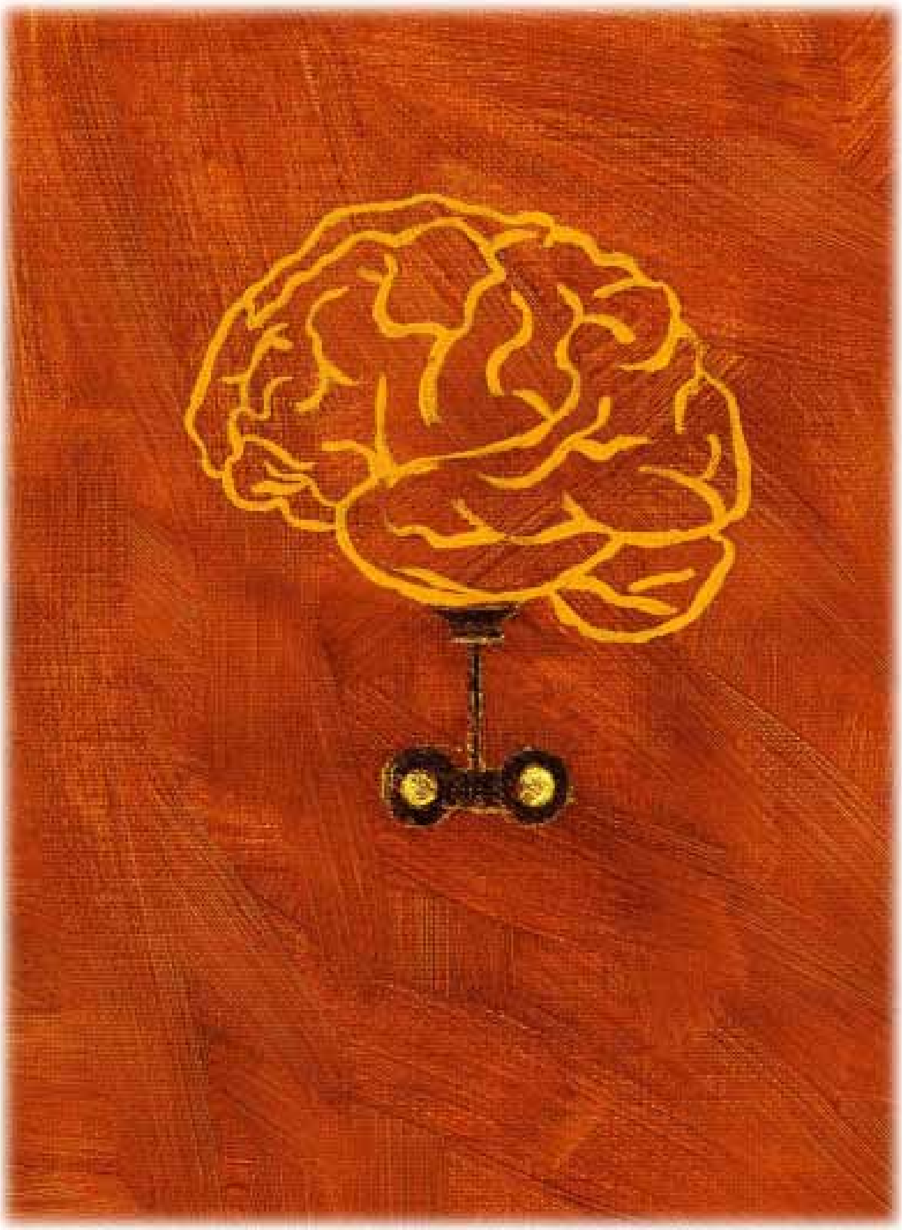
GTC

Formerly Grant Thornton Capital

Trendline

For the quarter ended December 2013



Seeing the wood for the trees

2013 will be a year potentially remembered by investors as a significant inflection point regarding investment market forces. When the dust and commentary have settled on the year, certain dominating influences including the United States and politically driven financial repression will remain.

The biggest story of the quarter, and indeed of the year was the announcement of the starting date for the much feared taper. The Federal Reserve (Fed) announced that it would finally begin reducing the amount of securities purchased by $10 billion per month to $75 billion from January 2014. Market reaction to the announcement in December was mild in comparison to the "taper tantrum" experienced in May.

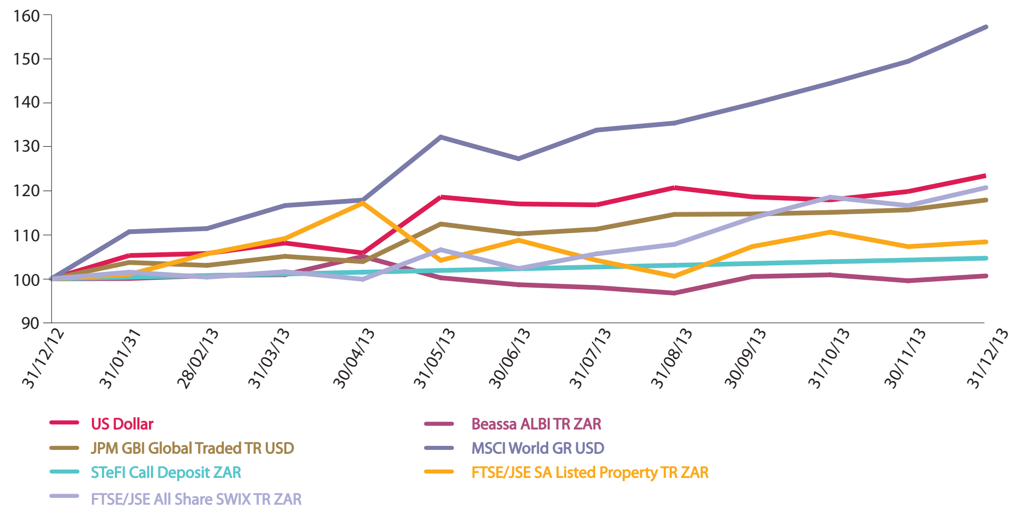
The differences in market reaction reflected below are primarily explained by remembering that May was the first time the idea of slowing down or ending the seemingly infinite Quantitative Easing (as the monetary stimulus has become known) was seriously proposed by the Fed. The market, by then addicted to Central Bank induced liquidity, did not enjoy digesting the concept of an end to - or indeed a slowdown in the 'sea of easy money'.

By December the market had come to terms with the reality that the taper would happen at some point and would not, as originally feared, mean an end to investment markets. This realisation, as well as an assurance from the Fed in December that it would hold long term interest rates at supressed levels for longer than originally planned (i.e. a stimulatory stance), helped to ease the announcement.

The taper, while minor in relative terms ($10billion less purchases versus $4.1trillion total assets) represented a huge shift (a 'sea change') in momentum in terms of monetary policy adopted by the Fed. For the first time since the financial crisis of 2007/2008 the Fed is looking to pull back on the amount of stimulus (monetary easing) being applied to the United States economy.

"The only constant in life is change."
– Heraclitus
(Greek Philosopher c.500BC)

Market indices



Source: GTC/Morningstar

This stimulus has been deliberately applied in an attempt to stave off an economic slowdown in the United States. The debatable economic theory on which this unprecedented experiment is based implies that by driving markets higher, individuals will become wealthier and in turn will spend more. Since the US economy is consumer driven this increased consumption should lead to improved business conditions and ultimately a growing economy.

While the economic foundation on which quantitative easing is based is thin the results of it are contentious and unclear. The wealth effect has undoubtedly occurred albeit with some unintended consequences.

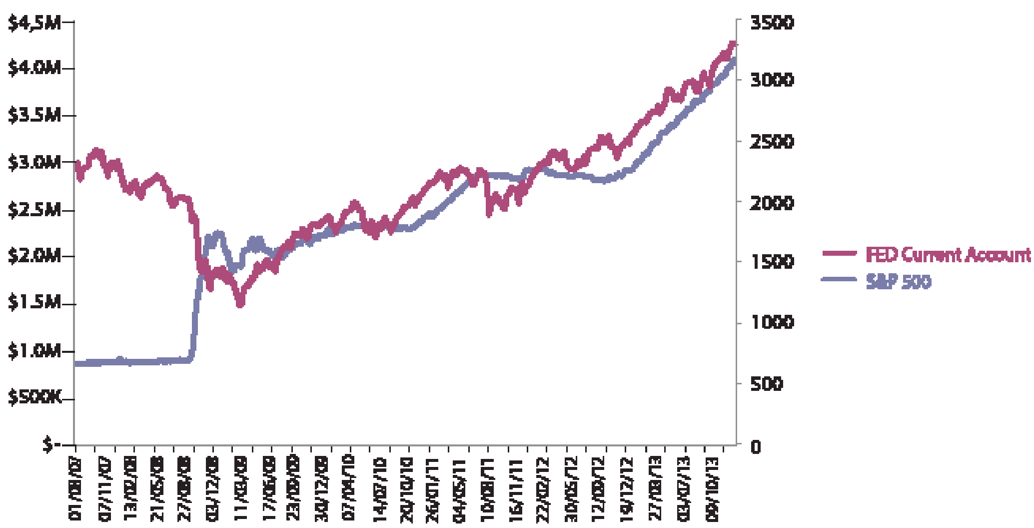
What is in doubt is the economic impact of the quantitative easing and wealth effect. The Fed had promised to pursue this easy monetary stance until such time as they witnessed a suitable recovery in the US economy, originally defined as being unemployment below 7% with a consistent GDP growth of 2%. While these targets have not actually been met, the Fed believes that there is now sufficient evidence of a sustained economic recovery/growth path in the US. This was further boosted by strong and above expected employment numbers in December.

Has quantitative easing worked?

Understanding the market's addiction to quantitative easing over the past 5 years has been crucial in understanding market behaviour. Whilst the link between GDP growth and stock market performance is theoretically plausible, empirical evidence suggests no such relationship. Despite this, markets have often moved in apparently opposite directions to economic data over recent years.
This is only explained by understanding that markets are currently driven to a large degree by sentiment and expectation.

Current thinking suggests that unexpected negative economic news causes the market to anticipate (guess) an extension of quantitative easing (i.e. a delay or reduction in tapering). This thinking is based on the knowledge that the Fed has stated that their intention to taper is based on a recovering economy. This anticipation of increasing liquidity is supportive of markets and results in further upside. Positive economic news has the opposite effect with the result that economic news flow and equity markets have often moved in opposite directions over the past few years. The fact that local and international markets are at all-time highs should tell us a lot about the state of the economy!

Fed Assets versus US Equity Market



Source: GTC/Morningstar

Fed Assets versus US Equity Market

	Pre taper (2008-2014)	Post taper
Economic growth	Developed world economies are recessionary to aneamic	Recovering to strong
Monetary policy environment	Stimulatory or increasing quantitative easing (QE)	Tapering or reducing quantitative easing (QE)
Investor risk appetite	'Risk on' - risk seeking	'Risk off' - risk avoidance
Developed v Emerging equities	Most equity markets rise but emerging market to outperform	Lower equity returns with developed world tooutperform
Interest rates	Falling or remaining at historically low levels	Rising or 'normalising'
Bond yields	Bond yields falling or remaining at all-time lows. Capital appreciation in bonds.	Bond yields rising with significan risk of capital loss in longer term bonds.
Equity market drivers	Momentum, quality and earnings growth	Qualtiy, fundamentals, value (?)
Currencies	QE Economies have devaluing currencies while riskier emerging market currencies are stronger.	Developed world and tapering currencies to streghten while emerging currencies and those with current account deficits in particular move weaker.

The table above sets out some potential characteristics of markets in a pre-taper versus post-taper environment. This table is not intended as specific investment advice but rather to help make sense of prevailing market movements.

The table shows that the tapering environment is one in which investors are more risk averse and place far more emphasis on fundamentals. Critically, the extent and timing of the taper could significantly impact market characteristics.

It's quite conceivable given the sheer enormity of developed world debt (The US alone has in excess of $16 trillion) that the ability to taper is limited by the impact of rising interest rates. Simply stated - rising interest rates will increase the debt servicing cost to the US and other developed economies, providing serious headwinds to any tapering effort. In this environment the 'flow' of quantitative easing, set to be $75billion of asset purchases in January 2014 may merely slow, rather than stop, resulting in the continuation of a 'risk on' environment.

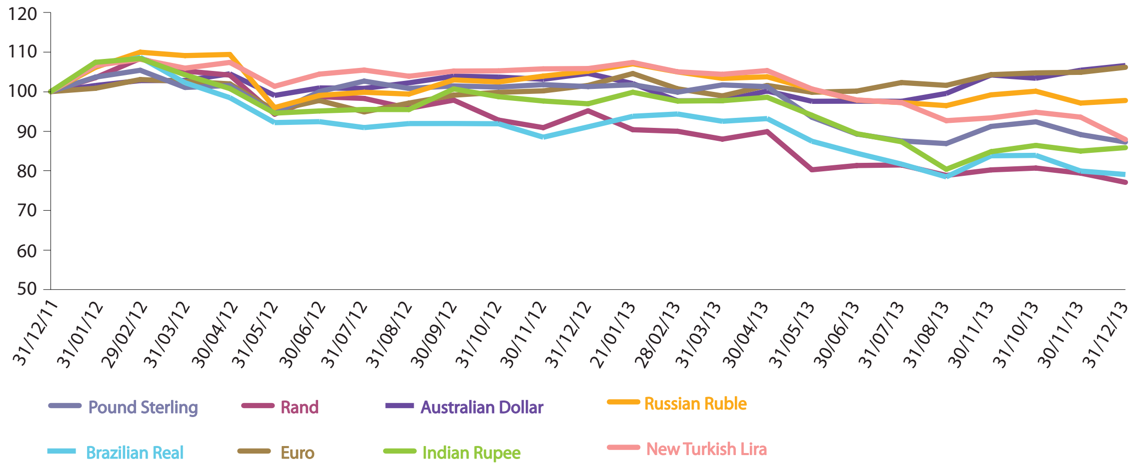
"The more things change, the more they stay the same."
- Alphonse Karr
(French writer c.1840AD)

From BRICS to glass

It is less than four years since South Africa celebrated its inclusion in the BRICS (Brazil, Russia, India, China & South Africa). Whilst South Africa had reasons for wanting this association, it is looking to avoid an association with another collective term growing in popularity - 'the fragile five'. The fragile five are those emerging economies most at risk in a tapering environment due to their need to continue to attract foreign inflows to finance large current account deficits. The group includes South Africa, Turkey, Brazil, India and Indonesia. The large and growing current account deficit was perhaps the biggest story in local market news over the fourth quarter of 2013.

With slowing economic growth, declining manufacturing, poor job creation and labour unrest, the South African economy finds itself under pressure. The current account deficit represents a further significant threat as it places our currency under pressure. This is due to the need to finance the deficit with foreign inflows of capital. In the quantitative easing environment of the past five years, capital has been abundant resulting in little to no impact on our currency. More recently, as the taper has become a reality, the realisation that a 'risk off' environment will see significant capital outflows from emerging markets in general, and South Africa in particular has hit home.

Three year currency performance in USD



Source: GTC/Morningstar

The graph above shows that despite our uniqueness as a country, our currency is moving in a similar manner as compared with other emerging markets. A weaker Rand creates cost-push inflationary pressure within the local economy with the potential for stagflation whereby higher inflation is coupled with lower economic growth. Cost-push inflation erodes discretionary spending power, which could have serious consequences for growth in South Africa's consumer driven economy. Whilst a weaker Rand benefits exporting businesses, the mining sector and tourism, it ultimately destroys wealth within our borders.

High returns and capital security? Caveat Emptor...

With central bankers around the globe attempting to drive up risk assets, many lower risk investors (such as retirees and pension fund trustees) have had to settle for lower returns. This makes sense when we understand that interest rates are being supressed at historically low levels - in some economies, ours included, below inflation. This environment forces low risk investors, particularly those with an income need, to consider investments with higher risk characteristics that they would ordinarily avoid. Whilst these higher risk investments do offer potentially higher returns they also carry greater volatility and a larger potential of capital loss. These factors have created an environment where investors need to be particularly careful before chasing returns.

An example of an investment being opportunistically advertised is one aired by Cambist on national television during international sporting events including the recent test match cricket series. Initially offering returns of 24% it's easy to see why this advert is garnering attention, as noted by some GTC clients. Investors otherwise holding cash or government bonds, earning an insufficient income are easily tempted by these high returns. The Latin phrase 'caveat emptor' (let the buyer beware) springs to mind and is apt advice for investors in the current environment.

The first question that an investor should ask is, "Is this investment regulated by the Financial Services Board (FSB)?" While not a complete failsafe, registration with the FSB ensures that certain checks and balances are in place limiting fraudulent behaviour. The Cambist website reveals that not only are they not registered with the FSB they are also not registered with the Credit Regulator or the Banks Act. This in itself should be a caution.

Cambist's reasoning for a lack of registration with any recognisable regulator is linked to the second question investors should be asking, "How are they generating their returns?" Simplistically, Cambist's returns are generated out of defaulting borrowers within the micro lending industry. Cambist argues that an investment into a loan ensures that they do not fall into the jurisdiction of the regulators. Micro loans, made to individual lenders with an inability to access more traditional and cheaper forms of debt, provide the underlying return generating investment. When borrowers default on the loan, a garnishee order is enforced on the borrower's salary providing a greater chance of future payment.

These defaulted loans are then on sold to various entities including Cambist where they are offered to individual investors. Effectively the very high initial rate of interest levied on the loan (up to 60% in some cases) allows for a margin to be taken by the various middlemen sitting between the ultimate investor and the original borrower. Whilst transparency is lacking, it seems logical that if the end investor is making 19.5% the other mouths in this investment supply chain are more than adequately fed.

For those intrepid investors who haven't yet walked away, a third question with an unsatisfactory answer is "What level of risk does this investment expose me to?" The unsatisfactory answer is that it is very difficult to quantify the risk of capital loss. Logically since the original loan has already undergone one default event, the chances of further defaults - even with a garnishee order in place - are high. This means the chance of the ultimate investor losing capital should be high as well.

To reduce this risk Cambist does offer a guarantee to investors. However there is little clarity on the financials or individuals behind the trust company ultimately paying the guarantee. South African investors should be wary of guarantees offered by unknown entities. South African investing history is littered with stories of lost savings despite these 'guarantees'. It is on the basis of similar low quality lending that the American sub-prime collapse originated, ultimately having global repercussions, the consequences of which are still with us now.

In summary, this type of unregulated investment, generated out of an industry with serious ethical issues, lacking transparency and with opaque level of risk should be avoided. GTC would not advise this investment for many reasons, including the morality of benefitting from low earners paying exorbitant penalty interest on loans they couldn't actually afford.

Market performances

The final quarter of the year delivered strong equity performances for local investors. The local equity market delivered 5.53% (ALSI) off the back of strong Financial (6.9%) and Industrial (6.69%) share performance. Resources while still positive only managed 2.15% for the quarter pulled down by a very poor quarter for the gold mining sector (-16.57%). The gold shares performance over the quarter was somewhat surprising given the continued Rand weakness over the quarter which would have been of some benefit. Gold shares in South Africa are suffering from very pessimistic market sentiment given the problems in the local industry (labour, costs etc.) as well as a declining Gold price on the back of the expected tapering.

Listed property eked out a positive return of 0.99% over the quarter with investors remaining cautious on a sector that has run very hard over the past few years and which is expected to be impacted by the tighter monetary policy environment.

Cash held steady at 1.3% (STEFI Composite) outperforming the All Bond Index which only managed 0.15%. Longer duration bonds in particular suffered from the improving economic climate in the US, which as explained above resulted in rising global yields in anticipation of the tapering decision.

The Offshore equity market produced stellar returns over the quarter with the MSCI World Index delivering 12.52% in Rand terms. Global Bonds, while negative in hard currency terms managed a Rand return of 3.08% over the quarter.

GTC fund performances

The **GTC Fixed Income Fund** has continued to deliver strong returns relative to cash over all periods as well as outperforming short dated bonds over the recent quarter. Although the manager has increased the fund's duration, the exposure remains concentrated on the shorter end of the bond yield curve. The increase in exposure to credit instruments has also been instrumental in achieving above benchmark returns as the fund has benefited from higher yielding assets with a minimal increase in risk.

The **GTC Wealth Accumulator Fund of Funds** has captured a significant portion of the equity market rally over 2013 delivering a return of 13.73%. This is in line with the Fund's objective and absolute return nature which seeks to achieve capital growth while protecting against market losses. The manager allocation within the fund has been transformed to include a specific manager to protect against downside risk. This implied an exit for Re:CM as their investment style was no longer applicable to the new objective of the fund. Since the change, the equity market rally added to previous gains and the new manager structure benefited from the changes.

The **GTC Capital Plus Fund of Funds** has delivered solid real returns over 2013.The biggest contributor to returns have been the local equity exposure. The fund has continued to benefit from the diversification and downside risk protection objectives, which has enabled multiple return sources. This fund has also been transitioned into a balanced fund with a preference for low capital risk whilst maintaining above inflation returns. During the last quarter, the fund benefited from the higher equity exposure.

The **GTC Conservative Absolute Growth Fund** (Rand and USD classes) has achieved outperformance relative to its benchmark over almost all reporting periods in both currency denominations. Rand weakness has contributed to more than 80% of the local funds return for 2013. The managers have continued to hold diversified asset class exposures over various developed markets, which have enabled the fund to maximise investment returns relative to the benchmark over all annualised periods.

Investment portfolios	3Mth	6Mth	12Mth	2Year*	3Year*	4Year*	5Year*
GTC Fixed Income B	1.19%	1.97%	4.26%	4.57%	5.19%	5.74%	6.56%
GTC Wealth Accumulator FOF B	3.65%	13.32%	13.73%	13.89%	9.48%	11.94%	14.88%
GTC Capital Plus FOF B	2.77%	6.74%	9.07%	9.65%	7.34%	7.80%	9.11%
FTSE/JSE All Share Index (ALSI)^	5.14%	17.90%	19.65%	22.21%	14.70%	15.33%	18.16%
FTSE/JSE Shareholder Weighted Index (SWIX)^	5.66%	17.10%	18.94%	23.00%	15.83%	16.63%	18.83%
BEASA All Bond Index (ALBI 1-3 year)^	1.10%	2.30%	2.85%	4.77%	5.60%	5.99%	6.02%
Cash (SteFi)^	0.92%	1.83%	3.62%	3.80%	3.92%	4.27%	4.91%
GTC Conservative Absolute Growth (R)	9.32%	8.34%	33.51%	24.09%	22.01%	13.20%	7.97%
GTC CAG's Composite Benchmark (R)^	7.77%	10.20%	28.99%	18.03%	20.10%	11.89%	6.99%
R/$ Exchange rate	3.79%	6.08%	23.55%	13.26%	16.34%	9.16%	2.03%
GTC Global Conservative Absolute Growth ($)	2.18%	7.19%	7.46%	8.96%	4.28%	4.69%	5.67%
GTC Global CAG's Composite benchmark ($)^	2.22%	5.64%	4.74%	4.48%	2.74%	2.95%	4.17%

* Annualised ^Benchmark returns include 1,5% fees Not all fund class returns are shown. Class B refers to indirect investments

Further information

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