GTC

Formerly Grant Thornton Capital

Trendline

September 2013

Credit growth surprises market

The growth of 1.6% (R39bn) in private sector credit during the month of August surprised market economists as the previous recording was a decline of 0.3% (R7bn) in July 2013. On an annual basis, private sector credit grew by 8.2% whilst the market expected just 7.2%. The major contributors were the increases in corporate credit which grew by over R30bn month on month and a renewed mortgage sector which added around R7bn to credit growth extension. This is the highest growth in mortgage loans since 2010.

The mortgage sector credit growth shows consumers have returned to the local property market but the levels of credit extension are still restrained relative to the heydays between 2005 and 2008. Over the past 12 month mortgage credit has risen by a total of just over R22bn, which is still a long way from the R160bn in 2007 and R113bn of 2008. Economists have also noted the increase in residential building plans passed, which further supports the consumer taking on mortgage credit to finance new houses, renovations and extensions to existing houses.

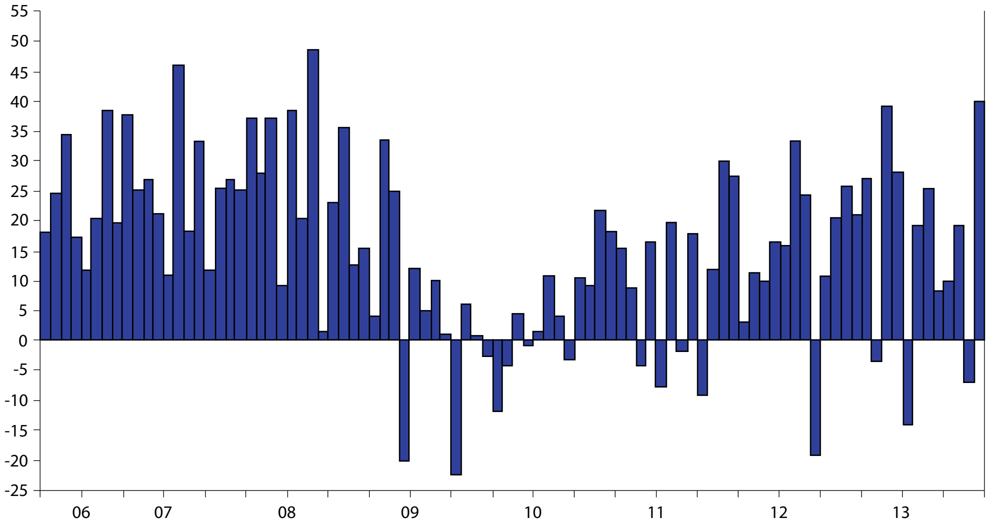
The chart below shows the extent of the credit growth relative to past months. The last time credit growth increased to around R40bn was back in 2008!

Unsecured credit has reduced in recent months which highlight a turnaround from the increased demand seen over the last few years. One of the key considerations in the reduction has been the banks tightening their credit policies due to the increase in bad debts. On an annual basis, personal credit has slumped 21% (July 2013), which is the lowest growth rate since August 2010. This shows a change in the composition of credit and may be the turning point where consumers begin to increase asset backed credit and reduce unsecured credit.

The US Government shutdown

Although the threats of a shutdown were raised in weeks leading up to the event, the probability of a government closure of non essential services seemed unlikely. The cause of the shutdown is the non approval of the 2013 – 2014 government budget by the House of Representatives which is controlled by the Republicans. They would like to see budget cuts being implemented in the budget.

Monthly growth in SA private sector credit (Rbn)



Source: Stanlib

On the other side, the Senate is controlled by the Democrats and they want to increase spending through the introduction of "Obamacare" and other new initiatives. In order for the Democrats to approve the budget, it must first get approved by the House of Representatives, only then can the President sign the approved budget.

This is not the first shutdown – there have been 18 in the history of the United States (US), the last of which occurred in 1995/1996. The end is not yet in sight and there are only a few days left for the debt ceiling to be breached.

The debt ceiling is the maximum level of debt a country can service without being declared bankrupt. The US is fast approaching this level, and with the US shutdown in effect, the President's hands are tied until the government is reopened for business. And precious time is ticking away!

The shutdown has impacted hundreds of thousands of jobs and services. Entire government departments have closed. These staff will not be paid for the duration of the shutdown and is therefore costing the economy millions per day.

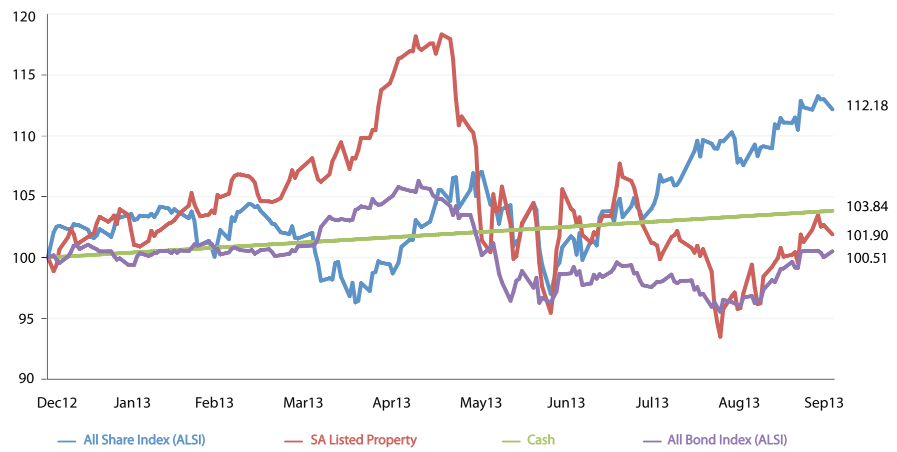
The markets have not reacted adversely to the news, but a delayed resolution could result in lower confidence in government, which could then translate into a negative market impact.

Market performances

In September 2013, the local equity market surged a further 5.1% (FTSE/JSE All Share Index –ALSI) household goods, retailers and banks added to performance. Contrastingly, platinum mining increased by 5.8% while gold mining declined by the same margin. For the 12 month period ending September, the local equity market added a cumulative 27% (ALSI).

Listed property bucked the trend last month, adding 6.7% for the month, taking the 12 month return to just over 10%, despite the interim volatility experienced between May and August this year. Local bonds also improved, up 3.9% for the month with the longer end of the yield curve adding the most significant performance. The 12 year + sector added over 5% while the 7-12 year sector added 4.3%. Cash delivered a consistent 0.43%.

Local asset class returns in 2013



Source: GTC and I-Net

The local currency remained volatile, having strengthened close to R9.50/US Dollar before returning to the R10/USD level. This was due to the return of foreigners to emerging markets including South Africa. This is also the reason for the improvements in listed property, bonds and industrial shares.

The foreign influence in the local equity, property and fixed income markets cannot be ignored as the foreign investments are based on their own developed market sentiment. Local investors have concluded that the industrial and financial sectors have delivered strong returns over the recent past, whilst resources are lagging the overall market returns.

Foreigners believe that industrials and financials are still keenly priced in developed markets and have employed the same principle when investing in emerging markets. The local investors are waiting to pounce, as they did in July and August, when resources gained 9.2% and 7.5% respectively against a flat return for industrials and financials.

Similarly, local investors are expecting a 2% to 3% real return (above inflation) for investment into local fixed income securities. In June this year, yields jumped from 6.1% to over 8% in the space of four weeks (the largest move recorded in SA bond yield history). It was only at this time that the local investors started to allocate capital to this part of the yield curve. Given the current level of inflation at 6.4%, local investors would be buyers at around 8.5%. The 10 year bond yield has since retreated to around 7.8% (due to foreigners returning to SA markets) and the local investors have also retreated, patiently waiting for the next move up in bond yields.

GTC Portfolio changes

During the month of August 2013, the GTC equity manager blend was transformed to include an equity manager with downside protection. The change implied that the exposure to Re:CM equity be removed due to the change in strategy.

Over the past year, the investment team has been evaluating various equity strategies to improve the risk and return ratio of the equity blend. During this time, it was evident that the views of Re:CM (deep value) although strategically correct, may be too early in the market cycle which has previously resulted in downside participation before realising strong gains for investors. Although we value the opinion and the foresight of managers like Re:CM in our equity allocation, these fund positions can overwhelm the performances of other managers.

As a multi-manager, GTC evaluates the managers' investment process and philosophy and we value consistency in the employment of these strategies, but there are also times when a dogmatic approach is detrimental to the overall fund performance.

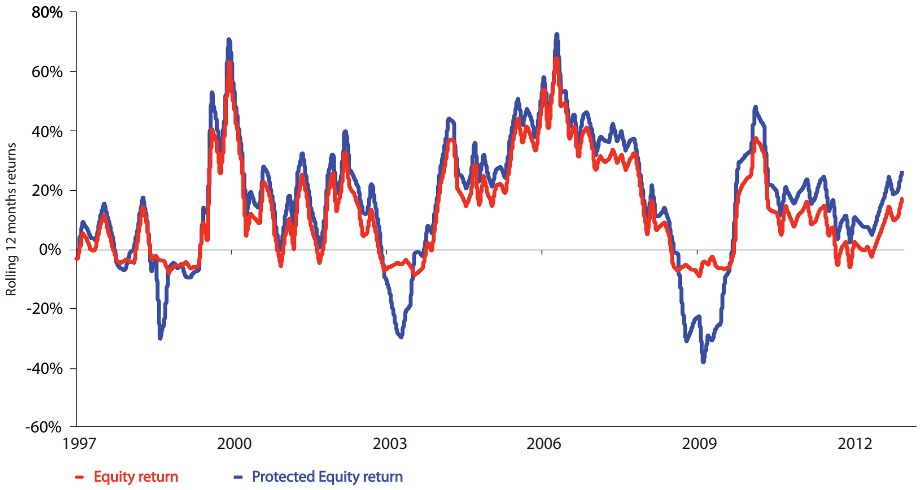
The GTC investment team therefore began exploring options that could protect investor capital whilst participating in the market upside and we found the perfect solution within the Prescient Protected Equity mandate. This allocation is designed to participate in the market upside through a purchased call option (which allows the holder to profit from the market exceeding the strike price) on the FTSE/JSE Top 40 All Share Index (Top40). The call option therefore allows participation on the upside, whilst limiting the downside to the premium paid for the option.

In addition, the manager is able to invest the cash into money market instruments and deliver a positive yield on the cash investments. As the equity market increases, the fund delivers performance from equities and the cash investments. When equity markets decrease, the extent of the participation is limited to the strike price and premium paid for the option, which is offset against the cash investment return.

The only thing that is
constant is change

- Heraditus

Rolling 12 month returns of equity vs. protected equity



Source: Prescient

The chart above highlights the relationship between the equity market (blue) and the protected equity portfolio (red) which clearly shows the upside participation and downside protection. The difference between the blue and red lines on the upside is due to the cost of the premium paid for the call option.The Prescient Protected Equity fund will represent 20% of the overall equity allocation.

Inflation increases above 6%

Over the past quarter, inflation has steadily increased to the current level of 6.4% (August 2013) which is a marginal increase relative to the 6.3% recorded for July 2013.

The major contributor to the high inflation has been the petrol price increases, which are attributable to the weaker Rand in recent months. Surprisingly, food inflation has also trended higher which has also increased the overall measure of consumer price increases.

For the year 2013, inflation is expected to average around 5.9% which compares less favourably to the 5.7% of 2012, the 5.0% in 2011 and 4.3% in 2010.

Despite the marginal slowdown in global food inflation, South Africa has shown a steady increase which is again due to base effects rather than cost pull demand from consumers. This implies that consumers have less influence on the price of food products while food inflation is manipulated by the exchange rate volatility, petrol price and wages.

Although the fuel prices eased earlier this month, the impact of the higher prices increases is still being felt throughout the marketplace. The oil price and Rand are both price sensitive and any negative news could result in either factor increasing rapidly, reversing recent price cuts in the fuel price.

Looking ahead, the Reserve Bank is unlikely to increase the repo rate from 5% on the basis of the inflation increases and is more likely to keep rates on hold for longer. Traditionally, increases in interest (repo) rates have been driven by the increase in consumer spending while the current inflation increase is as a result of administered price increases due to higher wages, electricity increases, fuel price increases and the exchange rate depreciation.

Release of the Taxation Laws Amendment Bill 2013 (TLAB)

The Taxation Laws Amendment Bill, 2013 was published for comment on 4 July 2013. The proposals will only become law once promulgated into a final Act and we will update this note at that time. Whilst the Bill involves more matters than retirement funds and long term insurance policies, this note focuses on these matters.

Tax treatment of contributions to retirement funds

The tax treatment of contributions by both employers and employees to the various retirement funds are not aligned, and unintentionally generous to tax exempt entities and higher earners. The proposed new legislation is aimed at having a uniform tax treatment for all contributions. The effective date of the proposed change is 1 March 2015.

Employer contributions

Currently, employer contributions to pension funds, provident funds, medical schemes and benefit funds are tax deductible up to a limit of 20% of an employee's "approved remuneration". These contributions to pension funds, provident funds and benefit funds are tax exempt in the employee's hands and do not lead to fringe benefit tax. It is proposed that employer contributions to pension funds, provident funds, medical schemes and benefit funds be tax deductible in full for the employer and that the contributions to pension and provident funds be regarded as a fringe benefit in the hands of employees.

Employee/member contributions

Currently, employee/member contributions to pension, provident and retirement annuity funds, are inconsistent. It is proposed that a uniform treatment be implemented and the tax deduction for employee/member contributions to these funds will effectively be limited to the higher of 27,5% of taxable income or "remuneration".

Employer contributions to pension and provident funds constituting a fringe benefit in the hands of employees, will also be regarded as employee/member contributions for purposes of the new system. An overall annual tax deductible limit of R350 000 will be applied to contributions over and above the limits set out above. Contributions in excess of the annual limits may be rolled over to future years where the amounts will be deductible together with contributions made in that year, but subject to the applicable yearly limits.

Where any contributions have not been deducted as at retirement, the nominal value will be set off against any lump sum income prior to the tax calculation so as to avoid double taxation. The fringe benefit of employer contributions to defined benefit schemes not allocated to a specific member, will be calculated based on a formula.

Benefit composition of provident funds

Current

To receive approval from SARS, pension funds may not pay out more than 1/3rd of the member's fund interest as a lump sum upon retirement unless such fund interest amounts to R75 000 or less. Should the fund interest be R75 000 or less, the member may take the full fund interest in the form of a lump sum (the *de minimus* amount). Provident funds do not have such a restriction and the full fund interest may be paid out as a lump sum upon retirement.

Proposed

Tax treatment of contributions to all funds will be aligned, thus aligning the benefit design. In future, provident fund retirement lump sum benefits will be limited to 1/3rd of the member's fund interest. To protect vested rights, only the portion of the fund interest relating to contributions post 1 March 2015, will be subject to this. Members aged 55 and older on this date, will not be subject to it. It is proposed that the *de minimus* amount be increased to R150 000.

Alignment of tax of individual disability and life policies

Current

Tax treatment of disability and life policies held by individuals are not aligned. Premiums on policies where payout constitutes a lump sum are not tax deductible and payouts are tax-free, but premiums payable on disability policies paying annuity benefits are tax deductible. The annuity benefits are taxable in the hands of policy holders.

Proposed

To align the tax treatment, disability and life policies will be subject to a uniform tax treatment. Premiums will not be tax deductible for the policy holder. Payouts will be tax-free. Where such policies are in the name of the employer and premiums are taxable as a fringe benefit in the hands of employees, benefit payouts will be tax-free in the hands of beneficiaries.

GTC fund performances

The **GTC Fixed Income Fund** has performed in excess of cash rates over all annualised reporting periods. Despite the low cash rate environment, the manager has maintained a higher yield relative to the benchmark through the use of credit and duration. The manager has also protected the average credit rating of the instruments, maintaining an above investment grade rating. Although there has been an increase in recent months in inflation, this is unlikely to result in higher interest rates as the price volatility is caused by administered prices and not consumer demand led inflation.

The **GTC Wealth Accumulator FoF** has achieved strong returns for investors over the past year which was in excess of 17%. In recent months, global investors have influenced the local market volatility through the exit of emerging markets in May 2013 and the subsequent return in September 2013. Foreigners have been keen investors into industrials and financials due to their preference for these sectors in global developed markets. Local investors, however, prefer the undervalued resource sector, which realised strong gains in July and August 2013, when the foreigners were away.

The **GTC Capital Plus FoF** has performed above its inflation adjusted target over the past year which was largely attributable to the increase recorded in local equities. The fund has increased its exposure to equities as other asset classes such as bonds, listed property and cash were delivering lower than inflation returns in recent months. Exposure to long duration bonds also reduced performance during May and June this year. The managers have remained cautious in their capital allocation and are aware of the increased probability of an equity market pullback given the new record highs achieved. During August 2013, the Re:CM portfolio was transferred to Prescient due to a change in strategy from fundamental value to quantitative protected equity. This is in accordance with our long term strategy of reducing investment risk and increasing capital preservation.

The **GTC Conservative Absolute Growth Fund** (USD and Rand classes) has achieved stellar returns in Rand terms, mainly due to the local currency weakness in recent months. The manager has also been increasing exposure to developed market equities which have contributed to the overall fund performance. The fund also has exposure to global listed property, fixed income, commodities and cash. Due to the conservative nature of the fund, the equity exposure is predominantly household brands with global exposures.

Investment portfolios	3Mth	6Mth	12Mth	2Year*	3Year*	4Year*	5Year*
GTC Fixed Income B	0.77%	2.18%	4.31%	4.55%	5.41%	5.96%	6.98%
GTC Wealth Accumulator FOF B	9.33%	7.37%	17.19%	15.72%	10.53%	12.66%	13.78%
GTC Capital Plus FOF B	3.87%	4.47%	10.55%	9.50%	7.24%	7.61%	8.74%
FTSE/JSE All Share Index (ALSI)^	12.13%	11.46%	25.11%	23.85%	16.12%	16.92%	14.67%
FTSE/JSE Shareholder Weighted Index (SWIX)^	10.83%	11.21%	23.45%	24.28%	16.58%	17.43%	15.37%
BEASA All Bond Index (ALBI 1-3 year)^	1.18%	1.16%	2.75%	5.13%	5.72%	6.11%	6.84%
Cash (SteFi)^	0.90%	1.79%	3.62%	3.85%	4.01%	4.41%	5.25%
GTC Conservative Absolute Growth (R)	-0.90%	12.16%	28.82%	16.44%	18.76%	12.62%	4.15%
GTC CAG's Composite Benchmark (R)^	2.25%	9.33%	23.37%	14.24%	16.54%	10.76%	5.63%
R/$ Exchange rate	2.21%	9.33%	21.44%	13.00%	13.08%	7.93%	4.23%
GTC Global Conservative Absolute Growth ($)	4.90%	1.86%	7.41%	9.43%	4.59%	4.25%	2.07%
GTC Global CAG's Composite benchmark ($)^	3.35%	1.77%	2.19%	4.18%	2.38%	2.46%	2.55%

* 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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