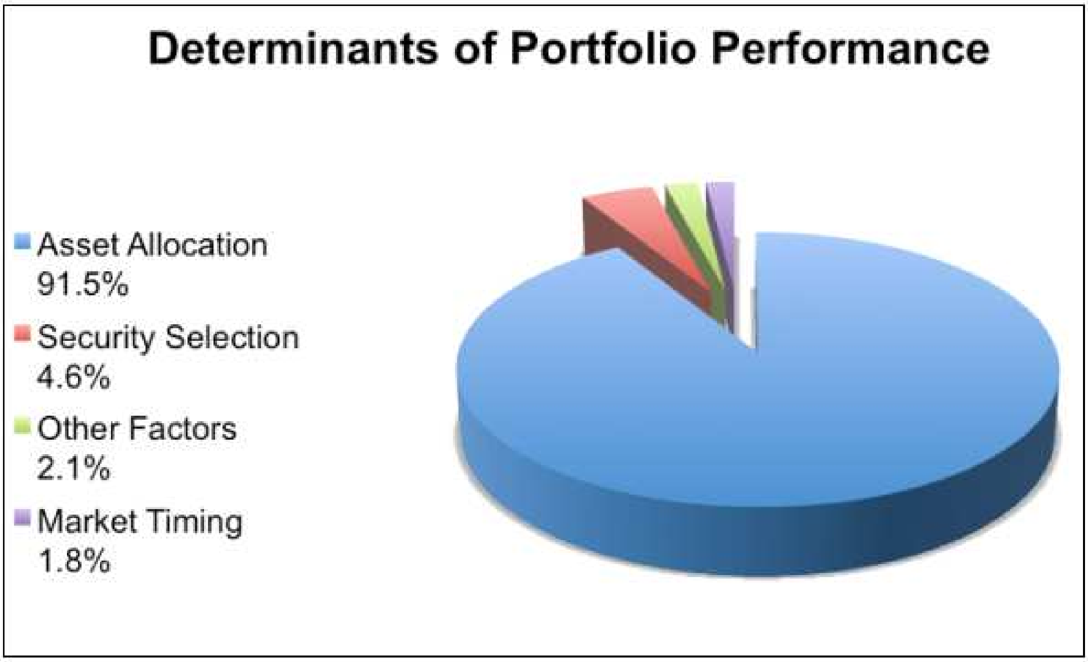
Our approach to investing

We believe that one of the most important decisions an investor makes is how to allocate funds between the various asset classes. In the USA a company called Ibbotson & Associates has done extensive research into the performance of various investments. According to their research as much as 90% of the difference in performance of various portfolios is determined by the way assets are allocated. This is more important than market timing and security selection.

The accompanying pie chart shows the importance of asset allocation to the variance of a portfolio's performance over time.



Source "Determinants of Portfolio Performance 11: An update by Gary P Brinson, Brian D Singer and Gilbert L Beebower. Financial Analysts Journal May – June 1991."

Research done since then confirms their findings. The initial decision an investor takes on how to divide their investments between the various asset classes is one of the most important decision that is taken.

Asset allocation, of course, can also help to spread risk and reduce risk.

While these studies relate to the USA they make sense as far as South Africa is concerned. Being in the right asset class is more important than trying to get above average returns in a poor asset class.

Long-term performance of South African assets:

The table below shows the average return on South African investments since 1900.

	Performance of South African Investments since 1900				
Asset Class	Average annual return Nominal	Real	Best annual return	Worst annual return	Standard deviation
Equities	12.7	7.4	107.7	-29.6	22.6
Bonds	7.1	1.8	46.6	-10.7	10.4
Cash	6.3	1.0	21.8	0.00	6.2
Inflation	5.3		47.5	-17.2	5.0

While the past is no guarantee of how the future will look, it does at least give us a basis from which to discuss investments. Not only does the table show the average annual return and best annual returns, it also shows the riskiness of each asset class. Risk is normally measured by the standard deviation of the asset class. (The higher the standard deviation, the riskier the class)

You will see from the table that equities have given you a real return of 7.4% per annum. In the past, bonds have given a real return of 1.8% per annum. In the future we would anticipate that bonds will offer a real return of between 2.0 to 2.5% per annum, which is better than the historical real return rate of 1.8% per annum. Cash will normally only pay 1% above inflation, and we would expect this to continue into the future.

How should you spread your investments?

If you look at equities, for example, the annual pre-tax return has averaged 12.7% per annum since 1900. The standard deviation was 22.6. This means that in 2 out of 3 years you could have expected a return of between –9.9% (12.7 and –22.6) or 35.3% (12.7 and 22.6)

Obviously, past patterns may not be carried into the future. Also note that annual equity returns can vary substantially year by year and can also be negative.

If your investment objective is to beat inflation, you should put some of your money into equities. Traditionally, this has provided both capital and income growth. In view of their superior historical performance, it may well be asked, why invest in anything other than equities? If you are taking a long-term view and have a great appetite for risk, this might be the correct strategy.

However, different asset classes perform differently at different phases of the economic cycle.

There are, for example, instances where bonds have outperformed equities. This has occurred fairly frequently in the past.

In recent years, for example, listed property has performed very well. However, the income is taxable and this reduces the after tax return to the individual who is at the top marginal tax rate. Despite tax, both of these investments would have done well even in after tax terms.

The table below which shows the performance of asset classes over the past 28 years suggests that rather than putting all your money into a single asset class, it would be better to spread your money across different asset classes. These returns apply to someone investing in South African rand.

Asset Class	Number of times asset class was the best performer	Number of times asset class was the worst performer
South African Bonds	5	4
South African Cash	0	2
South African Equities	7	8
South African Listed Property	8	2
Global Equities	4	4
Global Bonds	1	3
Global Cash	4	5

Equities

In view of their superior historical performance, a portion of your money should be invested in equities. One can either do this by buying a selection of unit trusts or by investing directly on the Johannesburg Stock Exchange.

Jeremy Siegel shows a very interesting table, based on his study of historical data in the U.S.A.

We have reproduced this table below. His study suggests that a person should invest in shares in the following percentages to get the best returns for the least risk.

Risk Tolerance	1 Year	5 Years	10 Years
Ultra-conservative (Minimum risk)	7.0%	25.0%	40.6%
Conservative	25.0%	42.4%	61.3%
Moderate	50.0%	62.7%	86.0%
Risk-taking	75.0%	77.0%	104.3%

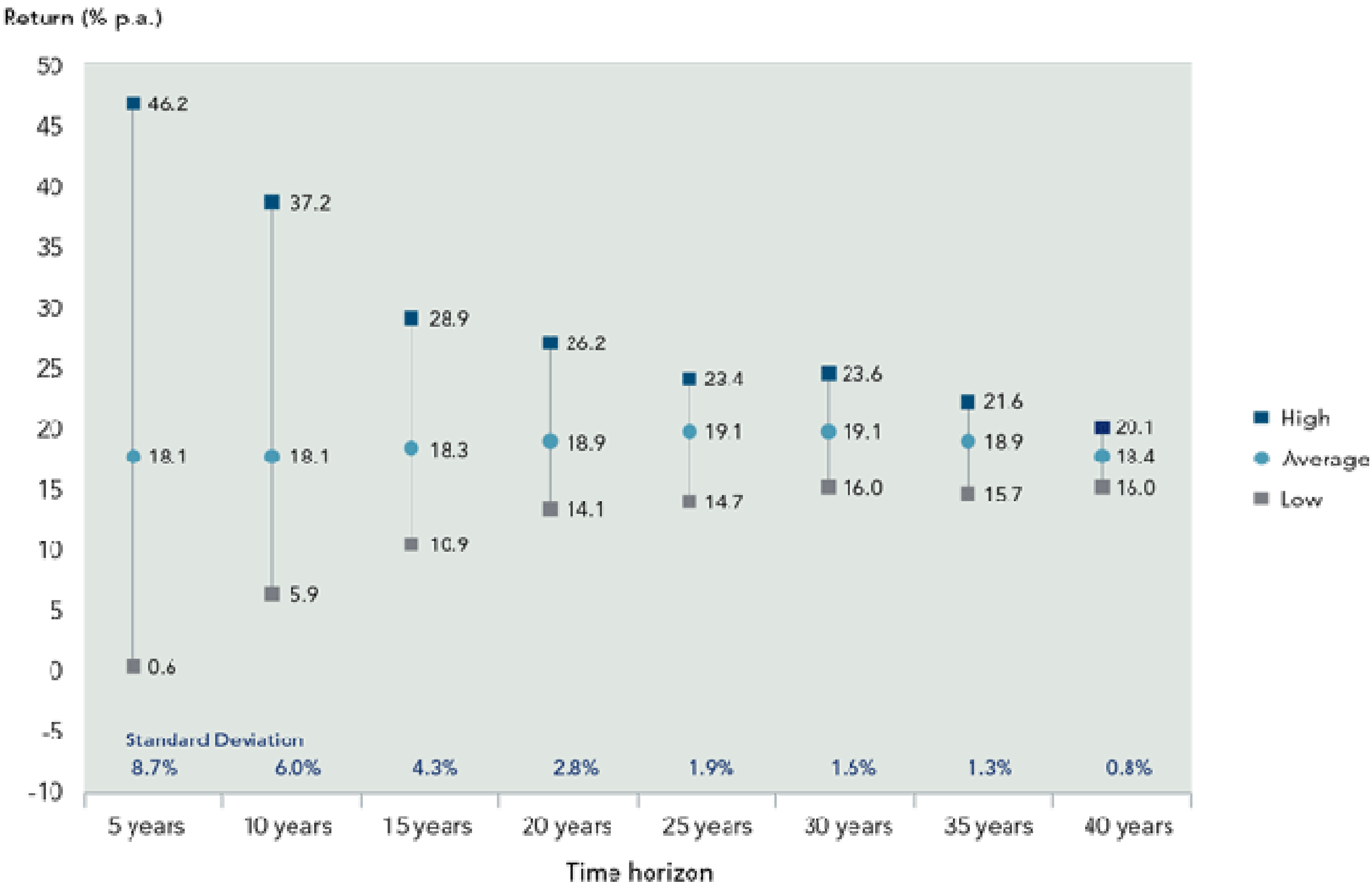
At IMS we would not recommend that any of our clients should borrow to invest in equities. We would also be nervous of someone investing more than 75% of his or her portfolio in equities in a retirement investment.

What we believe is the longer the period you are investing for, the more equity you should hold in your portfolio. You should however consider your ability to tolerate fluctuating returns. This we do by asking you to complete a risk analysis questionnaire.

Time diversification of risk

Franco Busetti in his book "The Effective Investor" pointed out that the risk of holding growth assets decreases as an investors holding time increases.

Coronation using this figure as a base brought the graph he used up to date.



Source: Busetti (The Effective Investor, 2009) with additional calculations by Coronation

This graph shows how returns can vary substantially over shorter holding periods. However, as the holding period increase, the range of returns narrows.

In 2016, a poor year for South African equities, only 23.99% of South African domiciled unit trusts, excluding money market funds, had inflation beating returns.

Over 10 years the percentage rises to 92.78%

If one looks at South African multi asset funds with a high equity content, only 10 of the 157 funds beat inflation, i.e. 6,37%.

Overseas Investments
The question is should you consider investing overseas? We would say yes.

The rationale is very simple, and is applicable to any investor anywhere in the world. As you diversify your investments, you reduce your risk.

By investing overseas you may be able to earn the same return as you would domestically, for less risk. Alternatively, for the same level of risk you could earn more.

We would suggest that most people should consider holding some of their assets in non-rand investments, as part of a long term investment strategy.

Property
As far as property is concerned, your choice lies between a direct investment into property or via property trusts or property syndications. We would normally suggest that one invests a portion of ones money into property. At the moment real estate investment trusts are quoted on the Johannesburg Stock Exchange and they are showing yields that compare favorably with what is available on bonds and which provide the possibility of income growth as rentals increase.

We do not expect listed property to continue their out- performance of recent years. For many years yields on listed property were extremely attractive. As interest rates declined, people realized that this sector offered very good yields and some possibility of income growth. As a result, prices went up.

We think one should view property trusts as an alternative investment to bonds for income purposes. In addition, they may produce moderate-income growth which is very useful if you are retired.

Bonds
For many years ordinary individual investors tended to spurn bonds. The reason for this was twofold. Firstly, the interest paid out on a bond is fully taxable. Only the first R23 800 of all interest is tax-free. This figure increases to R34 500 if you are over 65. As we have already pointed out, tax affects returns.

The after tax return, if the investment had been made in a retirement fund instrument, would have been higher as these funds are now not taxed on interest income. Generally, it would be better to hold taxable investments in a retirement funding vehicle rather than in a voluntary investment.

Another reason why investors ignored bonds was the easy monetary policy adopted by the financial authorities in the past. For a long time interest rates were kept deliberately low. Often the return on bonds was less than the inflation rate. In recent years, however, the monetary authorities have followed a policy of real interest rates, i.e. bonds have paid interest in excess of the inflation rate. This has changed the outlook for bond investments.

It must also be noted that bonds are less volatile than equities and give an investment portfolio greater stability. Although bonds can be bought directly, we would advise you to purchase units in a bond or income fund. This allows you to spread your risk. For example, the funds will hold bonds with different maturity dates. This lessens your risk to changes in interest rates.

Remember that if interest rates rise, the capital value of a bond declines; if the rates decrease the capital value of the bond increases. The decline or rise would depend on the extent of the change in the interest rates and the number of years the bond must continue before it matures.

We would recommend that we also look at investments, which are indexed to inflation, to protect you against a possible rise in inflation rates.

We would suggest that a portion of your funds be invested in bonds, call and money market instruments.

Emergency reserves
One should hold some money on call as an emergency nest egg. Some people suggest one should keep six month's income available for an emergency. We think this is good advice. A money market account is a good vehicle for this.

We would suggest your emergency reserves are held in your individual capacity and not in a provident or pension fund.

Style allocation
We suggest that you spread your equity investments between different investment styles. We suggest that you do so because at times different investment styles will perform differently. This is true for all markets.

In the United States for example, value shares have underperformed for 10 years. The longest period of underperformance recorded since 1925.
South Africa followed a similar pattern.

This outperformance of a particular style can last for a number of years. Unfortunately when market sentiment changes it often does so quickly. In South Africa it changed in 2016 and some value managers showed exceptional returns.

Research done in the U.S.A suggests that investors consistently underrate value and small capitalization shares and overrate the anticipated performance of growth shares. In the case of value shares this can lead to a difference of 2% per annum in returns. We believe that this phenomenon also occurs in SA.

Small company shares in the U.S.A have historically given an excess return of 4% per annum. However, that excess return occurred over one specific period. For long stretches of time, small company shares underperformed the market.

One of the unique features of the South African market is the importance of the resources sector. To this extent our market is more similar to the Canadian and Australian markets than to the U.S.A market shares. South African equity managers are normally underweight in resource shares and overweight in industrial and financial shares, which explains why the general equity funds are often poor trackers of the JSE.

Timing or rebalancing
We do not believe in trying to time markets. Since 1926 U.S. equities have given real return of over 6% per annum. Over that period if you had been out of the market for 60 of those months, i.e. about 7% of the time, your nominal return would be zero and in real terms you would have lost money.

Why?

As humans we are programmed to vacillate between over optimism and excess pessimism. When the Rand plummets, we rush to invest overseas.

When the Rand doubles in value no one wants to invest overseas, even though the market is 50% cheaper than it was when everyone was rushing to get out of Rands.

We need a system, which forces us to sell high and buy low.

While we do not believe in market timing we do believe in the rebalancing of assets to fit the clients risk profile.

We use the following principle. If a major asset category has increased by more than 5% i.e. equities move from 60% of your assets to 70%, one must reduce the percentage allocated to the asset class to at least 65% and preferably back to 60%. If the weight of a minor asset i.e. specialist equity increases by more than 25%, i.e. specialist equity goes from 5% to 10% of the portfolio, we reduce it back to a minimum of 6.25% and preferably back to 5%.

Expected Return

There are no guarantees. We cannot tell you what the market will do over the next year or two. This is like forecasting the weather. We can tell you what the long-term returns are likely to be for various asset classes. This is like telling you that the climate in Gauteng is generally warm in December and cold in July and that on average we have x number of rainy days and y number of sunny days.

We could, over a 10 to 20 year period expect a real return of 6% from equities. In no one year is it likely to be 6% and in some years it will be negative.

We anticipate a real return of 2.5% from bonds because we can buy a government backed inflation linked bond that will guarantee that rate real return of approximately 2.0% with no risk.

We would expect a real return from property similar to that for equities. Since property today gives a lower income return than bonds, we are anticipating a real capital growth of 3% to 6% per annum. Like equities it will fluctuate.

We would therefore expect the following real return over the next 10 years.

Equities	60% X 6%	3.60
Bonds/Income	30% X 2.5%	0.75
Property	10% X 6%	0.60
Total Return		**4.95**

If inflation varies between 4% to 6% we would anticipate a nominal return of between 9% to 11% per annum.
We prefer to work on real returns from capital rather than on cash flow models as a small change in assumptions or conditions can have a dramatic impact on the end results. Just think of those insurance quotations, which projected a return of 15% per annum. We also prefer to work with after inflation returns rather than nominal returns.

Withdrawal Rates

One of the most critical decisions an investor who is retiring takes is the rate at which capital is withdrawn. A critical question is how long will my retirement money last?

The answer depends upon four factors:

- withdrawal rate
- asset allocation
- return on investments
- costs

ASISA gives a table which one can use as a general guide when you select a withdrawal rate. However, one needs to take into account your own unique individual requirements.

Years before your income will start to reduce

		Investment return per annum (before inflation and after all fees)				
		2.50%	5.00%	7.50%	10.00%	12.50%
Annual income rates selected at inception	2.50%	21	30	50+	50+	50+
	5.00%	11	14	19	33	50+
	7.50%	6	8	10	13	22
	10.00%	4	5	6	7	9
	12.50%	2	3	3	4	5
	15.00%	1	1	2	2	2
	17.50%	1	1	1	1	1

Source: ASISA Standard on Living Annuities

A number of points need to be made:

- the lower the withdrawal rate, the longer the capital will last
- the later you retire the greater the likelihood that you will not run out of money
- over the longer term you need to invest a significant portion of your money in growth investments like equity.

What IMScc will do for you

We believe that the investment approach we have suggested above will allocate your assets among different asset classes, investment styles and geographical regions in way that will enable you to achieve your financial goals at a level of risk you are comfortable with. In addition, this investment plan will also take into consideration the implications of tax, estate duty and your income requirements.

We will monitor the agreed plan and if necessary recommend changes so that your objectives continue to be met. We will report back to you at regular intervals to ensure that you are sleeping well at night with IMS at the helm.

Being a client of IMS gives you access to an investment philosophy that allows you to sleep well at night. This philosophy is garnered from a close relationship with us, which keeps you informed at every turn. We believe in content-rich, honest and frequent communication. Making use of the wide range of experience offered by our practice, your experience will be a unique one. Our knowledge is your advantage.