momentum

asset management

straight to the core

momentum asset management core strategies

june 2014

Diversity is in our DNA

contents

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foreword

In this edition of *Straight to the Core*, we unpack the Core Strategies team's process a little further and consider a scenario-based approach to longer-term investing and how this can help in better managing market volatility.

In our stock pick article, which looks at Woolworths, we provide details on why we like the stock and possible future scenarios that may pose both upside and downside risks (with specific reference to the David Jones transaction currently under shareholder consideration). This detailed analysis provides real insight into how a well-defined and researched portfolio construction process is necessary to effective asset management.

The Johannesburg Stock Exchange has enjoyed a stellar run since its recovery from the 2007-08 global economic meltdown and we consider whether the bull market in stocks has run its course. With rating agencies S&P and Fitch recently delivering their sombre sovereign ratings downgrade messages; we take a look at South Africa's growth outlook and its impact on investments against a constrained local bond, property and equity backdrop.

Thank you to those of you who take the time to send us feedback. As always, we value your input and encourage interaction.

Patrick Mathidi

Head of Core Strategies
Momentum Asset Management

Effective asset management: applying a scenario-based approach to a longer-term investment outlook

By Patrick Mathidi: Head of Core Strategies

An investment process focused on risk budgeting involves closely managing asset class, sector, individual instrument and theme risks in the context of an overall investment portfolio. Sufficient diversification of the various independent alpha drivers helps manage the risk of a material drawdown and permanent destruction of capital. As a result, this portfolio management philosophy, which places risk at the core, may not make for a top performer at all costs. However, over a full market cycle, reduced downside risk through adequate diversification and a focus on adding value incrementally and consistently should result in favourable, risk-adjusted returns over time.

An ability to generate competitive, risk-adjusted returns on a consistent basis through a full market cycle can be achieved through active investment management based on asset class and equity selection being integrated with modern portfolio construction processes aimed at allocating risk to investment ideas where there is most conviction. Key to this approach is the belief that intrinsic valuation (both at asset class and individual stock level) is the only sustainable basis for long-term investment success and an intimate understanding on the part of the portfolio manager of the risk embedded in the portfolio (with the assistance of modern risk budgeting and portfolio construction tools) helps focus the mind and stimulate further

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debate on the various major contributors of risk. It is therefore crucial that there be true alignment between the quality and conviction levels of the research outputs, an appropriate allocation of the risk budget by the portfolio manager to those high conviction ideas and an efficient and consistent representation of those ideas in client portfolios.

Scenario-based approach to investments

Investment professionals, like most other professions, should never claim absolute and accurate knowledge about the future. Key to our investment philosophy is the belief that the future is always uncertain and, as a result, we do not have a singular view of the world. Instead, we prefer to consider various scenarios to try and 'crystalise' where we could be wrong (on the down and upside) given our central thesis. We prefer a comfortable margin of safety cushioning our investment views, coupled with an awareness of the downside risks and what those could mean to our portfolios if our view turns out to be incorrect. We therefore apply robust and realistic scenario permutations to both asset allocation and stock selection decisions.

Our investment analysts are industry specialists and incentivised like portfolio managers to ensure that they take more accountability for their investment recommendations (as reflected in the portfolios). Key to their ability to provide sound guidance is a focus on understanding the industry dynamics of, and changes in, competitive forces in the industries they assess, which helps to better understand the drivers behind company return on equity (ROE). This means that analysts spend less time building unwieldy earnings forecast models and more time thinking about what is driving value in the company and what the investment case of the stock should be.

A sound investment decision framework should include three aspects: the valuation of the company, quality of the company and consideration of the business cycle and investment themes that might impact the company.

This three-tier approach to investment decision making has certain advantages. Firstly, valuations based on a sustainable ROE are more consistent through time than valuations based on an earnings estimate. Secondly, the breakdown of ROE into components can help an analyst understand the key drivers behind the company and the impact that those drivers can have on the valuation (and investment returns).

Understanding the impact of financial leverage on ROE is also important as efficient use of leverage can significantly enhance shareholder returns in certain cases. Traditional accounting frameworks tend to 'confuse' operating and financing items in the same place on the income statement and balance sheet and these should be separated.

Companies that sustainably generate an ROE higher than their cost of equity create value for their shareholders and should trade at a premium, while companies that earn an ROE below the cost of capital destroy value and should trade at a discount.

Determining a stock's risk/reward outlook

The future is uncertain and how a base case investment thesis on a company will play out can never be predicted with absolute certainty. It is therefore important to investigate how a base case could be wrong as the answers to this question lead to both upside and downside scenarios to the base case and these can result in a more informed risk/reward view of the stock. Discussing the different scenarios and the likelihood of them occurring also assists in better visualising the risk/reward trade-off. A single 'point' estimate of a share's return cannot fully reveal an analyst's complete understanding of the company's investment case.

A well-defined and researched portfolio construction process, which entrenches risk budgetting and a team approach without collective decision making (i.e. individual accountability and measurement), is the core component of a sound investment strategy. This investment management methodology ensures self-discipline and a consistent approach to alpha generation and downside risk management.

Please refer to the article on Woolworths, which seeks to showcase our stock selection process. The Momentum Balanced Fund overview then upacks our asset allocation and portfolio construction methodology. ■

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Has the bull market in stocks run its course? If so, what's next?

By Herman van Papendorp: Head of Macro Research and Asset Allocation and *Co-portfolio Manager (balanced funds)

We have witnessed a stellar run on the Johannesburg Stock Exchange (JSE) since its recovery from the 2007-08 global economic meltdown. Equity markets have run significantly, both globally and in South Africa, over the past five years, almost tripling in value since bottoming in March 2009. Markets have been performing predictably in an environment where global central banks injected copious amounts of liquidity into the global financial system in the aftermath of the financial crisis. Normally, the bulk of this liquidity stimulus would have been absorbed into the real economy to finance a rebound in economic activity. However, with business and consumer confidence at rock-bottom due to the financial crisis, the resultant weak economic recovery required only limited capital to finance expansion, with the excess liquidity inflating the valuations of financial market assets (particularly equity markets). Hence their strong performance.

Some equity market valuations have now rerated to levels above their respective longer-term means, which should constrain future returns from these equity markets. A good example of this is the US, where valuations are now above long-term averages, whereas some regions, like Europe and the UK, have seen a valuation uplift (but are not as yet expensive) and other regions, like Japan and emerging markets, are still outright cheap. Within this, South Africa has been a very strong performer, with valuations looking extremely expensive relative to other emerging markets or versus the country's own history. South Africa is therefore trading like a developed equity market, without the corresponding developed market fundamentals behind it.

Seeking opportunities

For an equity investor, this can be seen as problematic as it strips away the margin of safety in the asset class. Investors should seek

*Under supervision as co-portfolio manager of the balanced funds

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opportunities where risk/reward is skewed in their favour. In South Africa, equities are currently expensive, which means that the return uplift is compromised relative to the risk that is being taken.

Global equities have had a good run and are seen as approaching fair value, but they should also be looked at relative to the returns available from other asset classes. In this regard, the global fixed-income market still looks more expensive than equities, with the relative risk/reward still ostensibly in favour of global equities.

Similarly, the South African equity market looks expensive on a number of metrics, but, relative to domestic fixed income, it seems fairly valued, or even slightly on the cheap side. This is due to fixed income looking expensive at current relatively low yield levels. If you compare the current earnings or dividend yields of the South African equity market to current bond yields and take into account their respective long-term averages, there is some value in local equities. However, this does not take away from the fact that investing in South African equity has some risks in the current climate.

Locking in gains

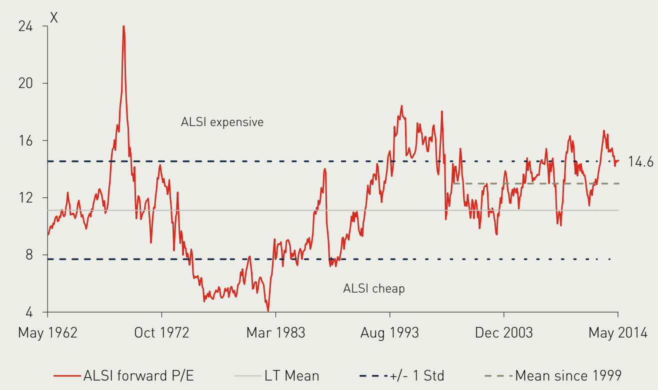
The past five years were very much an abnormal situation as far as liquidity creation is concerned. Global central banks had not previously resorted to widespread quantitative easing (QE) in a collective effort, but had always used interest rates or money supply levers as their main policy tools. The next five years will more than likely be a period of normalising monetary policy from near-zero interest rates and abundant QE towards the gradual removal of QE and higher rates.

This will probably create an environment where asset classes will behave quite differently in the coming years, relative to the past five years. We position our portfolios with a forward-looking approach and, running a balanced fund, we expect lower absolute asset class returns than what the past five years have offered. Furthermore, in this period of renormalisation, the volatilities of asset classes are bound to increase. In the interim, exposure to defensive asset classes, such as cash, should be considered in a low-return and high-volatility environment, although this is not an investment strategy for the long term.

Fixed-income assets are likely to offer lower returns in a rising interest rate environment, while simultaneously experiencing higher volatility: a mix that you do not want as an asset investor.

On the equity market side, we have had a meaningful rerating of equities in recent years and, for the next while, will probably see returns coming increasingly from profit growth as valuations approach long-term averages. With equities in South Africa at historically high levels, conservative thinking needs to be heeded, with a preference for better-valued global equities **(see chart 1)**. ■

Chart 1: ALSI expensive vs. own history



Source: I-Net, Momentum Asset Management

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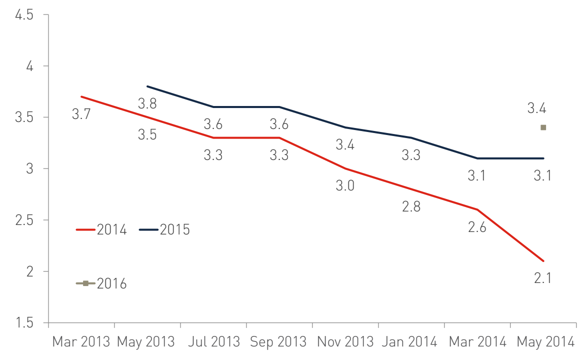
South Africa's growth outlook and its impact on investments

By Sanisha Packirisamy: Economist

The outlook for South African inflation and growth (with upside risks to inflation and downside risks to growth in the coming year) has a major bearing on local investment returns. Rising inflation and interest rates impact negatively on economic growth and corporate profits, thereby constraining the performance of local bonds, property and equities.

At the latest Monetary Policy Committee (MPC) meeting, the South African Reserve Bank (SARB) downgraded their real GDP growth forecasts for South Africa by 0.5% to 2.1% in 2014 **(see chart 1)**. Against the backdrop of an expected SARB inflation profile that stays above the target range for the next year, this poses a dilemma for monetary policy making. The SARB revised growth forecasts lower given the on-going labour tensions in the platinum mining industry, where protracted strike activity only recently ended. To date, employees have lost over R10 billion in wages, whilst the industry has lost around R23 billion in revenue. Although mining only constitutes around 6% of total real GDP, mining exports account for nearly

Chart 1: SARB real GDP growth revisions (% y/y)
SARB likely to downwardly revise their growth forecasts due to recent prolonged strike activity



Source: SARB, Momentum Asset Management

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half of South Africa's total exports, while related downstream sectors, such as manufacturing and retail, were also negatively impacted by the strikes. The extended strike action therefore exerted broad pressure on economic growth and the already-extended current account deficit.

S&P pulls the trigger

Although the SARB slashed their 2014 growth forecasts (and may have to do more of the same at the upcoming July meeting), the committee only marginally downwardly revised their 2014 inflation forecast to 6.2% (previously 6.3% at the time of the March MPC meeting), thereby exacerbating the low growth/high inflation policy conundrum. More recently, rating agencies S&P and Fitch delivered a sombre message, suggesting that South Africa remains in a low growth/high debt environment. Fitch placed South Africa's sovereign rating on negative outlook, while S&P pulled the trigger and lowered South Africa's foreign currency rating from BBB to BBB- on the back of strike and capacity-related growth concerns in the medium term (and also noted the negative implications that these will have for the budget deficit and debt trajectory). Nevertheless, currency and market moves were limited as S&P maintained a stable outlook on the rating, placating markets.

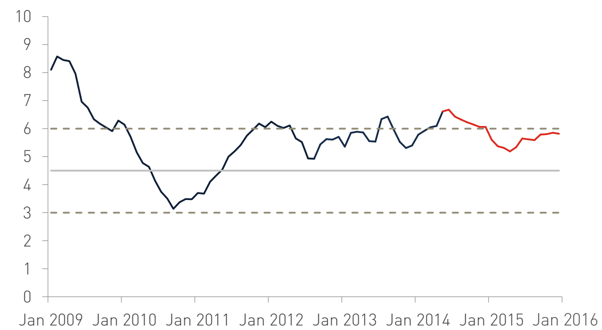
Although an improvement in global risk appetite has seen a retracement in the local currency from levels experienced during late January/early February, the rand remains vulnerable given weak domestic macro fundamentals and global risk factors. A more benign global monetary policy environment, on the back of weaker-than-anticipated global economic data in the first quarter, coupled with disappointing high-frequency data in the domestic market, kept the SARB from hiking rates at the May MPC meeting. Nevertheless, the door for further rate hikes remains open given that the SARB reiterated that monetary policy accommodation remains high in the context of negative real interest rates, while inflation risks and expectations remain uncomfortably high.

Further rate hikes expected

To date, inflation expectations have remained close to the upper band of the 3% to 6% inflation target, but have not breached the target markedly. It is likely that the SARB will keep a watchful eye on whether inflation expectations increase meaningfully as this is likely to have a further negative impact on core inflationary measures. Furthermore, both the SARB and Fitch have noted that inflation expectations settling at the upper end of the target remains undesirable. Momentum Asset Management expects inflation to remain sticky in the short term as the lagged impact of a weaker currency exerts upward pressure on both headline and core measures of inflation. May's headline consumer inflation print of 6.6% pointed to rising goods inflation as items such as cars and clothing increasingly reflected a higher degree of currency pass-through **(see chart 2)**.

Although the MPC has held rates steady at both the March and May MPC meetings, we are still expecting further interest rate normalisation this year. We expect a further hike of 50 basis points at the July meeting, followed by a further 25 basis points in November 2014 and March 2015 respectively due to mounting inflationary pressures and an elevated current account deficit. Our interest rate view is biased to fewer hikes should further growth risks arise due to an increase in strike activity or further pressure on electricity supply. A rising domestic interest rate cycle, against the backdrop of global policy normalisation, should constrain South African asset class performance, particularly local bonds and listed property, while increasing the relative attractiveness of risk-free cash in a generally low-return environment. ■

Chart 2: Headline consumer price inflation (% yoy)
We expect inflation to remain outside the target band for the remainder of the year



Source: Stats SA, Momentum Asset Management

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The investment case for Woolworths Holdings Limited

(“Woolworths”) or (“WHL”)

By Elton Oliver: Equity Research Analyst

It has been over two months since Woolworths announced its bold move to acquire 100% of David Jones Limited (“David Jones”) or (“DJ”), an iconic Australian department store, for A$2.1 billion (c.R21.4 billion). Our research suggests that this could possibly be one of the largest direct investments into Australia by a South African entity.

Based on WHL’s relative share price performance since the announcement (c.12% higher, post the initial 7.6% sell-off in price after the announcement), it would appear that shareholders have warmed to the transaction. WHL management has spent a great deal of time with investors and analysts during the DJ site visits in Australia and investor roadshows aimed at explaining the rationale for the transaction and how the synergies will be achieved. Since the announcement, DJ’s share price has moved c.21% higher, despite there being some lingering concerns around a possible blocking of the transaction by Solomon Lew (owner of a c.11.8% share in Country Road Group (“CRG”)).

Mr Lew’s shareholding in CRG has prevented WHL from obtaining complete ownership and delisting CRG. It is reported that he has acquired c.9.9% of DJ and there is speculation that Mr Lew is building a stake in DJ in order to either block this transaction or use his stake in DJ as a bargaining chip for a superior price in the event that he disposes of his stake in CRG.

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In this article, we share our investment thesis on Woolworths within the context of our stock selection framework and highlight the associated risks to our view. Our investment thesis rests on management's ability to execute and deliver on the synergies that they have identified. We believe this transaction will be transformational for WHL as it will result in WHL becoming a much larger business, with the ability to exploit the scale benefits associated with a larger group.

Factors that support our decision to invest in Woolworths:

A. Woolworth's rationale for acquiring David Jones[1]

1. Australia has a higher population growth and household spend per capita than South Africa ("SA") and most other developed countries. For example, SA's population growth is c.1.3% per annum and household spend per capita is c.US$ 6 200, compared to Australia, which has a population growth of c.1.5% per annum and US$25 000 spend per capita.
2. WHL believes that further southern hemisphere expansion will allow them to leverage common fashion trends during the same season, with enhanced sourcing capability. This should prove to be a key advantage over northern hemisphere competitors.
3. WHL has a long and successful track record in the Australian retail sector through its acquisition of CRG and, more recently, Witchery.
4. An opportunity to take WHL products and brands into other markets, exploiting the scale benefits of an enlarged group.

[1] Source: Woolworths roadshow presentation (9 and 10 May 2014)

B. The synergy benefits

WHL management have identified precisely the areas of the DJ business from which they will extract synergies. The incremental uplift to earnings before interest and tax ("EBIT") from the synergy benefits are expected to be a minimum of A$130 million per annum within five years. The synergy benefits identified are as follows:

1. To grow the DJ private label, which currently contributes only 3.5% of group sales, and to introduce WHL private label brands like Studio W, RE and JT ONE to the market. The target is to grow private label to c.20% of total sales (more in line with the international department store benchmarks). This initiative will result in improved margins and an estimated minimum of A$70 million incremental EBIT once the private label mix reaches 20% of total sales.
2. Growth of CRG concession brands. The intention is to expand the breadth and depth of the Country Road, Witchery and Mimco brands and introduce Trenery into DJ stores for the first time. This is expected to add a minimum of A$30 million incremental EBIT.
3. Optimise the group real estate portfolio (separate to the property opportunity discussed later in the article). This relates to the introduction of further village store formats and is expected to add a minimum of A$20 million incremental EBIT.
4. Improve margins through group sourcing. This entails migrating the sourcing of the DJ private label onto the WHL platform and obtaining volume-based sourcing benefits. This is expected to add a minimum of A$10 million additional EBIT.
5. In WHL's assessment, and in our base case, no incremental EBIT benefit has been given to:
   - The introduction of the DJ loyalty scheme.
   - Enhancing the omni-channel offering.
   - Cost benefits from rationalising back offices and eliminating duplicated costs. Myer Holdings Limited (DJ competitor), in its failed merger proposal with DJ, identified cost-saving benefits to the extent of $85 million.

We are confident in management's ability to deliver the above synergies because:

- The WHL CEO, Mr Ian Moir, is very familiar with the retail environment in Australia given his past work experience at CRG, Australia.
- This management team, under Mr Moir, has, in some shape, manner or form, successfully implemented these initiatives, in either Woolworths or CRG, which we feel reduces the execution risk.

C. Valuation

At face value, the acquisition price of DJ appears expensive at a forward price to earnings ("PE") multiple of c.21x. WHL itself does not appear cheap at 17x forward PE when compared to its own historic average forward PE of c.12x **(see chart 1)**.

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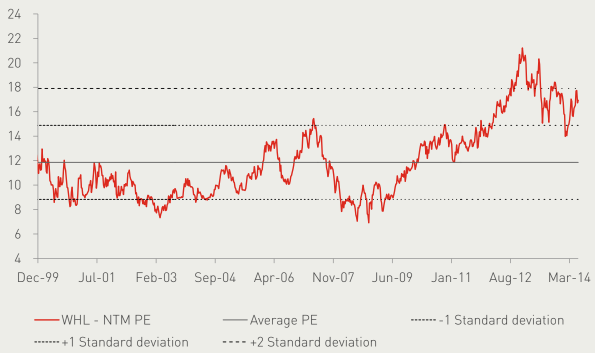
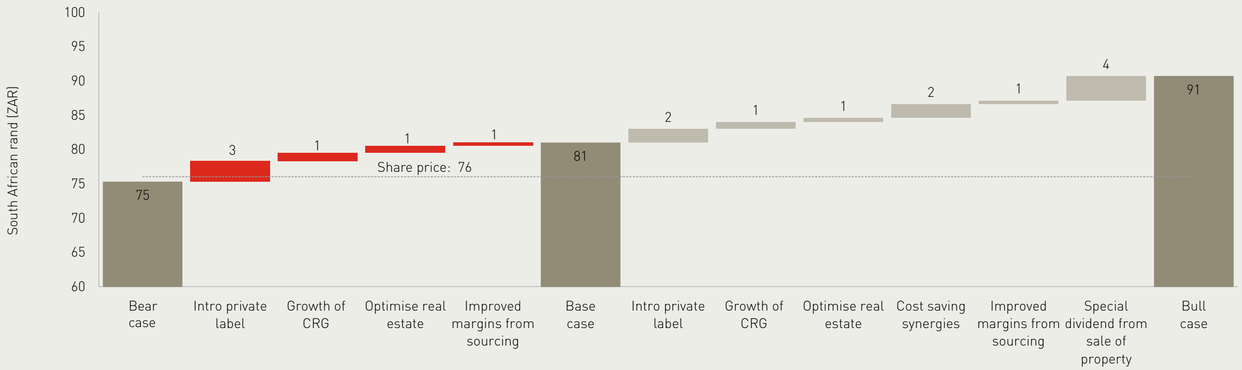
Chart 1: WHL's historic forward price:earnings multiple



Source: Factset; Momentum Asset Management

Chart 2: Bull and bear case scenarios based on the expected synergy benefits



Source: Momentum Asset Management

However, the fact that DJ owns four properties provides an underpin to the valuation and could provide an opportunity to unlock shareholder value in the event of disposal. These four properties were revalued during 2012 and assessed to be collectively worth A$612 million, although it is believed that they are worth much more than A$612 million today (i.e. two years later) and more so if they are sold with developmental rights. On the assumption that the four properties are worth A$800 million (two years post the previous valuation and if sold with developmental rights) if two of the four properties are disposed of and realise a total of A$400 million (and with the cash returned to shareholders), the acquisition PE multiple is reduced from c.21x to c.17x, which appears more palatable.

The PE-based valuation does not, however, take into account WHL's acquisition of DJ and associated synergies and we therefore rely on the residual income ("RI") valuation method in our assessment of value. In our base case, which is conservatively based on the minimum synergies being achieved after five years, we arrive at an intrinsic value for the combined WHL and DJ group of R81 per share, which implies c.7% upside to the WHL current share price of R76 per share. After running some bull and bear case scenarios on the synergies **(see chart 2)** to assess where we could be wrong in our valuation, we established that, if our bull case plays out, the intrinsic value for the combined group could be worth R91 per share, which amounts to c.20% upside from the current share price. We believe the risk reward skew is to the upside, with sufficient margin of safety on the downside.

D. Capital allocation

Mr Moir is a good allocator of capital and creator of shareholder value. Since the 2011 financial year, when he took over as CEO of WHL, the WHL ROE improved from c.39% to c.51.5% in 2013, far

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exceeding WHL's estimated cost of equity ("Ke") of c.12.6%. This provides evidence of the strength of the management team.

For the aforesaid reasons, we feel that investing in WHL is a compelling investment opportunity.

Points to bear in mind and risks to our view:

1. Although we are confident of management's ability to deliver on the synergies, the key risk is execution risk and the timing of the synergy benefits as our investment case is based on these being achieved within the expected timeframes.
2. For the WHL group as a whole, the proportion of sales generated from Australia is estimated to increase from c.20% in 2013 to c.44% in 2015. This effectively dilutes WHL's emerging market exposure.
3. In the enlarged group, the proportion of EBIT generated from food is estimated to be diluted from c.30% to c.20%, making WHL more of an apparel retailer. The combined group may trade at a lower PE multiple because apparel retailers are generally more discretionary and interest rate sensitive than the more defensive food retailers.
4. We estimate the transaction to be earnings dilutive in FY15 due to transaction and higher funding costs.
5. There is a possibility of this transaction being scuppered by Mr Solomon Lew (referenced previously).

Key dates to watch:

Monday, 14 July 2014: DJ shareholders vote to approve the transaction. The transaction requires approval by the majority of DJ shareholders (being a majority in the number of shareholders who vote and at least 75% of the total number of shares voted). ■

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Momentum Balanced Fund

Fund information - month ended 31 May 2014

Portfolio managers

Patrick Mathidi
Head of Core Strategies
Fifteen years' industry experience, with eight years at Momentum Asset Management

Herman van Papendorp
Head of Macro Research and Asset Allocation
Twenty-two years' industry experience, with one year at Momentum Asset Management

The Momentum Asset Management Core Strategies team's investment process is team based, leveraging the collective insights of the team, as opposed to exposing clients to the vagaries of a single star manager. The portfolio managers have meaningful discretion and remain ultimately responsible for the portfolio's performance against its stated objective.

Herman is the head of Asset Allocation and Macro Research, which ensures a robust emphasis on strategic and tactical asset allocation within the fund. The team also incorporates a full bench of highly experienced equity research professionals who provide continuous stock analysis and recommendations.

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Fund objective

The fund seeks to provide investors with high levels of income and moderate capital growth through a blend of domestic and offshore asset classes that include equities, fixed income, property and commodities.

Investment philosophy and process

The Momentum Balanced Fund leverages the full spectrum of the investment capabilities of the Momentum Asset Management Core Strategies team. The Core Strategies team is well established, with robust processes in place to strive for consistency of returns with predictable outcomes. The team operates within a strong risk management structure, which aims to deliver steady alpha through market cycles within a benchmark-cognisant framework.

Investment process

A top-down strategy is followed when deciding on the asset allocation and sector exposure of the fund, while stock selection is based on a bottom-up approach that encapsulates our investment belief that intrinsic company valuation is the only basis for sustained, long-term performance. While some value may be added through other, more short-term considerations, such contributions are always regarded as less reliable sources of alpha and, as such, should only constitute a small portion of the overall risk budget allocation (and hence of the overall return).

Key fund facts

Benchmark	CPI + 5%
Peer group	SA – Multi Asset – High Equity
Fund managers	Patrick Mathidi and Herman van Papendorp*
Fund size	R4.35 billion
Annual management fee	1.25% + VAT
Performance fee	(0% to 1%) + VAT
TER	1.65%
Maximum equity	75%
Offshore	25% global, 5% Africa
Risk level	Moderate to high
Inception date	1 February 1995

* Herman van Papendorp is under supervision

Asset allocation

In broad terms, our overall top-down asset allocation process consists of two steps. Firstly, we assess the likely prospects for global and domestic economies and markets. We are thus cognisant of global and local macro environment implications for asset classes, e.g. for equities vs. bonds, developed vs. emerging market equities, global fixed income, the US dollar, commodity prices, etc. We also monitor the asset classes that typically outperform/underperform during the current stage of the South African and global business cycles. Secondly, we determine the extent to which these prospects are priced into asset classes to identify divergences between asset prices and fundamentals to provide asset allocation opportunities to generate alpha. In this regard, we assess the current valuation of each asset class against its own history, as well as the relative valuations between the different asset classes against history.

A crucial overarching component of our asset allocation decision-making process is to marry asset class return probability ranges with the inherent risks (volatilities) of these asset classes in order to properly reflect the risk-adjusted returns of the different assets.

Equity research

The Core Strategies team's equity process rests on three pillars:

Pillar 1: We use normalised through-the-cycle fundamental valuation techniques.

Pillar 2: We assess the quality of companies by scoring them based on three predominant criteria: industry attractiveness, competitive advantage and stewardship.

Pillar 3: We consider the extent to which companies are exposed to pre-identified investment themes and risks, including pending regulatory risks, exposure to the business cycle, etc.

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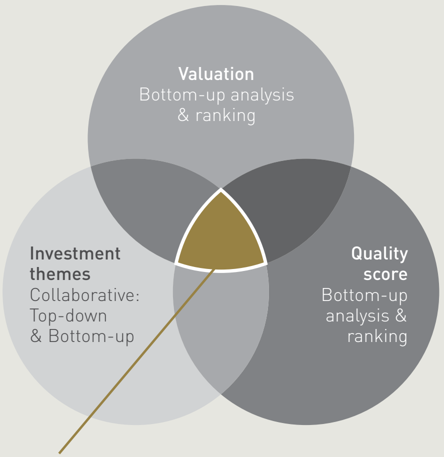
High-conviction stocks are allocated the maximum risk budget once they fill the requirements of the 'golden' triangle, as depicted to the right. Ultimate consideration is tilted towards valuation; however, where a good quality company shows pedestrian potential returns given our valuation, it is most likely that we will still find a position for it in the portfolio provided it is on the right side of the cycle. But, it is unlikely that such a company will occupy the largest absolute and relative weighting to benchmark. The same thesis applies to a cheap stock which, from our assessment, is of poor quality and has numerous themes against it.

Three pillars: Our framework for identifying 'leaders'



High conviction - Stocks that are not only cheap, but also expected to benefit from an identified investment theme/view and are of average or above-average quality.

Fund positioning as at 31 May 2014

Top holdings (% of equity)

British American Tobacco PLC	7.63
Standard Bank Group	7.49
Sasol	6.22
BHP Billiton PLC	5.99
Naspers	5.47
Firstrand	5.45
MTN Group	5.39
Bidvest Group	4.95
Steinhoff International Holdings	4.96
Anglo American PLC	4.56

Source: Momentum Asset Management

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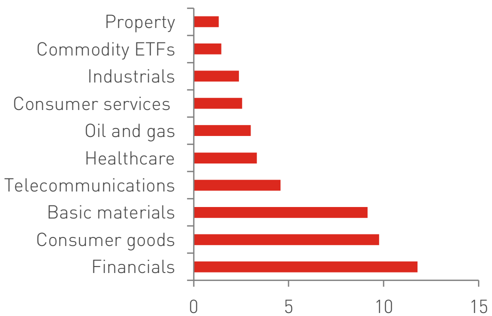
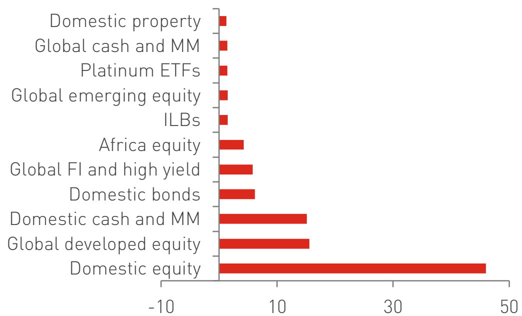
Equivalent sector exposure (%)



Source: Momentum Asset Management

Effective portfolio exposure (%)



Source: Momentum Asset Management

Why the Momentum Balanced Fund?

- Suitable for long-term investors targeting substantial inflation-beating returns over time, with moderate capital volatility.
- Diversification across asset classes and regions.
- Substantial equity holdings provide the potential for capital growth over time.
- Consistency of returns with predictable outcomes.
- Operates within a strong risk management focus (few surprises).
- The fund is Regulation 28 compliant and ideal for retirement and pension fund savings.

Market outlook

We expect the ongoing tapering of quantitative easing measures in the US during 2014 and the eventual tightening of monetary policy in 2015 to effect a rise in global nominal and real interest rates in the coming years. As such, we anticipate returns from the global fixed-income asset class to remain under pressure during this time. During the period of global policy normalisation, South African fixed-income assets are likely to underperform cash (particularly on a risk-adjusted basis), in our view. Furthermore, the first year of a rising domestic interest rate cycle has historically seen better returns from South African cash than from domestic bonds or equities. Although the absolute returns from cash might look unenticing, we deem these risk-adjusted returns in an expected domestic low-return environment as very attractive. The combination of rising domestic bond yields and a potential derating against bonds should negatively impact South African property returns.

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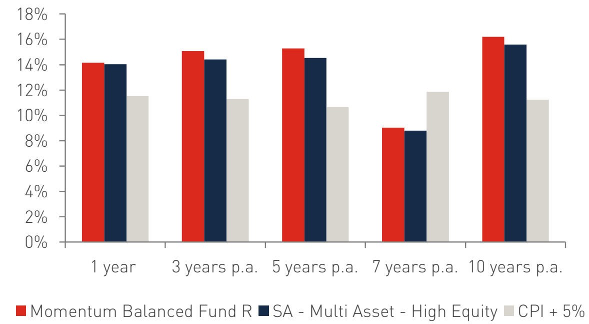
In contrast, global equities should be supported by accelerating earnings momentum, in line with global economic recovery, low, but positive (and eventually rising), inflation, more capital returns to shareholders in the form of dividends and share buybacks and fair to cheap valuations. Unfortunately, South African equities are likely to be a lagging performer within the global equity asset class as they look expensive on most valuation metrics.

Even though we view domestic equities as expensive against their own history and other emerging market peers, we continue to search for relative value within the asset class through our rigorous stock selection process. We currently prefer stocks that generate a significant amount of their earnings from offshore sources, given our negative view on the USD/ZAR. These include holdings in British American Tobacco, Steinhoff, Intu and Mondi. We continue to maintain exposure to banks through our holdings in Standard Bank and FirstRand, given our view that we are in a moderate rising interest rate environment. Banks tend to react positively to rate hikes (positive endowment), in contrast to retailers. There should also be restructuring benefits forthcoming for Standard Bank from its redeployment of capital away from low growth and return environments and into high growth areas like Africa.

We also like diversified mining stocks ahead of single-commodity producers – we remain constructive on China's growth prospects and its increasing demand for commodities while facilitating the urbanisation of its population. We believe the likes of BHP Billiton is well positioned to benefit from such an outcome. We have some exposure to the platinum sector, as we remain positive on the platinum price demand/supply fundamentals. For all the stocks we hold in the portfolio we have strong conviction that favourable relative valuations provide them with key support. ■

Fund performance as at 31 May 2014



Source: Morningstar Direct

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glossary of terms

Cost of equity (Ke)
The cost of equity is the return that stockholders require for their investment in a company.

Earnings before interest and tax (EBIT)
Earnings before interest and taxes (EBIT) is a measure of a firm's profit that excludes all expenses, except interest and income tax expenses. It is the difference between operating revenue and operating expenses.

Intrinsic value
The actual value of a company or asset based on an underlying perception of its true value, including all aspects of the business, in terms of both tangible and intangible factors. This value may or may not be the same as the current market value. Value investors use a variety of analytical techniques in order to estimate the intrinsic value of securities in the hope of finding investments where the true value of the investment exceeds its current market value.

Price to earnings (PE) ratio
A valuation ratio of a company's current share price compared to its per-share earnings.

Residual income (RI) valuation
Is an approach to equity valuation that formally accounts for the cost of equity capital. Here, 'residual' means in excess of any opportunity costs measured relative to the book value of shareholders' equity; residual income (RI) is then the income generated by a firm after accounting for the true cost of capital.

Return on equity (ROE)
The amount of net income returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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Back page and disclaimer

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