RESEARCH-DRIVEN | LONG-TERM FOCUSED

Northstar Asset Management Market Report: Q2 2017

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In addition to our usual range of interesting articles, this quarter we are really pleased to introduce John Steenhuisen as the writer of "Chatter in the corridors", which will provide useful and very practical insights into the future of South Africa and the direct impact thereof on the man on the street.

THE BIG PICTURE

IS SA'S POOR ECONOMIC GROWTH THE DEATH KNELL FOR YOUR LOCAL INVESTMENTS?

By Adrian Clayton

2017 the year of the worrywart:

2017 probably ranks as the most pessimistic year I have witnessed since 1995 in terms of investor sentiment towards South Africa. Reasons are plentiful and a succinct list would include socio-political instability, drought, violent crime, corruption and poor economic growth.

Economic growth and stock returns, are they married?

In this section we will explore whether economic growth is the key factor for generating sound investment returns from stocks over the long term. We then propose what investors really should be focusing on to ascertain whether South Africa is a sound investment destination.

Empirical evidence:

There is no better place to start than empirical data. A number of studies [JR Ritter (August 2012): 'Is Economic Growth Good for Investors?'] [MSCI (May 2016): 'Is there a link between GDP Growth and Equity Returns?'] have been conducted to establish whether countries with higher economic growth rates enjoy higher returns from their stock markets over the long term. The answer is no, they do not. In fact, studies dating back to 1900 show that developed countries with higher economic growth rates actually produced lower stock market returns. Investors would have been better off in 1900 buying into companies in developed countries with low GDP growth rates.

Similar academic analyses have been conducted on emerging markets since 1988 and the results are identical - the correlation between real returns on equities and the compound growth rate of real per capita GDP was minus 0.41.

GDP data per country—1997 to 2016

Country	Real GDP per capita growth	Real MSCI return (LC)	Real MSCI return (USD)	Correlation (GDP vs. market returns)
Australia	1.7%	7.4%	9.9%	-20.2%
Austria	1.0%	6.0%	6.4%	49.8%
Belgium	0.9%	4.9%	4.5%	37.3%
Canada	4.2%	7.1%	9.7%	65.6%
Denmark	0.9%	11.4%	11.0%	39.6%
Finland	1.4%	10.3%	8.0%	26.1%
France	0.9%	5.0%	3.8%	28.3%
Germany	2.4%	7.5%	5.2%	27.1%
Ireland	4.6%	1.3%	0.7%	39.8%
Italy	0.2%	-0.2%	-0.6%	-4.8%
Japan	-0.1%	5.9%	3.1%	37.0%
Netherlands	0.5%	4.3%	3.6%	-3.4%
New Zealand	1.7%	5.2%	9.0%	27.4%
Norway	2.5%	10.1%	11.2%	30.4%
Singapore	2.1%	10.0%	11.0%	57.6%
South Africa	2.7%	11.7%	12.2%	55.5%
Spain	1.3%	3.6%	3.9%	-3.2%
Sweden	0.7%	10.5%	10.2%	47.2%
Switzerland	1.0%	3.9%	3.8%	43.2%
United Kingdom	0.3%	3.8%	3.0%	14.0%
United States	1.1%	4.1%	4.1%	-2.7%
Average	**1.5%**	**6.4%**	**6.4%**	**28.2%**

Figure 1. Gross domestic product (GDP) by Country. Source : Bloomberg, Northstar

Particularly interesting is that South Africa had the lowest per capita GDP growth rate out of 21 countries surveyed from 1970 to 2011, yet the JSE was the 8th best performing market in US$ over the period.

Our own work using a data series from 1997 to 2016 (Figure 1, previous page) indicates that there is not necessarily a negative relationship between stock market returns and economic growth. In fact, the relationship appears almost non existent.

So why does economic growth not affect equities?

Well it does, in the short term that is! Where economic growth unexpectedly changes, stocks do respond but investors often overreact to the data and misprice equities. Economies self-correct and this usually occurs faster than anticipated - a current example being Russia (Russian crisis 2014 to 2017).

Why is the long-term relationship negative between real per capita GDP growth and stock returns?

Firstly, economic growth does not necessary always benefit shareholders to the same extent as it might labour and consumers. Fast growing economies are often characterised by poor capital allocation decisions where significant investment projects have delivered poor returns. Practical examples of this would be the ghost cities in China and the unoccupied office blocks in Dubai.

Secondly, investors tend to price in too much growth and good news upfront. China is again a prime example of an economy that has enjoyed prolific GDP growth, yet stock market returns have been dismal.

Thirdly, stock market returns are not a function of economy-wide earnings and are instead driven by per-share-earnings growth for listed companies. In most economies, the majority of companies are not listed.

Lastly, the structure of the economy might be distorted against shareholders, preventing them from being adequately rewarded. Typically, this is as a result of poor legal and institutional mechanisms creating a weak corporate governance environment. It could also occur due to government legislation redirecting profits towards stakeholders, other than shareholders, in the form of taxes and wages. So if economic growth is a less relevant predictor of stock market returns, what can be predictive?

Four factors are return predictors and must be assessed collectively:

Firstly, the normalised price earnings (P/E) of the market. The idea is to establish a P/E that adjusts for the cyclicality of economic activity. At times the price of stocks might appear low versus the earnings they are generating, but this could be as a result of booming short-term economic factors. In these instances markets seem cheaper than they really are.

Equally, the P/E might appear high, yet earnings are at a low point due to recessionary conditions. In this situation, the market appears expensive but is not. A simple normalised P/E tends to be an excellent predictor of future returns.

Secondly, predicting the fraction of corporate profits that are likely to be paid-out to shareholders in the form of dividends and share repurchases. The empirical data points clearly to the best returns coming from periods when markets offer high dividend yields and where these are sustainable.

Thirdly, that shareholder equity will be deployed into projects with meaningful returns above the cost of funding that capital. Market participants demand certainty that earnings reinvested by companies will be correctly managed by the custodians of their capital, namely the corporate managers of firms.

Lastly, that the distribution of the economic pie is not expected to be changed. To grasp the response from markets to economic redistributions, look no further than stocks in Argentina, Venezuela, Zimbabwe and mining shares in South Africa.

Conclusion

In conclusion, fretting over South Africa's current dismal growth is time wasted. Calculating and understanding cyclically adjusted stock ratings (P/E's and dividend yields) is energy better expended. By doing this work, we are identifying opportunities within the South African market. However, all the analysis in the world will help little if Government alters the split of economic profit away from shareholders.

FROM THE ANALYSTS: EQUITIES

ANHEUSER-BUSCH INBEV (AB INBEV) —THE CREATION OF A TRULY GLOBAL BREWER

By Lizé Coetzee

AB InBev - always the hunter:

AB InBev announced its intention to acquire SABMiller in September 2015. The combination of the world's two largest brewers did not come as a complete surprise, as there had been many failed bids over the past decade. After a year of facing legislative hurdles, commission inquiries and shareholder petitioning, the deal was approved for $104 billion (R1.5 trillion) in September 2016.

Deal value and Northstar research on SAB Miller:

SAB shareholders were given two options: 1) receive cash of £45 per share or 2) a combination of cash and unlisted shares that would not be tradeable for five years at an implied price of £49 per share.

At the time, our fundamental research determined that the combined entity should be worth €107 per share. AB InBev ticked all the right boxes in terms of our test of what constitutes an 'Advantaged Company' – passing our scoring on Management, Industry and Competitive positioning within its industry (Moat). Over the long term these types of companies tend to be creators of wealth for shareholders.

Although AB InBev was rated by Northstar as an 'Advantaged Company' at the time of the transaction, the share was trading at a 7% premium to our view of intrinsic value. This and the heightened deal risk, prompted us to elect for the cash offer rather than the shares, which had a lock-up period of five years. Our view was to bide our time and wait for an entry level more reflective of fair value. The capital gains implications of accepting cash or the new AB InBev shares were identical, capital gains tax being unavoidable.

Share price behaviour since the deal:

SAB Miller Shares were delisted from the London Stock Exchange and the JSE with effect from 30th September 2016. Subsequently the share price declined (see Figure 2), mainly due to concerns emanating from poor performance in Brazil on the back of political turbulence. This presented a buying opportunity at fair entry levels.

Moat – Size, scale advantage and brand portfolio:

The acquisition of SAB has entrenched AB InBev as a global brewing giant in an industry where scale advantage is a critical competitive advantage. AB InBev sells one in every three beer sold worldwide and is the unrivalled market leader in four of its geographies.

Of the top ten brands sold worldwide, AB InBev owns six including Budweiser and Corona. This illustrates the importance of branding and premiumisation strategies, which allow for higher product pricing.

Industry – consolidation allows for pricing power:

The industry has experienced a consolidation phase since the late 1980's with AB InBev (in its various forms) at the forefront of this, merging 18 different brewers to date. Today, the top four brewers control approximately 45% of global volumes (Figure 3, over the page). This creates high barriers to entry due to significant capital requirements, allows for pricing power over customers (retail and wholesalers) as well as bargaining power over suppliers (providers of inputs needed for the brewing process).

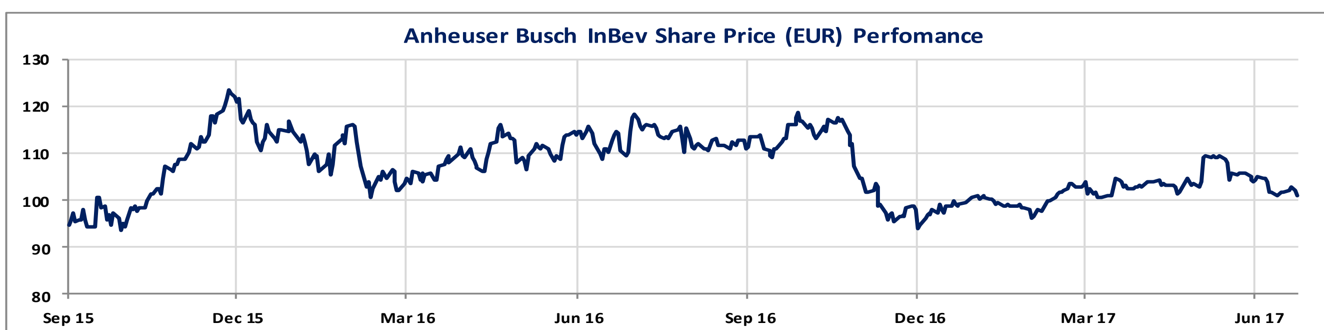

Figure 2. AbInBev share price history. Source : Bloomberg, Northstar

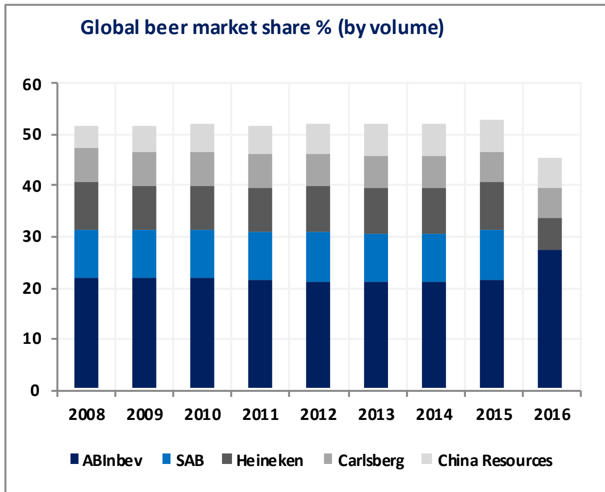

Figure 3. Global beer market. Source : Bloomberg, Northstar

Figure 4, below, illustrates that in comparison to its three main competitors, AB InBev generates lower revenue per unit due to the larger mix of developing markets in its revenue base. However, due to its integrated, efficient global operations, it manages to generate an operating profit margin nearly twice as much as Heineken.

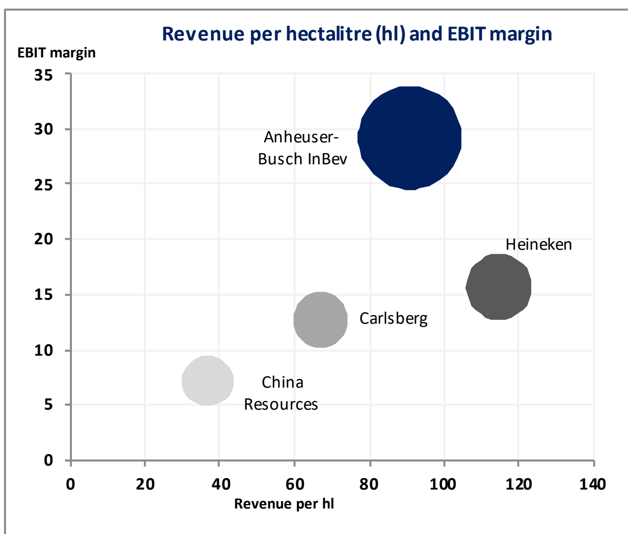

Figure 4. Revenue per hl and EBIT margin. Source : Bloomberg, Northstar

Industry - demographic and consumption patterns are favourable:

A large pull factor for AB InBev to acquire SAB is depicted in Figure 5. As GDP per capita increases from low levels, average beer consumption compounds at an increasing rate.

Prior to the acquisition, AB InBev's largest markets were North America, followed by Brazil and then Asia Pacific. With the addition of SAB, Anheuser gained access to Africa as well as additional emerging European countries, alleviating concerns of slowing growth in developed markets.

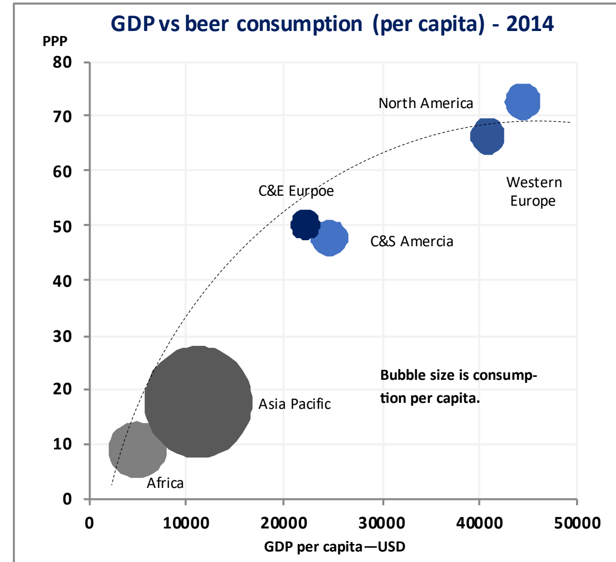

Figure 5. GDP based on purchasing power parity (PPP) per capita 2014. Source : Bloomberg, IMF, Northstar

Outstanding management team:

The management team has a deserved reputation for ruthless cost cutting, whilst at the same time increasing operational efficiency across multiple levels of its acquired businesses. These skills are integral in ensuring the stated SAB cost savings will be obtained while improving operational efficiencies.

Management have been able to extract between 14% and 21% of cost savings from the acquisitions of Modela and Anheuser-Busch. The original guidance for the SAB acquisition suggested that management will be able to extract 12% of additional savings from the combined entity.

Given their track record, we expected that this figure would be revised upwards as the integration process began. This expectation was proven correct when they increased the guided cost savings by $350 million (an extra 3%).

Conclusion – long-term wealth creation:

The decision to take the cash alternative for SAB shares was twofold: 1) we believed that the offer was quite full and 2) we felt that an opportunity to buy Anheuser shares in the open market at lower prices would materialise.

This approach proved accurate as we reinvested into Anheuser-Busch InBev at a price of €97 after having originally exited the SAB position at £45 (the commensurate Anheuser share price was €117 at the time) thus gaining 17% for our clients.

FROM THE ANALYSTS: EQUITIES

BIDVEST—UNEARTHED A JEWEL

By Andrew Randles

History:

Bidvest was a commonly owned counter across long-standing clients at Northstar, it was also owned within our collective investment schemes (unit trusts). We viewed it as a high quality business with exceptional management and we knew that the management team intended un-bundling the real jewel in the crown, the International Food Services Business.

Before the unbundling:

When we first looked at Bidvest the company was a multi-national conglomerate with approximately 42% of operating profit coming from their expanding global food services business and the remainder in a variety of businesses in South Africa and Namibia. 18 different business divisions constituted the original bundled Bidvest Group making it incredibly difficult for analysts to value and the default approach by the market was to simply apply a 'discount' to certain components of the firm. The Northstar research team valued the conglomerate business at R384 (April 2016) before the unbundling while the company was trading on the market at a price of R356.

Post the unbundling:

Bidvest announced a separate listing for their food services business in February 2016, following mooted discussions to list on the London Stock Exchange in 2012. The actual separation of the food business from the rest of the company took place on the 30th of May 2016. The result being two separately listed companies, one focused on food – BID Corp, the other an industrial conglomerate, retaining the name Bidvest. What follows are our in-depth views on these two underlying businesses and how we responded to the unbundling within our unit trusts – where we could transact freely without incurring undue tax events for our clients.

The food services Industry—BID Corp:

The food services industry has the following tailwinds - increasing consumer confidence, decreasing unemployment, increasing real GDP per capita and moderate inflation levels. In addition, the industry is enjoying a secular shift in convenience eating as opposed to cooking at home. Technavio (market research firm) predicts that the global food services market should grow by a 4% compound annualised growth rate through to 2020.

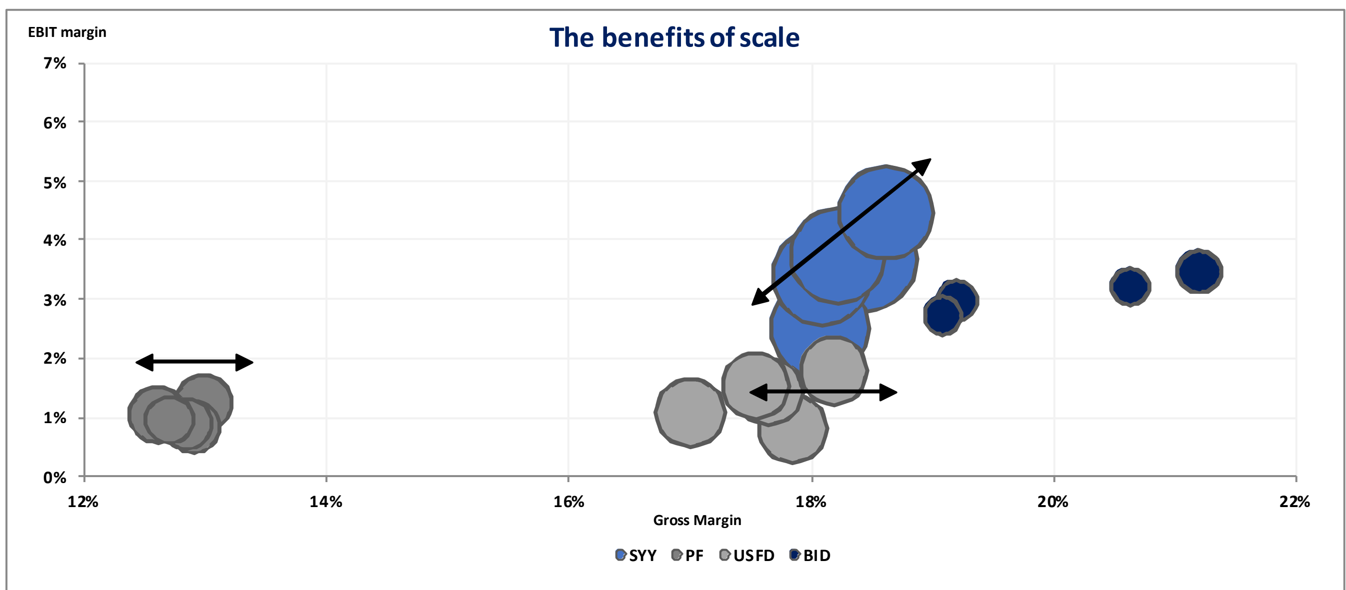

Figure 6, the benefits of scale. Source: Bloomberg, Northstar.

Globally there are many players within this highly fragmented industry, which at a first glance would lead to poor industry dynamics. What encourages us however is that this is an industry where scale is king and firms are consolidating. This should enhance margins for dominant players.

Figure 6 shows how the largest US food business, namely Sysco Corp (SYY), enjoys larger Gross and EBIT Margins than its main competitors. This is predominantly a function of its scale advantage. We have also included Bid Corp in the graph, its higher margins can be ascribed to scale within its specific markets. In addition, the geography in which it operates allows it to earn higher margins.

BID Corp's two-fold moat:

BID Corp operates market leading food service product distributors in the United Kingdom; the European Union, Saudi Arabia, the Middle-East, Australasia, China, SE Asia, Chile; Brazil and Southern Africa. BID Corp's operations generally occupy either first or second market share position in their geographies and capture approximately 33% of the global food services market.

Two moats have arisen, the first around scale advantage and the second based on the geography of their business activities. Scale benefits manifest in the form of more stops per truck route, increased bargaining power with suppliers and customers, and the benefits of a powerful distribution network.

Restaurants within the geographical moat serviced by BID Corp are fragmented and therefore require specialised services, which are at higher profit margins.

The industrial business – Bidvest:

Bidvest Industrial (now Bidvest) operates within the Southern African economy with large market shares across a number of industries in South Africa and Namibia. Divisions include: automotive, commercial products, electrical, freight, office and print, services and financial services.

The South African economy has been plagued by low growth and policy uncertainty leading to a number of divisions underperforming.

We estimate that this is a cyclical event, which will normalise. The Namibian fishing business and the office and print business are going through secular decline due to regulatory changes for fishing and a technology paradigm shift in terms of office and print.

Commercial Products Services and Financial Services are exhibiting moderate to high sales growth with resilient margins.

Bidvest's moat in South Africa:

Many of these businesses do not necessarily have an obvious competitive advantage being fairly commoditised in nature. However, strong market shares alongside a healthy balance sheet and strong cash generation affords the group the ability to acquire quality businesses at low valuations in a distressed environment.

A top-class management team:

The management team for the combined business was previously lead by Brian Joffe, the quintessential South African entrepreneur, who later took a Chairman role and has remained Chairman at BID Corp. Between the CEO of Bidvest, the CEO of BID Corp and Mr. Joffe there are 78 years of industry experience in the team, which has demonstrated exceptional capital allocation skills over time.

How we responded to the unbundling in our unit trusts?

At Northstar we spent time understanding the value of the individual businesses and settled on a sum-of-the-parts valuation as the most appropriate for the conglomerate. Bidvest was trading at R370 on May 27th of 2016. On the 30th of May 2016 and post unbundling BID Corp, Bidvest's share price opened at R118 and BID Corp opened at R304. This immediately unlocked R52 or 14% of value for shareholders and our clients.

A second opportunity followed where, post-unbundling, BID Corp traded significantly higher than our view of its intrinsic value, whilst Bidvest traded significantly lower than our calculated intrinsic value. As a result, we sold BID Corp and invested in Bidvest. Subsequently, BID Corp's share price fell from R304 to R232, whereas Bidvest rallied from R118 to R181. At the time of writing this article, BID Corp trades at a share price of R286 whereas Bidvest is priced at R156.

We believe this corporate event and our response thereto on behalf of our clients demonstrates the real benefits of our tireless and dedicated approach to proprietary research at Northstar Asset Management.

FROM THE ANALYSTS: FIXED INCOME

RATIONAL INVESTING IN THE SOUTH AFRICAN FIXED INCOME MARKET

By Mark Seymour

Focusing on the facts:

In our fixed income section we get to the crux of why rating agencies have downgraded South African debt. We then provide vivid proof of how these rating changes have, over a number of years, been priced into South African assets. We ask what the market is actually telling us about South African risk. Finally, we show how we are positioned within the Northstar Met Income Fund to maximise returns per unit of risk, taking South Africa's inherent threats and opportunities into account.

Why have our ratings changed negatively?

Ratings agencies monitor a slew of factors including fiscal policy, political stability, levels of public debt and economic growth. While fiscal policy adherence and political stability might be a matter of opinion, there is no disputing the hard debt and growth numbers.

In Figure 7 below we show South Africa's 5 year annualised nominal GDP growth and we compare this to South Africa's 5 year annualised total gross loan (debt) growth.

The following important deductions can be made from Figure 7:

- GDP growth has been declining since 2008.
- Loan growth declined from 1998 to a low point in 2008, since then it has risen prolifically.
- Since 2010 loan growth has exceeded GDP growth.

Per Figure 8 it is apparent that SA inflation has been well managed, but the trajectory of decreasing inflation from 1998 to 2007 reversed concurrently with weaker nominal GDP. This has resulted in real GDP in South Africa falling consistently to the point where the economy is presently experiencing negative real growth.

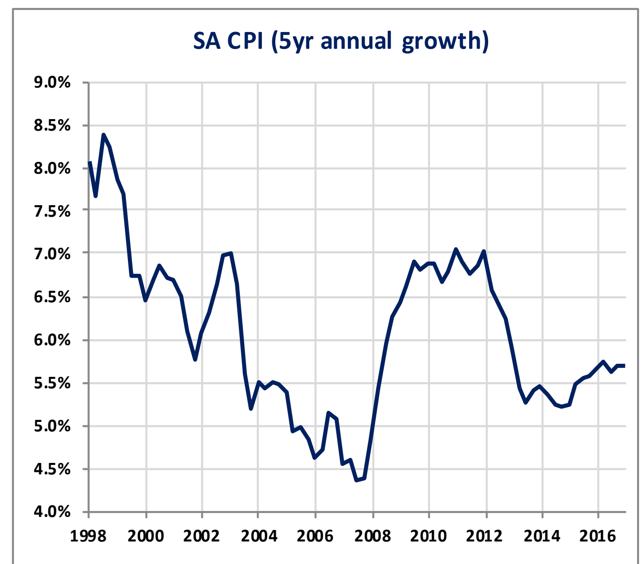

Figure 8, SA CPI 5yr ann. growth. Source: Bloomberg, Northstar.

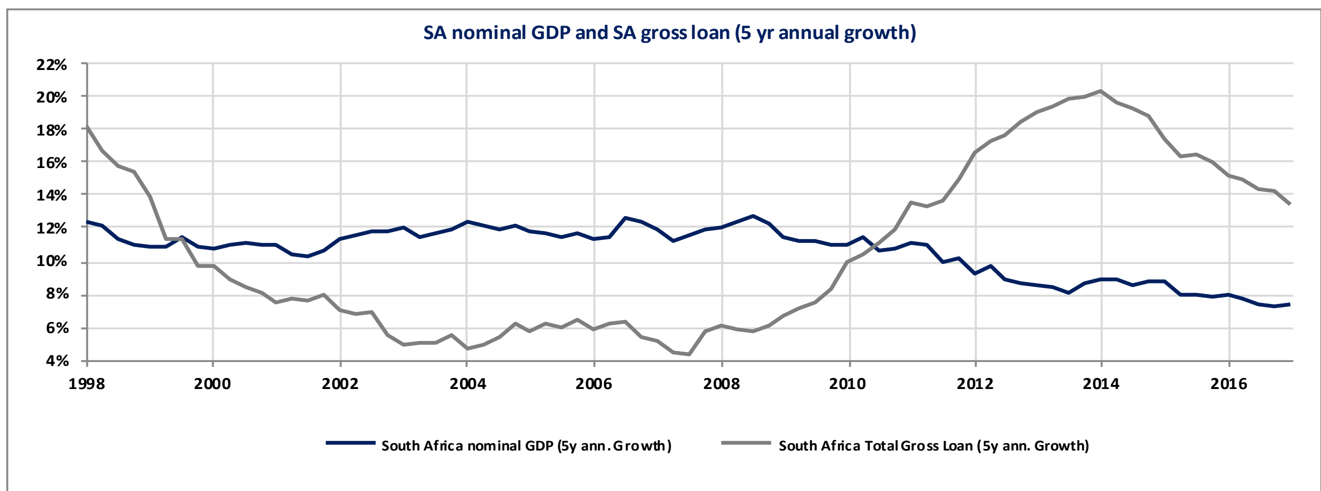

Figure 7, SA nominal GDP and gross loan. Source: Bloomberg, Northstar.

How asset prices have reflected rating downgrades:

What we show in Figure 9 (below) is that the yield on the 30 year South African Government Bond over time and we compare this to the ratings that the various agencies have applied to South African debt since September 2002. The ratings are inverted, so when they are dropping on the graph, it implies that SA's rating is improving, when they rise, the rating is worsening. The following important deductions can be made from the chart:

- Rating agencies improved SA's credit rating from 2002 to 2011 – the honeymoon period for SA.
- SA 30 year bond yields rallied from 2002 to 2008.
- In 2008 our bond market began to discount poor economic growth and higher inflation.
- In 2011, when rating agencies began the first downgrades of South African debt, local bond yields moved perfectly in sync, selling-off consistently with the downgrades.
- Yields have continued to reflect the downward trajectory of the rating agencies, with a neat fit.

What is the market actually telling us?

Yields and capital values are inversely related with respect to bonds. What this means is that higher yields imply lower prices and visa versa. With yields rising on SA long bonds, the market is re-pricing South African Government debt down and is in effect demanding a higher future return to compensate investors for South Africa risk.

We believe this is rational and the question is what level of return would adequately compensate investors in long-dated South African bonds?

In all our modeling our normal required return is 3% real, but historical analysis reveals that this required return escalates during periods of heightened uncertainty. Consequently, we are presently using 4% real as a required return for long-dated bonds.

We view the current situation as one where risk is elevated without clear answers on the outcome or duration of this risk. Risks include further downgrades and Government dishonoring fiscal targets.

What does this mean for our positioning in the Northstar Met Income Fund?

We have positioned the fund to perform, while avoiding undue risk.

The portfolio is neatly positioned with a modified duration of 1 and by incorporating high quality corporate debt, the gross yield on the fund is 8.7%. To attain a similar yield in SA Government bonds would require buying 10 year bonds, a risk we consider inappropriate.

Based on our view of domestic inflation, the 8.7% yield on offer in the fund will result in a 2% real return for our clients.

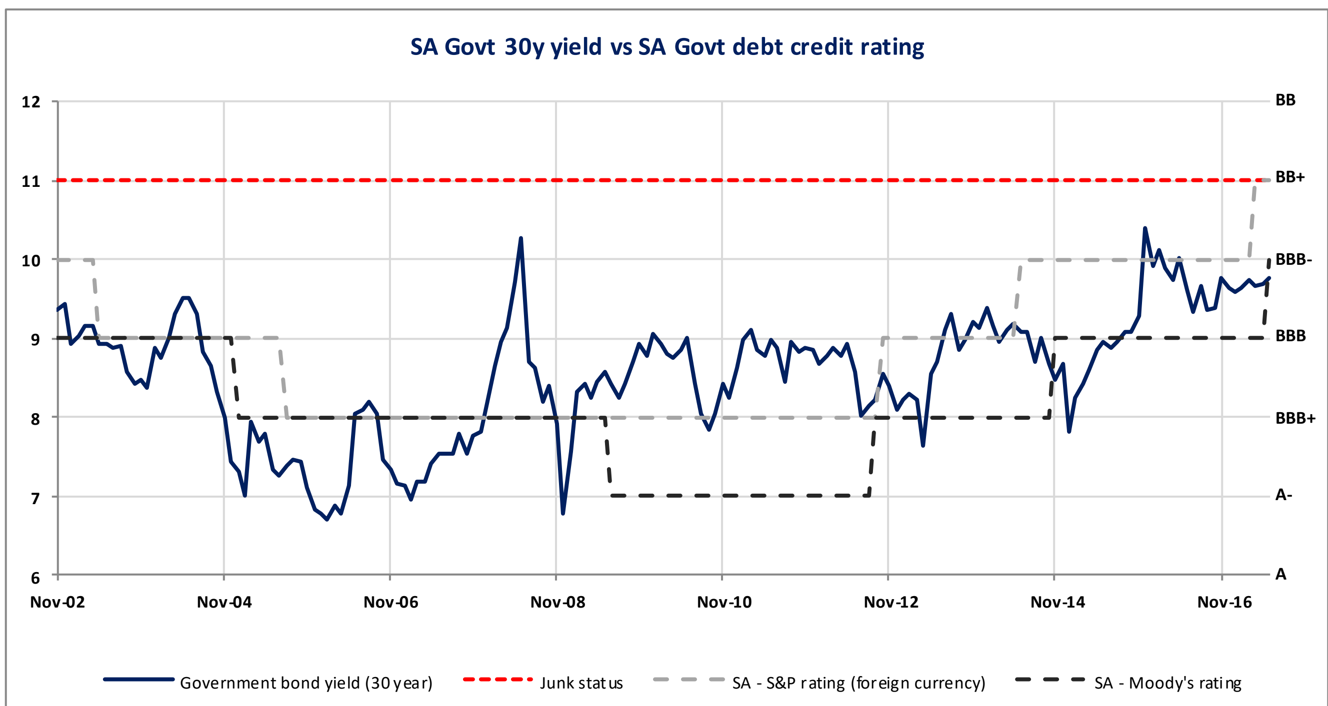

Figure 9, SA govt. 30yr yield vs debt rating. Source: Bloomberg, Northstar.

CLIENT CORNER AND NORTHSTAR NEWS

CORPORATE SOCIAL RESPONSIBILITY
CHANGE OF FUND ADMINISTRATION PLATFORM

By Matt Bertram

Matt Bertram, COO responsible for client servicing, operations and finance

Sentiment

I am sure that the mere heading of this article will engender mixed emotions. Donor fatigue, a stagnating economy, increasing social tensions and frustrations with current politics does detract from our motivation to do good deeds. It is easy to become paralysed and to simply do nothing.

From the outset, Northstar Asset Management has held the view that, despite these challenges, we will always set -aside a percentage of our income to support initiatives that we understand and believe will make a difference to the lives of those less fortunate than ourselves and, in the long term, be beneficial to all of us living in South Africa.

Who we support

The initiatives identified by the donations committee for this coming year include the Crane Foundation, Tears, St Luke's Hospice, Ethembeni and Learn to Earn. We also support a school boy at Maritzburg College as well as two scholars at Niko Brummer Primary in Beaufort West. Finally, at Christmas, each staff member is given the opportunity to donate R1 000 to an initiative of their choice.

The list of charities appears extensive and may give the impression that Northstar has deep pockets, but quite the opposite is true. We are a small firm but one that believes that true giving occurs when it really hurts. We thought we would include within our newsletters some information about our chosen charities for your interest.

This time around we focus on Niko Brummer, where we have partnered with the school to sponsor two scholars as weekly borders. Zane and Quelynne are both in Grade 5. They live on a farm near Nelspoort and after excelling at their local school, which was limited in what it had to offer achievers, were sponsored to move to Niko Brummer. Zane and Quelynne have continued to do really well and as an asset manager, we are pleased to see that their mathematics scores are great! Zane wants to become an engineer and Quelynne has aspirations of becoming an attorney. It has been staggering to see the impact that the school has made on these two young people's lives and the belief they now display in a much more hopeful future. We are proud to be associated with this initiative, and should you drive through Beaufort West, have a look out for Niko Brummer Primary School on the main road.

Change of fund administration platform

Direct investors in the Northstar Met Income and Northstar Met Managed funds would have recently received correspondence from Met Collective Investments (Met CI) that the Northstar MET portfolios are being amalgamated with the Sanlam Collective Investments (SCI) portfolios, with effect from 7 September 2017. This simply means that the administration platform of the fund is changing from Met CI to SCI. The good news for direct investors is that we've decided to change our fee structure to clean class from that date. This means that the investment fees (excluding VAT) are reducing from 1.00% to 0.85% for the Northstar Met Income Fund and from 1.35% to 1.10% for the Northstar Met Managed Fund.

CORRIDOR CHATTER

SHOULD THEY STAY OR SHOULD THEY GO?

By John Steenhuisen

John Steenhuisen is the Chief Whip of the Official Opposition in Parliament. He was first elected to public office as a Durban City Councillor at the age of 22. Since then he has gone on to serve in the Kwazulu-Natal legislature and in the National Assembly. John is passionate about politics and the future of South Africa. John is a sought-after speaker both locally and internationally and enjoys sharing insights on the political landscape in South Africa and abroad.

Given the daily barrage of bad news, most South Africans are feeling like a battered boxer who has gone one round too many. Blows range from staggering revelations arising from the Guptagate emails, which lay bare the web of state capture, to reports of crime, depressing warnings from international ratings agencies and a slip into technical recession. Couple this with turmoil in our political environment and many parents are asking themselves the question: is it time for the kids to go?

Lift your eyes

In the current maelstrom, it is an emotionally wrenching internal conflict, you want the very best for your children, but in reality no parent really wants to be separated from their children by oceans, or relishes the prospect of an intercontinental flight just to hold their grandchildren. In the short term, things may look rather bleak, but in the midst of a raging storm it is important for us to also lift our eyes to the horizon, for it is there that the future really lies.

Clouds gathering on foreign shores

The first point worth making is that things are not looking terribly bright on foreign shores either. The Trump ascendency in the United States proclaims “America first”. The fallout from the Brexit fiasco and the muddled election in the UK. The immigration crises besetting Europe. All have led to more insular and inward looking societies. Clouds of anti-immigrant sentiment gathering in these countries will inevitably lead to a contraction of immigration opportunities.

The issue of personal safety is often cited as a push factor. However, recent horrific incidents of terrorism in foreign capitals from London and Paris to Sydney and Melbourne show that safety in these countries is also a concern, often on a grander scale. Everyday tourist attractions, markets, rock concerts, coffee shops and public transport are targets, none have been spared from random and vicious terror attacks on innocent civilians. On a recent trip to the EU capital, Brussels, the nervousness I witnessed in commuters boarding public transport was palpable.

Back home most of us never have the slightest worry hopping on the Gautrain or MyCiti. We let our children go off to concerts and we don't give a second thought to grabbing a coffee at our local barista. This is something which we often take for granted. Yes, personal safety is an issue in South Africa, but living in a foreign country doesn't necessarily guarantee your safety anymore.

It’s all about the right choices

The problems facing us are not insurmountable. Many of them, from the meltdown in our state-owned enterprises and stagnant economic growth to schizophrenic government policy-making are all the result of bad decisions and poor choices. Take for instance the recent bombshell of the new mining charter, poorly handled and with disastrous consequences for both the industry and jobs.

They are not, however, the intractable obstacles that face many other countries. A lack of raw materials and natural resources, extreme climates, an aging population or totalitarian dictatorship, are near impossible to fix. Most of our problems can be fixed relatively quickly. We have all the ingredients to repair what is holding us back and unleash our potential by simply making the right policy choices and appointing the right people.

The fundamentals are strong

The point, to borrow an investment term, is that South Africa’s fundamentals are relatively strong. Our constitution has done the job that its framers intended. It has passed the tests, repeatedly acting as a check and balance on executive abuse.

Our banking system and financial service sector regulations are strong and internationally respected. They did their job in largely shielding us from the worst of the international banking crisis.

Our media is vibrant, active and report regularly without fear or favour.

Our courts held the line against government excess and have handed down landmark judgements upholding the rule of law and protecting citizens.

Our top universities, despite occasional student protest, all still make it into the top 500 international rankings of universities offering world-class higher education.

The land of opportunity

When it comes to South Africa its important not to make rash decisions in the current storm of circumstance. I believe a medium to longer-term view is required.

As Vladimir Lenin said "*there are decades when nothing happens and then there are weeks where decades happen*." Things are moving very quickly here, and it's not all doom and gloom. In the last month alone we have witnessed Hlaudi being booted from the SABC and Ben and Brian have both been dislodged from Eskom.

The governing party is heading to an elective conference in December where new leadership will emerge. The recent advances by the opposition in key metros have shown that political change is possible. The looming 2019 contest and its prospects of coalitions will be the first election since democracy where the outcome is not a foregone conclusion. In all this interesting flux and contestation lies great potential for change and opportunity.

Opportunities will abound in South Africa when the skills revolution required to kickstart our economy takes hold. The inevitable unbundling and part-privatisation of moribund state-owned enterprises will open opportunity in a variety of fields from energy to transport logistics. The recent strong results from Telkom clearly signals this as the way to go.

And so, in all this we would be wise to follow the sage advice of acclaimed novelist Yuval Noah Harari: *"tone down the prophesies of doom and swap panic for bewilderment. Panic is a form of hubris. It comes from feeling one knows where the world is heading. Bewilderment is more humble and therefore more clear sighted. If you feel tempted to declare the apocalypse is upon us, try telling yourself instead the truth is, I just don't understand whats going on in the world'*

For our nation's greatest resource is our people. Our resilience in the face of crisis is world-renowned; by our very nature we are not quitters. This special place on the southernmost tip of this great continent still holds enormous opportunity and untapped potential. Those young people who choose to stay, unshackle the potential, innovate in the disruption, and ride out the risk will reap huge rewards.

PRODUCT HIGHLIGHT

NORTHSTAR MET INCOME FUND

Mark Seymour

What is the investment objective of the fund and what will it likely invest in?

The objective is to deliver a return in-line with STeFI call x 110% over a three year rolling period. STeFI call is an index of the rate that an investor would receive on call at a bank, so the fund aims to deliver 1.1x that return over a three-year rolling period.

Who is the fund suitable for?

It is suitable for any investor seeking a better return than bank call accounts and with an investment time horizon of 3 years. A large component of the investment return will be income and the fund currently has a 8.7% gross yield, so it is very well-suited for income-needy investors.

What is the risk profile of the fund?

Taking a conventional approach to risk where equities are considered high risk (although over the long term we do not believe equities are high-risk assets) and cash is considered low-risk (here too we do not believe that cash is always low-risk), this fund operates closer to cash and is thus rated a low-risk investment. Over time, the return profile of the fund will be smooth.

Why did Northstar launch an income fund?

For three reasons, the first being the needs of our clients. Many of our clients have extra capital which they want invested to maximise returns but they do not want this exposed directly to equities.

Equally, they want an enhanced return relative to a bank account.

This fund is designed to offer that over time. Certain of our clients also require income and this fund provides quarterly income.

Secondly, we needed a vehicle to house our clients' capital as we migrate it into markets over time. We have been very careful with deploying capital into equities too aggressively over the past few years, believing that the JSE offered fewer opportunities than normal.

This has proven a correct strategy in that markets are effectively flat over 4 years. During this time we have continued to generate decent returns for our clients using the Northstar Met Income fund.

Lastly, our team has three fixed income specialists, all of whom have been involved in managing very successful fixed-income funds in their previous roles within other firms. We want to harness these skills for our Northstar clients.

What do you expect from the fund in the years ahead?

We have positioned the fund in very high quality investments to reduce risk, yet the gross yield on offer is a respectable 8.7% at the moment. I believe that we will outperform the fund's objective over a reasonable time period of three years. The Northstar Met Income Fund is currently performing well and I am satisfied that we are providing sound returns per unit of risk being taken.

Further information on the fund is available on our website: http://northstar.co.za/page/individual-fact-sheets/

Northstar Met Income Fund cumulative returns

%	YTD	1m	3m	6m	9m	1y	2y	Launch
Fund	3.78	0.67	2.37	4.65	6.19	7.91	6.95	6.34
Benchmark	3.13	0.63	1.89	3.76	5.69	7.66	7.24	6.93

Cumulative for all periods less than 1 year, annualised for all longer periods

Figure 10, Northstar Met Income Fund. Source: Morningstar as at 31 May 2017

ADVISOR CORNER

CHOOSING THE RIGHT VEHICLE FOR YOUR OFFSHORE INVESTMENTS

By Nick De Villiers

Nick is responsible for servicing financial advisors who use Northstar Asset Management.

Background to the article

Northstar Asset Management has seen rapid growth in demand for offshore investments, particularly from high-net-worth clients wanting offshore segregated share portfolios. The recent launch of the Northstar Global Flexible Fund has been very popular and complements our offshore share portfolio service. It offers clients access to an investment vehicle that at times can reduce offshore equity exposure when markets offer limited value.

While the investment merits of our offerings are without question, there are tax and estate duty implications which have inspired us to do further research on the subject. What follows is applicable to resident South Africans and does not constitute advice, particularly in terms of tax recommendations; it is instead merely our findings on the subject. In addition, other factors to consider should include future liquidity requirements, the ability to take funds offshore and tax planning. In addition, tax rules change, for example SARS are looking at endowments but no changes are currently pending. There are two main issues the investor needs to consider:

- Inheritance taxes
- The need for an offshore will and legal representation in the probate process, as many jurisdictions do not recognise South African wills or legal practitioners.

Inheritance tax in the United Kingdom and the United States of America

The United Kingdom and the United States of America levy estate taxes on most assets (especially fixed assets), owned by individuals, that are situated in those countries (“situs assets”). Both countries in broad terms levy estate tax/inheritance tax at a rate of 40% after allowing exemptions of USD60 000 for non-US tax residents and GBP 325,000 for non-UK based residents respectively.

The existing estate duty double taxation treaties in place between South Africa, the UK and the US do not eliminate but merely reduce the total estate tax liability from 60% to 40%.

Options to manage offshore inheritance taxes

There are three options available to manage estate duty taxes and for certain options probate:

1. An offshore trust or company.
2. A wrapper (such as an endowment or sinking fund) offered by one of the large South African Life Companies. Probate is not an issue.
3. An offshore unit trust.

Option 1: Offshore trust or company

This option requires competent legal and accounting advice to establish properly and once established, is potentially difficult to unwind. It is expensive and the fee structure is not always totally transparent. In addition, it is important to note that the owner relinquishes all control of these assets to the offshore trustees. No South African trustees, or beneficiaries who are citizens of the country in which the trust is domiciled are permitted. This may well be worth considering if you have a very large asset base offshore.

Option 2: Endowment policy (wrapper) with a South African life assurance company (life policy or sinking fund policy)

An endowment policy is issued in terms of the Long-Term Insurance Act (LTIA) by a registered life insurer and is a contractual agreement between an investor and an insurance company whereby the investor agrees to pay a lump sum or a regular premium to the insurer and the insurance company agrees to pay the investor the savings as a lump sum, after the period agreed to by the parties (minimum of five years), 'tax free'.

In practice, the provider holds the underlying assets and grants the owner the rights to manage them. Therefore, a share portfolio or unit trust can sit within the wrapper and be actively managed. It should be borne in mind that as a result, there is balance sheet risk for the investor and it is important to choose your intended provider carefully.

The wrapper should be viewed as a long-term vehicle as there are liquidity constraints around accessing the underlying funds.

Key benefits of endowments:

- A South African endowment/sinking fund product is not subject to UK or US inheritance taxes and is not subject to the 6% levy on UK trust companies.
- All administration, including tax payments, are done by the provider.
- There is no capital gains tax (CGT) event on death of the policyholder, as ownership transfers to the second life insured or nominated beneficiary.
- There are no legal requirements to repatriate the proceeds of the plan, either on maturity, or on the death of the insured.
- The proceeds can be paid in any currency, country and to any person nominated by the insured.
- Endowments work for high marginal tax rate individuals. Income tax in the fund is levied at a flat 30% instead of the highest tax rate of 45% and CGT is at 12%, rather than 18% for higher tax payers.
- The CGT calculation is in USD. This avoids CGT being paid on the weakening ZAR.
- Endowments (not sinking funds) offer insolvency protection after three years.

Main drawbacks:

- As mentioned there is balance sheet risk and there are liquidity constraints. The latter can be managed with the life company.
- Section 42 transfers to rollover CGT in and out of the wrapper are not permitted. It should be noted that the policy can be closed at any time and the same restrictions apply to offshore unit trusts.
- There is a deemed CGT event if government changes the wrapper rate.
- There are no interest exemptions but on a large portfolio this should not be significant.

Endowment costs:

- The wrapper costs are on a sliding scale from 0.30% to 0.65% annually and the minimum investment amount is USD 25 000.

Option 3: Offshore unit trust

A unit trust based outside of the UK and US is able to invest in assets in those countries and will not be subject to the situs rules. For example, the Northstar Global Flexible Fund is based in Ireland. Inheritance tax is managed, but probate and CGT in ZAR are still relevant unless the unit trust is included in an offshore LISP run locally (the LISP could cost 0.30% to 0.50% annually).

Modelling and conclusions

To help us better understand the longer-term cost benefit analysis of the endowment and unit trust options we modelled, at a high-level, possible outcomes for each over a 10-year period and compared these to a standalone offshore share portfolio. We applied a range of assumptions including portfolio turnover, cost of the endowment, exchange rate movements, and CGT rates. To make sure it was on a like-for-like basis we ignored the intrinsic costs of running a share portfolio and a unit trust.

Using our standard scenario and on a like-for-like basis ignoring the management of inheritance tax, the results indicate that over the long term a portfolio within an endowment, and the unit trust (outside of an offshore LISP) broadly result in the same overall return and that this is higher than the unprotected share portfolio.

Varying the assumptions applied in the endowment model shows that the lower CGT amounts payable offset against the cost of the endowment result in a range of outcomes of -4% to +5% over the 10-year period as compared to the unprotected share portfolio. Over that time-frame this is a relatively low variance. In addition, the administration of an endowment is covered by the life company, the probate cost is nil and the CGT can be rolled over to a beneficiary. This makes a reasonably compelling case for investors with funds of at least USD1m (and even potentially less) and who are not currently in a vehicle to at least consider this option further with their financial advisor. For investors with smaller portfolios the unit trust is a good option to consider.

In conclusion, investing overseas is a strategic investment decision and while tax and other factors should be understood they should not hinder it.

STAFF MEMBER PROFILE

MARK SEYMOUR

Adrian Clayton

Mark Seymour joined Northstar in January 2013 and is the head of fixed income.

What did you study at University?

I completed an Electro-Mechanical Engineering degree at the University of Cape Town. I subsequently joined the Masters course in Biomedical Engineering at UCT where I was involved in the design of a digital scan mammography apparatus.

Where have you worked?

Apart from my engineering-related work, my previous employment includes Appleton (2001 to 2004), PSG Alphen Asset Management (2004 to 2010), PSG Asset Management (2010 to 2013). PSG acquired Appleton which led to me working within PSG Asset Management for many years before joining Northstar in 2013.

What do you enjoy most about investing?

I enjoy screening for investment opportunities and working out what potential returns are likely to materialise over time. It is satisfying to monitor the market's irrational behaviour over the short term and to observe how rational pricing eventually guides the price towards reasonable value. This is most rewarding when clients enjoy the benefit of these investment opportunities.

How do you best allocate your time for the highest impact?

I allocate more time to identifying, analysing and understanding investment opportunities with long-term prospects and avoid focusing on day-to-day news flow which cultivates price volatility.

What is your focus at Northstar?

My focus is quantitative screening and generating investment ideas, portfolio optimisation and managing the Northstar Met Income fund.

Where is your own money invested?

My savings are invested within the Northstar unit trust range. My domestic investments are split between the Northstar Income Fund (of which I am the lead manager) and the Northstar Met Managed Fund (managed by Adrian and Marco). We have recently launched our Northstar Global Flexible Fund and considering our successes abroad over many years, I will be investing in this fund too.

What do you hope to add to Northstar in the years ahead?

I intend playing an ongoing and meaningful role in continuously improving our investment process, which we regard as a perpetual journey. We have come a long way over 5 years and now have a powerful team, process and research platform to work off, which is a boon for our clients. That said, our goal is consistency of performance and I continue to implement processes to attain this.

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