment strategies.

You may reduce the volatility by spreading your investment over different asset classes – diversification. A good rule of thumb that we use when investing is to limit your exposure to equities on the following basis. We take your age off 100 and that would give an indication of maximum exposure to equity and risk appetite. If you were 60 you should have around 40% exposure to equities (100 – 60).

ABOUT MAGWITCH

Magwitch Securities is a Financial Services Broker offering the following products as a comprehensive financial solution to both individuals and businesses:

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- Risk Benefits
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- Retirement Planning
- Investment Planning
- Estate Planning
- Foreign Exchange
- Money Market
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