QC

Quarterly Commentary
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COMMENTS FROM THE CHIEF OPERATING OFFICER

Rob Formby

Twenty years in unit trust management is a milestone that could not have been achieved without the trust of you, our clients.

A lot can happen in 20 years. The iPhone was introduced in 2007, 11 years ago. Facebook and WhatsApp, which started in 2004 and 2009 respectively, have been around for less than 20 years, while Google has been around for exactly 20 years. These companies, among others, have in many respects both changed the world we live in and, at the same time, are an indication of how much the world has changed.

Within this context, the Allan Gray Equity Fund has just celebrated its 20th anniversary. While the world changes, our investment philosophy and process remain the same. We continue to believe that investing in assets that have been undervalued or shunned by the market, and selling them when they reach fair value, is the most effective way of growing your wealth, without taking on too much risk.

Julie Campbell, who was six years into her tenure at Allan Gray when the Equity Fund was launched, takes a comprehensive look at our first-ever unit trust. In her article she reminds us how the Equity Fund started, how it is managed, and provides some interesting examples of how the portfolio has changed.

When the Equity Fund started, Julie, along with other Allan Gray employees at the time, received a gift of R1 000 invested in the new fund. The value of this investment is now worth 50 times more. But looking back reveals that these returns have not come in a straight line. Investors in an equity mandate need to be prepared to buckle up tight and endure what at times can be a bumpy or disappointing ride. Endurance certainly can pay off, but you can also get bruised if you need to access your investment unexpectedly in a downturn or expect constant, regular growth.

The current climate is a case in point. The FTSE/JSE All Share Index (ALSI) has returned a modest 6.7% per year for the past three years, against an inflation rate of 5.2% over the same period. More recently, the ALSI is down 3.8% year to date. Our Equity Fund has fared a little better, but even so absolute returns this year are low at 0.4%.

While periods such as these are stressful for investors, negative sentiment starts to reflect in share prices and value begins to emerge. This gives us the opportunity to buy undervalued companies which have the potential to deliver stronger returns over the longer term.

Valuing companies

One of the shares that have been in and out of our portfolio over the last 20 years is Naspers. The share made up 4.8% of the Equity Fund back then (versus 0.24% of the ALSI) and is now 7.9% (versus 18.2% of the ALSI). The sheer size of this company gives credence to the time spent researching and debating its future prospects and investment potential. Ruan Stander explains how he goes about valuing Naspers, looking at price-to-earnings on the one hand and a sum-of-the-parts valuation on the other as he draws a conclusion.

Valuing a company is layered. There are many factors that need to be considered, none of which can be looked at in isolation. Good governance is an important aspect of long-term sustainability, and executive remuneration is integral to our investigation of the investment case of a company. Poorly structured incentives can cause long-term damage. We think very carefully about the executive remuneration policies of companies in which we invest our clients' capital, as Pieter Koornhof explains in his piece.

It is not always easy to apply our philosophy

As stated earlier, we have remained true to our investment philosophy and process since the launch of our Equity Fund – and indeed since Allan Gray himself started the company in 1973. An investment philosophy – which is essentially the stated way that a fund manager invests – is one of the key aspects that can be used to determine the skill of an investment manager. There are others, as Vuyo Nogantshi discusses.

An investment philosophy in concept is quite simple, but its success is only as good as its application. Many times over our history, our resolve has been tested, and we have been made to look foolish as we have stuck to our guns in the face of underperformance. Often we have had high conviction in the potential of a company only for the price to fall further. The skill is to trust the process, to be patient and wait for the thesis to play out.

Underperformance is a normal and expected part of the cycle when you are a contrarian manager, as Stefan Magnusson from Orbis explains, using Orbis's investment in Chinese technology company NetEase to illustrate his point.

What does the price say about your unit trust investment?

Looping back to our Equity Fund, another interesting thing to note is the change in price of a unit over time. When the Fund was launched, its units were priced at 939 c; today they sit at 41 328 c. But unit prices are not the same as share prices and the story they tell about your investment follows a different thread. Ray Mhere explains all in this quarter's Investing Tutorial.

Twenty years in unit trust management is a milestone that could not have been achieved without the trust of you, our clients. I thank you for this and look forward to the next 20 years.

Kind regards

Rob Formby

ALLAN GRAY EQUITY FUND'S 20TH ANNIVERSARY

Julie Campbell

... the Equity Fund has consistently achieved higher upside in its returns than its benchmark, with lower downside risk.

If you had invested R1 000 in the Allan Gray Equity Fund when it was launched on 1 October 1998, it would be worth R56 572 today (at 30 September 2018). A similar investment in the benchmark[1] would be worth R17 874. As Allan Gray's first unit trust celebrates its 20th anniversary, Julie Campbell, who as an Allan Gray employee was given a celebratory R1 000 investment at the launch of the Equity Fund and who has remained invested, looks at the Fund's positioning over time and how our investment philosophy has been applied to achieve its objectives.

The Allan Gray Equity Fund was launched against the backdrop of one of the most significant periods of underperformance in Allan Gray's history. Our clients' portfolios in 1997 and the start of 1998 had almost no exposure to technology and financial services companies, which performed exceptionally well despite our assessment that they were overvalued. Instead, our clients' portfolios were heavily weighted towards resource stocks, which were out of favour despite our research indicating that they were undervalued by the market. The three-year trailing relative share underperformance as at 31 March 1998 was 6%.

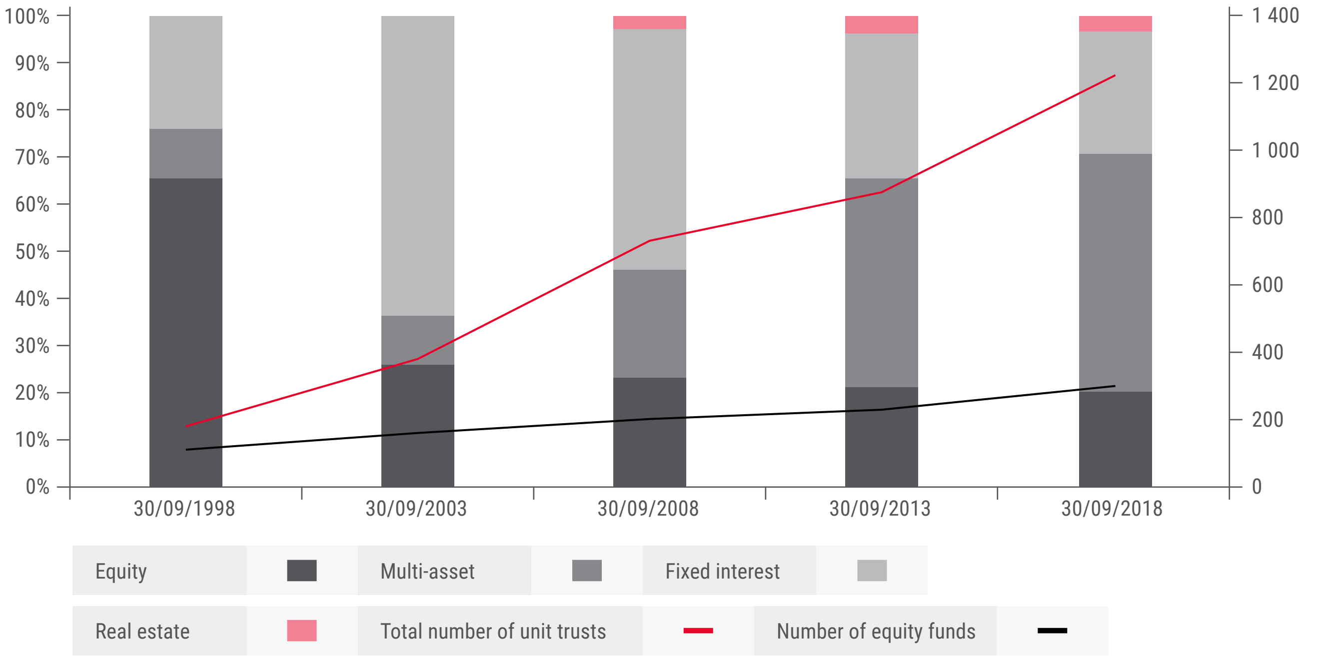
Subsequently, between 20 April and 11 September 1998, the local stock market declined 42% from its peak. During this period, market sentiment reversed and financial and technology shares slumped dramatically. Despite heightened market fear, the risk of further market weakness seemed low, and we believed that the potential returns from investing in equities seemed especially attractive. We considered it an opportune time to begin our journey into the unit trust industry and launched the Equity Fund to open our doors to a much broader pool of investors, for whom we believed we had the ability to generate long-term outperformance. Allan Gray was the last of the top 10 institutional managers at the time to launch a unit trust.

[1] The market value-weighted average return of funds in the South African – Equity – General category (excluding Allan Gray funds). From inception to 28 February 2015, the benchmark was the FTSE/JSE All Share Index including income.

Some things change ...

Of course the industry landscape has changed a lot since then, as can be seen in **Graph 1**. After the significant market volatility and downturns in 1998 and the early 2000s, there were major shifts in domestic mandates away from equity to fixed interest. In the last 15 years, the popularity of multi-asset unit trusts, which diversify across asset classes, has increased significantly, with South African multi-asset funds now representing 50% of local industry assets. As shown in **Table 1**, the number of unit trust management companies has virtually doubled in the last 20 years from 26 to 48, and the total number of South African unit trusts has increased six times from 186 to 1 227.

Graph 1: The local industry over time



Source: ASISA, Allan Gray research

Table 1: Then and now

	September 1998	September 2018
Business Day price (rand)	2.5	21.3
Rand/Dollar	5.87	14.15
Gold (US$)	297	1 192
Oil (US$)	15	83
All Share Index	4 703	55 708
Dow Jones	7 843	26 458
SA CPI (%)	8.8	4.9
Prime rate (%)	25.5	10
SA long bond (%)	17.4	9.2
Number of unit trust management companies	26	48*
Number of SA unit trusts	186	1 227*
Allan Gray Equity Fund price	**939.52**	**41 328.57**

* 30 June 2018.
Source: IRESS, ASISA, Allan Gray research

… some stay the same

Since inception of the firm, our investment philosophy has been to focus on the fundamentals of shares we invest in. We assess value from a long-term perspective, seeking to buy shares that are trading well below their intrinsic, or underlying, value. By intrinsic value we mean the value a sensible businessperson would ascribe to a company.

We adopt a multi-portfolio manager approach to managing our clients' portfolios. This means that each portfolio manager is allocated a share of the pool of money to manage, and that investors get exposure to a blended portfolio of all of their ideas.

The portfolio managers are supported by a team of analysts, who research and recommend shares for a "buy list". The portfolio managers act on their own conviction when selecting shares from the buy list, and they are held accountable for their individual decisions. Over the past 20 years, the number of portfolio managers managing the Equity Fund at any one point in time has ranged from three to five.

Managing succession – ensuring a seamless transition from one generation of decision-makers to the next – is critical and underpins our ability to deliver on our stated goal of generating long-term outperformance for our clients. Since 1998, we have seen four generations of decision-makers managing the Equity Fund, with each team simply passing the "baton" while the underlying process and philosophy remain unchanged. Today, Andrew Lapping, Duncan Artus, Jacques Plaut and Ruan Stander are the portfolio managers.

Shareholdings over time

The portfolio managers aim to create a diversified portfolio, investing in shares in which they have high conviction across all sectors of the stock market. Looking at the Equity Fund's holdings from 1998, there are a few interesting takeaways. Most notable is that at inception, the Equity Fund, despite being small, was not particularly concentrated at a stock level. At 31 December 1998, AVI Holdings (AVIH) was the largest individual position at 5% of Fund, and there were 47 positions. AVIH was an industrial conglomerate with numerous listed subsidiaries. The AVI we know today, however, includes only a few of the consumer businesses previously held by AVIH.

The Equity Fund's history also demonstrates the strengths of active management. There were numerous shares in the 1998 portfolio that have subsequently performed very poorly or gone bankrupt. Fortunately, many of these positions were sold when the portfolio managers deemed it suitable and the money was redeployed into new investments. For example, in 1998, the Equity Fund held a 7% position in the Altron group of companies; if this position was held until the eventual delisting, it would have been a terrible investment, but the position was sold during South Africa's infrastructure boom in the early 2000s.

> Over the long term, the compounding effect of above-average returns creates significant wealth for investors.

Today, the Equity Fund owns four companies that were also in the Fund in 1998, all of which have been sold to zero at a point in time, sometimes more than once. The companies are Sappi, Sasol, Naspers and Woolworths. The total annualised rates of return, with dividends reinvested for these shares since October 1998, are 13%, 21%, 32% and 24% respectively. These returns compare to the total Equity Fund return net of all fees of 22.4%. Naspers, the best performer of the four, was the largest holding among them in 1998 at 4.8% of Fund, but of the four it is the one we have held for the least amount of time over the past 20 years.

Although the Equity Fund invested only in domestic shares for most of its history, in March 2015, we broadened the mandate to allow investments in offshore assets. The Fund can invest a maximum of 30% offshore, with an additional 10% allowed for investments in Africa outside of South Africa.

Given that the South African market comprises around 1% of the global universe, the ability to invest in foreign equity allows the Equity Fund to benefit from further diversification and exposure to industries that are not well-represented on the JSE. We believe this will allow us to add more value for investors over the long term.

The Equity Fund invests the bulk of its foreign assets in equity funds managed by Orbis, our offshore investment partner. At end September 2018, the Equity Fund had a 29.4% exposure to foreign assets outside of Africa and 2.1% exposure to African assets outside of South Africa.

Risk of capital loss

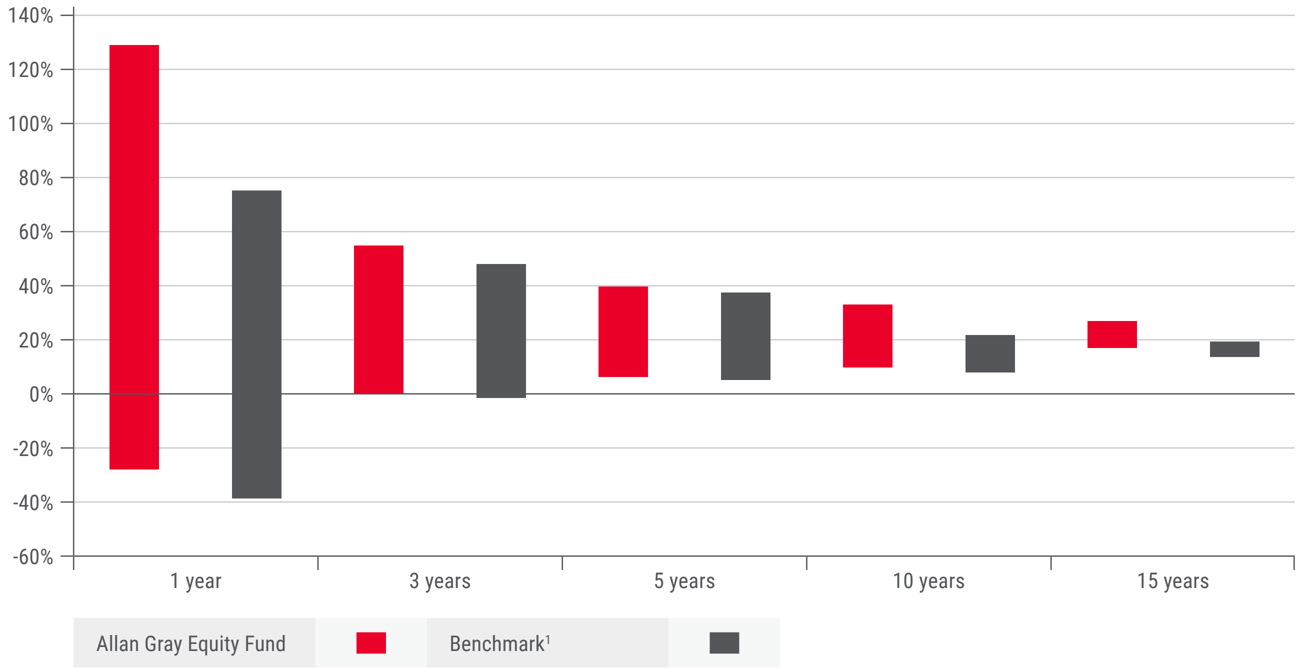
The Equity Fund's goal is to create long-term wealth for investors by investing in shares that offer the potential for higher returns over time. It aims to beat the average performance of similar unit trusts without taking any more risk. Investors in the Equity Fund must be prepared to accept the risk of capital loss, and be comfortable with volatile returns, especially over the short term, where a wide range of positive and negative returns over rolling one-year periods have been experienced since inception.

Graph 2 shows that volatility tends to smooth out over time. When we compare the Equity Fund's range of rolling returns experienced over one-, three-, five-, 10- and 15-year periods with those of the benchmark, we see that as the period over which an investment is held increases, the range over which the returns extend decreases. The time horizon serves to mitigate the variability in returns.

The graph also demonstrates that the Equity Fund has consistently achieved higher upside in its returns than its benchmark, with lower downside risk. Over the long term, the compounding effect of above-average returns creates significant wealth for investors.

It also helps to understand our definition of risk. At Allan Gray, we define risk as the probability of a permanent loss of capital. We don't see volatility as risk, as volatility only

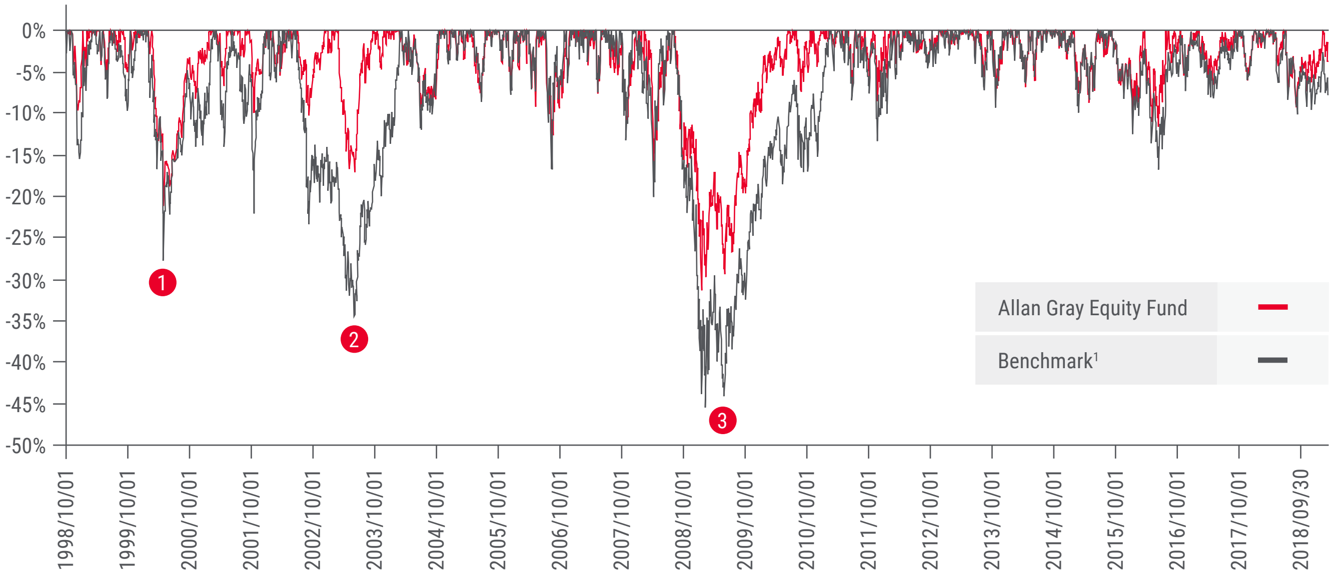
Graph 2: Range of returns



Allan Gray Equity Fund					
	1 year	**3 years**	**5 years**	**10 years**	**15 years**
Minimum	-28%	0%	6%	10%	17%
Average	22%	20%	20%	19%	20%
Maximum	129%	55%	40%	33%	27%
Benchmark[1]					
	1 year	**3 years**	**5 years**	**10 years**	**15 years**
Minimum	-39%	-1%	5%	8%	14%
Average	17%	16%	16%	16%	16%
Maximum	75%	48%	37%	22%	19%

Source: Allan Gray research

Graph 3: Maximum drawdowns



	1		2		3	
	Equity Fund	Benchmark	Equity Fund	Benchmark	Equity Fund	Benchmark
Maximum drawdown	-21%	-28%	-17%	-34%	-31%	-45%
Days to recover	266	287	105	266	497	714

Source: Allan Gray research

translates into a realised loss if an investor actually exits the Equity Fund. In looking at permanent loss of capital, we are not only concerned about the probability of capital loss, but also what the size of a loss might be. We can measure the potential size of future losses by looking at the maximum drawdowns of the Equity Fund over time. Maximum drawdown is the maximum decline in the investment performance (including income) over any period, i.e. the decline from a peak in the price to the trough.

Graph 3 shows that the largest drawdown in the Equity Fund's history was 31%, which would have been experienced by an investor who had been invested in the Equity Fund for the 160 days from 20 May 2008 to 27 October 2008. By comparison, the largest drawdown experienced by the benchmark (which at that time was the FTSE/JSE All Share Index) was 45% over the period 22 May 2008 to 20 November 2008.

Equally important is the time it takes a fund to recover from such a loss, which in the case of the Equity Fund was 497 days. The benchmark took 714 days to recover, almost 1.5 times as long. This reflects that the Equity Fund has taken on less risk to achieve its performance objectives.

It is useful to note that an investor who had remained invested for a five-year period commencing at the peak on 20 May 2008 would have received an annual return of 10.2%, despite this period including the largest drawdown experienced in the Equity Fund's history. Inflation only returned 5.7% over this period. This demonstrates the importance of adopting a long-term approach, and not selling in panic and realising losses during a market downturn.

Investing for the long term

Investors who believed in the Allan Gray investment philosophy and chose to invest in the Equity Fund – including those Allan Gray employees who held on to their R1 000's worth of units in the Equity Fund they received back in 1998 – have been well-rewarded, as shown in **Graph 4**. The annualised return of the Equity Fund net of all fees and expenses since inception has been 22.4% per annum, versus 15.5% for the benchmark.

Of course we must always remember that past performance is not necessarily a guide to future performance. However, history suggests that if you are prepared to accept a measure of higher risk, then higher exposure to equity over a long time horizon has the potential to deliver higher growth –

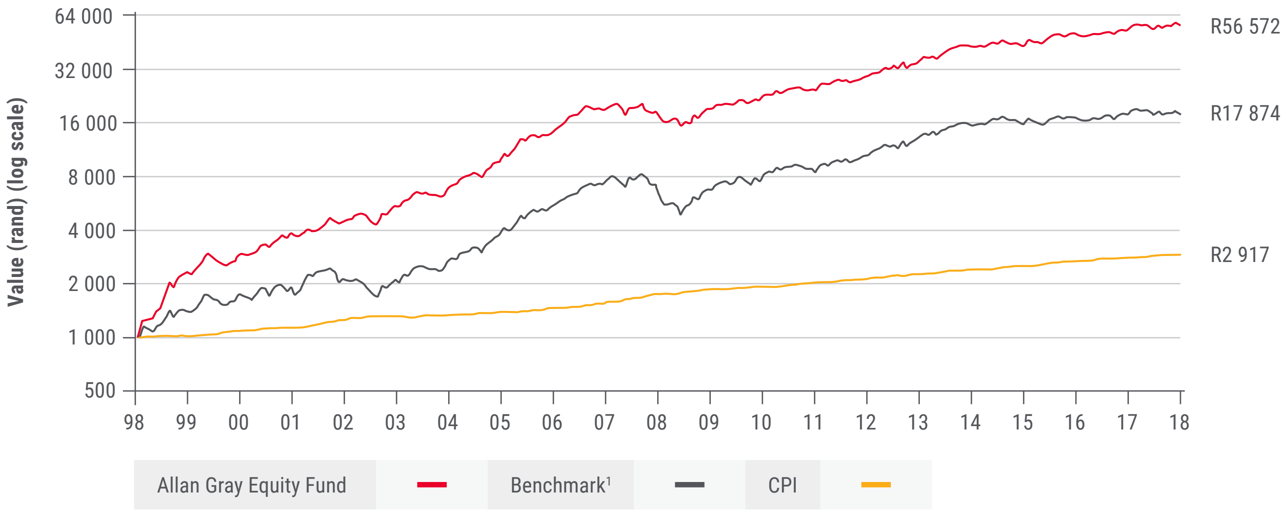
but only if you have the stomach to ride out periods of market turbulence and remain invested for the long term.

A long-term track record is hollow if your clients don't remain invested to enjoy the long-term outcome. As such, we aim to work with our clients, their advisers, consultants and other intermediaries to ensure we deliver excellent service, one of the hallmarks of which is to clearly and simply communicate our approach so that our clients can share the underlying conviction that we have in our approach, team and firm.

Trust is hard won, and easily lost. We look forward to the next 20 years of maintaining the trust that our clients have placed in us.

Note: Please see page 26 for performance figures and total expense ratios and transaction costs.

Graph 4: Allan Gray Equity Fund performance over time



Source: IRESS, Allan Gray

Julie joined Allan Gray in 1992 as a performance analyst. She is a senior manager in the Product Development team and a director of Allan Gray Life. Previously she led the Fund Operations team in the Institutional business. Julie completed her BSc (Hons) in Mathematical Statistics at UCT.

AN INVESTMENT CASE FOR NASPERS

Ruan Stander

Given the market multiple, strong growth and protection from competition due to network effects, Naspers offers attractive value to long-term investors.

As at 30 September 2018, Naspers made up 18.2% of the JSE. Whether you are for or against the stock, adequate time needs to be devoted to considering the investment case as including or excluding it will have a big impact on your portfolio. Ruan Stander explains his approach to valuing the company.

At a price-to-earnings (PE) multiple of 35 on core headline earnings and a 3.4 multiple of accounting book value, Naspers appears expensive. However, when the company is viewed as a sum of parts, the picture becomes compelling. The share price of R3 000 is trading at a 44% discount to our estimated asset value of R5 400 per share, which we calculate by looking at the market value of listed assets like Chinese technology company Tencent, the estimated fair value of unlisted assets such as online classifieds business OLX, and cash realised on recent asset disposals. The margin of safety is so significant that a closing of the discount would create R1 trillion of value for shareholders, and halving the value of Tencent would still leave the company at a 10% discount to the sum of its parts.

Which perspective – PE or sum of the parts – is most relevant when considering an investment case for Naspers?

Let's start by addressing a pitfall of a sum-of-the-parts valuation. The sum is only as accurate as the parts.

What is a PE ratio?

A PE ratio is an indication of the price of a company relative to its earnings and calculated as the price of one share (share price) divided by the annual earnings that that share buys the owner (earnings per share).

A high ratio indicates that investors require the earnings to grow in the future and/or that the earnings are sustainable for a long period of time. A low ratio implies a business might not be around for a long time or could be in secular decline.

If Naspers were trading at our estimated fair value (R5 400), the PE would be closer to 60. If Naspers consisted of excellent businesses growing earnings 5% faster than the stock market, these businesses would have to grow at this rate for 25 years to match the stock market's PE ratio of 18 – a very optimistic assumption. However, this is not required as the profitability of some of Naspers's businesses (Tencent's online gaming business, MultiChoice South Africa and Russian online classifieds business Avito) is being offset by losses in various start-up businesses across the world.

A theoretical manufacturing conglomerate with loss-makers across the world would not seem attractive since upfront capital spend should allow an average business to earn reasonable profits; losses would likely indicate an inferior product or production process. But for online businesses, this analogy does not translate well, since the barrier to entry is not capital spend, but rather network effects, and start-up losses are typically required to establish a network effect.

Network effects

Brian Arthur was one of the first academics to write about "network effects" or, in his words, "increasing returns". The concepts and conclusions of his 1983 paper were so different from established equilibrium economics at the time that the paper was rejected by four top journals over a period of six years. Today, the empirical evidence is overwhelming, and indeed Arthur has been rewarded with various prizes and an influential role in the way information technology companies think about their businesses.

The theory maintains that if you have a business where value per user increases with the number of users, then it is very hard to predict market share when the market is young, but once your firm establishes a significant lead, market share tends to "lock in", or persist. Facebook is a classic example where more users make the product more attractive to new users as they can connect to more people. Interestingly, the effect can be so strong that networks can exclude superior technologies, such as in the classic case study of VHS video cassettes winning against Betamax.

The implication for young network effect businesses is that it is advisable to focus on achieving a significant lead, even (especially?) at the expense of profitability, since a locked-in lead will ensure substantial profitability at a later stage. Examples of companies many of us use today, such as Google, Amazon and Facebook, took between four and nine years to reach profitability in search of a significant lead. Today, they enjoy very high returns with market positions that have held firm despite fierce competition. In all three cases, their competitors (eBay, Yahoo, Myspace/Friendster) were arguably too focused on showing profits early on and, as a consequence, ended up being overtaken and, with the exception of eBay, outcompeted into irrelevance.

Do Naspers's loss-makers exhibit network effects?

Within the Naspers/Tencent stable, three significant business models stand out in the loss-maker column: online classifieds, online food delivery and online payments (especially WePay in Tencent). When evaluating these business models, network effects are clear, and one can point to case studies where the winner keeps on winning after incurring initial losses to establish a lead:

- In online classifieds, a buyer's chance of finding what he is looking for increases with the number of sellers and vice versa.
- In online food delivery, the customer's selection increases with the number of restaurants listed, and more users allow a restaurant to serve them effectively.
- Online payment requires adoption by many merchants and users to make it worthwhile.

There are, however, pitfalls when evaluating young network effect businesses:

- Substantial subsidies to customers can create an artificial market (i.e. user growth which disappears when subsidies are removed).
- New technologies could disrupt existing winners if they are not willing to adapt.

Does the theory translate into reality for the portfolio of companies Naspers owns?

One way of checking this is to see if the Naspers portfolio of ecommerce businesses shows increased returns while growing at a healthy rate. **Graph 1** on page 12 illustrates that the organic growth rate, as well as profitability, improved in the ecommerce segment for the year to March 2018, indicating increased returns and a low likelihood of unsustainable customer subsidies.

Given that Naspers's online businesses should exhibit network effects and the evidence shown in Graph 1 indicates increasing returns, the next question is: What would earnings look like when the losses reverse to industry standard levels of profitability?

Naspers's normalised earnings per share can be seen as two parts that sum to US$9.2 per share. This is made up of Naspers's 31% share in Tencent, contributing US$7.6 to normalised earnings over the past 12 months, and Naspers's ecommerce businesses at normal margins of 17% on expected 2019 revenue, contributing US$1.6 (the segment reduced earnings by US$1.4 in the year to March 2018).

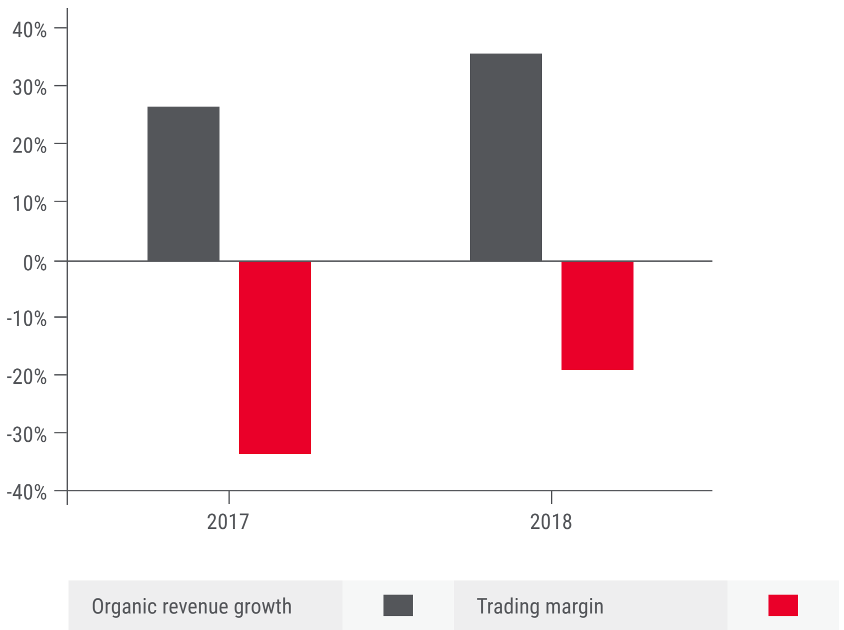
If we consider that the current Naspers share price is US$210, US$43 of this comprises the value of MultiChoice that will be unbundled, and cash realised on recent asset sales. Therefore, one is paying around US$167 (US$210 - US$43) for a normalised earnings stream of US$9.2 or an 18 PE ratio (US$167/US$9.2).

The same PE multiple as the stock market seems very attractive for a group of businesses that converts its accounting earnings to cash (since they don't need to spend on physical assets), should be hard to compete against given network effects, and is still growing at around 40% per year.

In addition, there is further upside that has not been included in the valuations above. Tencent's payment business, which has achieved significant scale and market share with estimated annual transaction value of between US$1 trillion and US$11 trillion, is not currently charging users or merchants since it is competing for dominance with Alibaba. Assuming a 0.5% profit margin on the transaction value would create an additional earnings stream of between US$3 and US$33 per Naspers share. Tencent's investment portfolio is worth around US$36 per Naspers share. Moreover, various Tencent businesses, such as online video and cloud services, are still in the loss-making phase and these losses have not been adjusted to a normal level of profits as we did with Naspers above.

Given the market multiple, strong growth and protection from competition due to network effects, Naspers offers attractive value to long-term investors.

Graph 1: Naspers eCommerce: Organic growth and improved profitability are evidence of increasing returns



Source: Company reports and Allan Gray research

Ruan joined Allan Gray in 2008 and is a quantitative and equity analyst as well as the portfolio manager of the Allan Gray Optimal Fund. He managed a portion of client equity and balanced portfolios earmarked for associate portfolio managers from March 2013 and was appointed as portfolio manager of these portfolios in November 2015. Ruan has an honours degree in Financial and Actuarial Mathematics, is a GARP-certified financial risk manager and a qualified actuary.

EXECUTIVE REMUNERATION: SKIN IN THE GAME

Pieter Koornhof

We think a good outcome is when a company performs well over the long term and its executives are rewarded handsomely (but not excessively) for performance within their control.

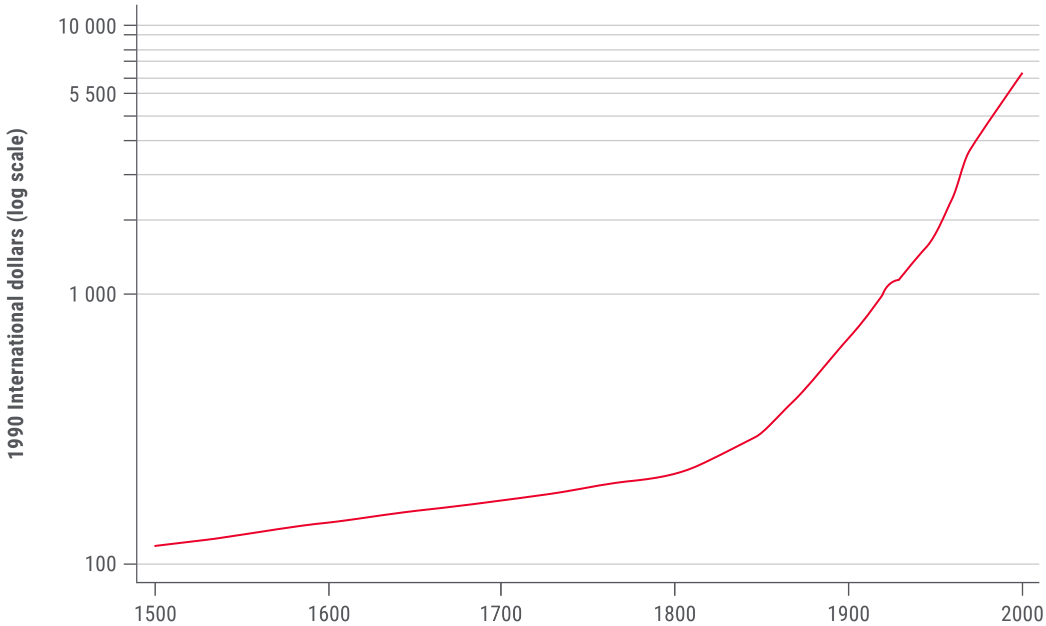
At Allan Gray, we think carefully about the executive remuneration policies of companies in which we invest our clients' capital. Why is this a worthwhile exercise? The answer lies in how companies are governed and the outsized impact that executives' incentives often have on the total shareholder return of the companies they manage. Pieter Koornhof explains.

The world's first publicly traded company, the Dutch East India Company (DEIC), was founded in the early 17th century. This marked the dawn of modern capitalism as it was the first time that the public (everyday people like you and me) could buy shares in a company that was managed by someone else. This separation of ownership from management was crucial as it enabled entrepreneurs to raise capital from the public to fund new business ventures and technological innovations. This, in turn, paved the way for the Industrial Revolution that heralded an era of unprecedented economic progress, as reflected in **Graph 1** on page 14.

Public companies have been an enormous benefit to mankind, but their structure presents inherent problems as soon became apparent at the DEIC. The DEIC was formed in 1602, and experienced its first governance crisis as early as 1609, when executives raided the company's coffers to enrich themselves at the expense of shareholders. And not long after, in 1622, there was the first shareholder revolt when it emerged that executives had been cooking the books and shareholders demanded a proper financial audit of the company.

What went wrong at the DEIC? Economists call this type of problem a "principal-agent problem" or "moral hazard". In the context of public companies, the root cause of the problem is that the incentives of executives who manage the company day-to-day are not always aligned with the long-term interests of shareholders, the owners of the company. The world has come a long way since 1622, yet today, despite centuries of advances in economics, contracting theory and corporate law, the principal-agent problem between shareholders and executives still frequently results in poor outcomes for stakeholders in public companies.

Graph 1: World average real GDP per capita from 1500 - 2000



Source: J. Bradford DeLong, "Estimates of World GDP, One Million B.C. - Present" (1998)

The solution and its shortcomings

Executive remuneration policies have arisen as the accepted solution to this problem. Many executives work hard because they enjoy their jobs, or because of some other intrinsic motivation, but some inevitably game the system for monetary gain.

The idea with executive remuneration policies is to structure the remuneration so that the executive gets a bigger payout if the company performs well (which also benefits shareholders and other stakeholders), but a smaller payout if the company performs poorly. In theory, executive remuneration policies should nudge executives to act in shareholders' long-term best interests. However, for a number of reasons, it is rarely that simple in practice.

Remuneration committees are composed of non-executive directors, who are unlikely to know the company nearly as well as the executives who manage it day-to-day. This information asymmetry leaves executives well-positioned to convince the remuneration committee that good performance is due to their brilliance, while poor performance is due to external factors outside of their control.

Similarly, it is difficult to set performance targets that are sufficiently stretching, and remuneration committees often have to rely on executives for guidance on this. However, it is in executives' self-interest to low-ball the targets to make them easier to achieve, and in doing so ensure big bonus payments.

It is also tempting to think that to get the best executives, companies must pay them the most. Research by MSCI has shown that this is not the case: **Graph 2** illustrates that companies whose chief executive officers' remuneration is less than the average of peers actually outperform over long periods of time.

It is difficult to determine the optimal performance factors, i.e. the metrics on which an executive's performance should be measured when determining their remuneration. Many performance factors can be gamed or, alternatively, may incentivise the wrong behaviour, often resulting in value destruction.

At Sun International and Famous Brands, for example, earnings before interest, taxes, depreciation and amortisation (EBITDA) was the primary performance factor for executives' remuneration, which possibly contributed to executives pursuing expensive offshore acquisitions. Unfortunately, EBITDA is often a flawed performance factor, as it does not factor in the cost of capital and the capital expenditure necessary to maintain the EBITDA.

The outcome was that, while executives at these companies received big bonuses for achieving their targets, shareholders suffered as the acquisitions were value-destructive. In addition, despite a remuneration committee's best intentions, even sensible performance factors sometimes have unintended consequences.

Another common pitfall is that executive remuneration policies are often quite short term, with very little remuneration tied to how the company performs over the long term. Short-term results often have a lot of noise in them and it takes time before it can be determined whether capital allocation has been prudent. As such, if a company is undertaking a capital project or acquisition and it is expected to take five years before it becomes clear whether or not it has been value-accretive, there is a fundamental misalignment if executives receive most of their remuneration after one or two years.

So how can these shortcomings of executive remuneration policies be overcome?

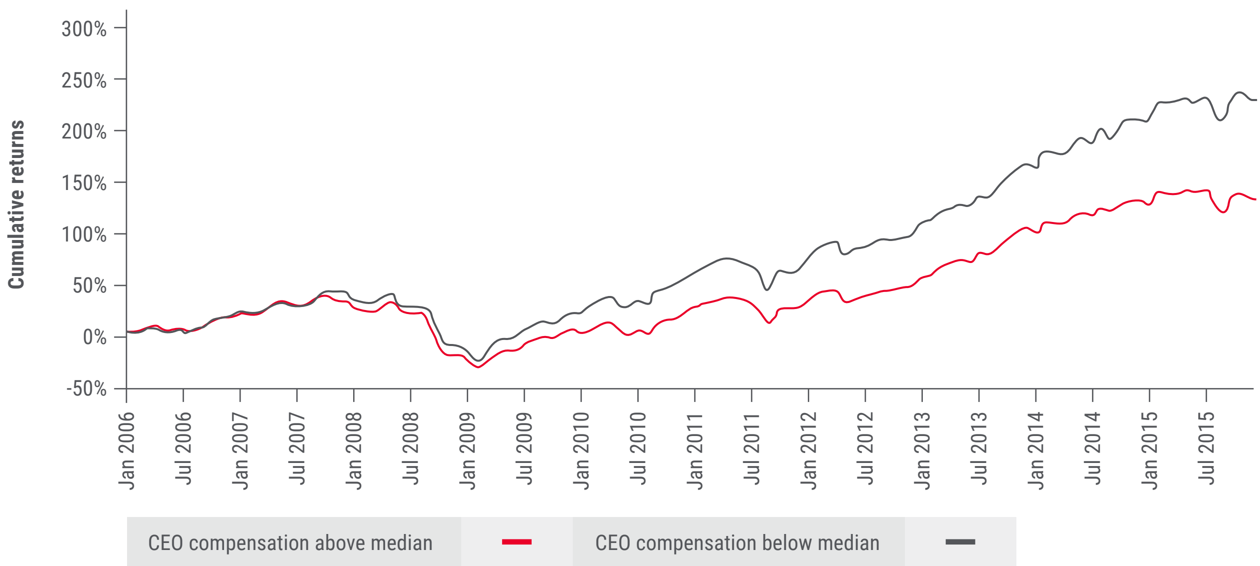
Allan Gray's approach

When looking at the remuneration policies of companies we invest in, our guiding principle is that executives should have "skin in the game". This is the best way to ensure that they act in the long-term best interests of shareholders. To achieve this, the following is necessary:

- Executives should build up a material long-term shareholding in the companies they manage.
- Most of executives' remuneration should be tied to the long-term performance of the company, with "long term" meaning at least five years.
- The performance factors used must be difficult to game and must incentivise prudent capital allocation, not value-destructive behaviour.
- The quantum of executives' total remuneration should not be excessive compared to that of executives in other companies in the same industry and/or of a similar size.

We think a good outcome is when a company performs well over the long term and its executives are rewarded handsomely (but not excessively) for performance within their control. This is also beneficial to other stakeholders as a company is unlikely to create value for shareholders over the long term unless it also takes care of its staff, environmental resources, regulatory obligations and other stakeholders. We also actively try to guard against bad outcomes, such as executives getting big payouts when shareholders and other stakeholders suffer.

Graph 2: 10-year total shareholder returns comparing total pay medians



Source: MSCI ESG Research. Returns shown are equal-weighted.

We carefully analyse the executive remuneration policies of companies we invest in. This research is done within the investment team as it is often an important component of the investment case for a company. Each company is different, so performance factors that work for one company may be inappropriate for another, and it helps if you have investment analysts who know the company well enough to tell the difference. We avoid box-ticking and try to approach each company with an open mind, while trying to be reasonably consistent across companies.

We also use various tools to help with this analysis, including a big data set we have built on the remuneration of most executives active at Top 40 and mid-cap companies. This includes details of various aspects of executive remuneration, including the quantum, structure, performance period and other relevant metrics.

We use engagements and proxy voting to influence remuneration committees to improve executive remuneration policies as we believe this can make a material difference to capital allocation and companies' subsequent shareholder returns. Please see our annual Stewardship Report and Policy on Ownership Responsibilities for more details, both of which are available on our website.

While a good remuneration policy is no panacea, it is an important tool to ensure that executives have skin in the game and act in shareholders' long-term interests.

BHP Billiton: An example of a good remuneration policy

We consider BHP Billiton's executive remuneration policy to be well-aligned with shareholders' interests for the following reasons:

- Most of the remuneration vests over five years. This is a long vesting period compared to that of most companies.
- The payouts are based on how the company performed compared to peers over the five-year period, with no payout if BHP underperforms its peers.
- The incentives are also share-based awards, meaning that over time, executives build a shareholding in the company.

Together, these factors ensure that executives have skin in the game. While this is no guarantee that BHP will perform well in the future, it is a good start.

Pieter is an analyst in the investment team. He joined Allan Gray in 2013 after graduating from the University of Oxford. Pieter is a qualified Chartered Accountant (SA) and Chartered Financial Analyst.

ORBIS GLOBAL EQUITY FUND: UNPACKING RECENT PERFORMANCE

Stefan Magnusson

... periods of poor performance and low investor confidence can often give us the opportunity to invest in high-quality companies at depressed prices.

As bottom-up stockpickers, we don't pay much attention to benchmarks or to what other investors are doing. Instead, our investment decisions are based on high-conviction beliefs that each individual stock in the portfolio is trading for much less than it is worth. While we firmly believe that this approach provides the best opportunity to deliver pleasing long-term returns for clients, it inevitably exposes us to the risk of underperformance at times when our best ideas perform poorly relative to the rest of the market. With this year being one of those times, Stefan Magnusson from our offshore partner, Orbis, explains that while underperformance is uncomfortable, it is an expected part of the cycle when you are a contrarian investor.

For the year to date, the Orbis Global Equity Fund (the Fund) has declined by 5.3% after fees, compared to the market's return of about 5%. This underperformance was driven in part by stock selection. Our exposure to emerging markets more broadly has also weighed heavily on performance.

The headlines from China

The escalating trade war with the US is not good news. China's economic growth trajectory had already been slowing down significantly from its remarkable three-decade average of over 9% per annum. While there is room for the government to stimulate the economy, higher overall debt levels and a desired rebalancing of the economy may temper such a response. Moreover, as the consumer of almost half of the world's commodity production, a slowdown in Chinese growth may have far-reaching effects on commodity producers and other China-dependent industries.

But headlines don't tell the whole story. At times like this, we look beyond the short-term noise to understand the likely impact on the businesses that we own in the portfolio. Assuming the fundamentals haven't changed, periods of poor performance and low investor confidence can often give us the opportunity to invest in high-quality companies at depressed prices.

We believe that's exactly what's happening today. This can be seen by taking a closer look at the Chinese video game developer NetEase, which has been one of the Fund's largest performance detractors in recent months.

We believe NetEase's earnings are resilient to the Chinese economy as its games have a loyal user base. Additionally, NetEase's games are a relatively cheap form of entertainment and as such are not likely to be the first purchase that users cut back on in an economic slowdown.

Uncertainty over gaming regulation

Along with broader concerns about the economic slowdown in China, uncertainty about online gaming regulation has recently spooked investors. China's gaming regulator is undergoing a restructuring and has not approved any applications for new games since March this year. At the same time, other government bodies are pushing to manage the time minors spend playing games. The impact on NetEase's share price has been painful. Its shares have declined by close to 40% from their peak in December 2017 in US dollar terms. Investors fear this heralds a wave of tightening regulation that would harm leading game companies.

We disagree. Discussions with a number of industry stakeholders suggest that the government is not aiming to suppress the gaming industry, and the relevant agencies are expected to resume approving games in a number of months. In the meantime, NetEase is largely insulated from the halt in approvals as its flagship franchises have already been approved and operating for years. We also note that the company has astutely navigated similar regulatory changes over the past decade, and we are confident that it will successfully navigate them this time as well.

Our confidence is in large part driven by the stewardship of William Ding, the company's founder, who is focused on creating long-term shareholder value through a relentless focus on product differentiation, continuous improvement, and dedicated investment in research and development.

New opportunities

Most recently, NetEase has spent a lot of money moving into new game genres as well as expanding overseas, with notable success in Japan. The company has also continued to invest heavily in new areas of ecommerce, music, and online education. While this increased spending has depressed margins in the short term, we believe it has seeded a promising pipeline of future earnings streams which the market has all but ignored. The music business, for example, has over 400 million users. And the ecommerce businesses, though not yet at scale, grew revenues by 75% in the 12 months to June 2018. In short, we are very excited about the potential of these businesses.

What are we paying for this potential?

NetEase trades at 25 times our estimate of 2018 earnings, but we believe the company's normalised earnings power is considerably higher. Today, the company's market value is US$30bn. After deducting the US$5bn net cash it holds, NetEase trades at around 13 times the normalised earnings of its core gaming business. Moreover, we believe that these earnings should grow in future. In other words, we believe the games business alone will generate more in profits in under 13 years than the entire company is worth today!

... [NetEase] has astutely navigated similar regulatory changes over the past decade, and we are confident that it will successfully navigate them this time as well.

That is very cheap for a business of this quality. For context, about 10 times earnings is what you might pay for a firm with cyclical profits, slow growth, and a levered balance sheet – not a consistently profitable, fast-growing company with billions in net cash. And this way of looking at the stock is likely conservative. If our analysis is correct, NetEase stands to earn significantly more than the profits of its gaming business as its new ventures begin to contribute in the years to come.

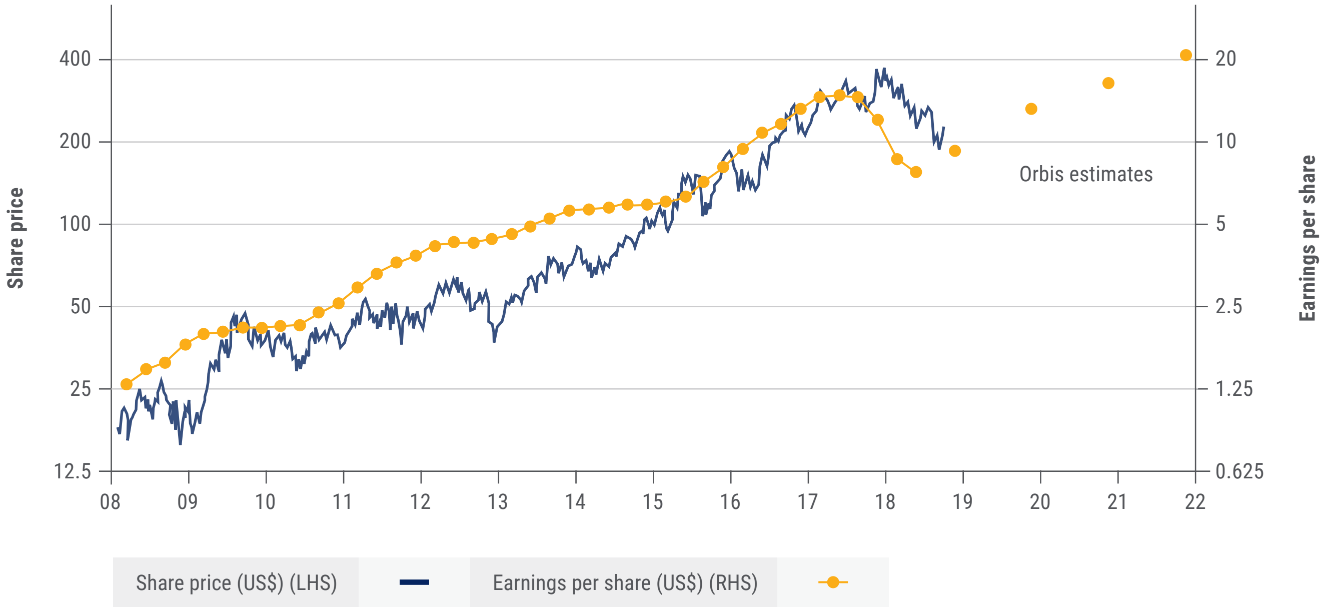
Pessimism can create opportunities

The current period of weakness reminds us of similar times in the company's past when short-term pessimism created an opportunity to increase our position. Since we initially invested in NetEase 10 years ago, profits have compounded at a rate of 25% per annum, which is equivalent to doubling every three years. Essentially all of these profits have been converted to cash, with free cash flow matching, and often exceeding, accounting profits. The company has shared this success with shareholders both in cash – paying over US$1.5bn in dividends over the period – and in price appreciation, rising by an annualised 25% in tandem with its earnings growth. See **Graph 1**.

It is hard to say what lies ahead in the short term for NetEase – or for China more generally. We have learned the hard way that things can always get worse before they get better. But taking a step back, what matters most to us is guarding against the permanent loss of our clients' capital and ensuring that your capital is positioned alongside ours in our highest conviction ideas.

Graph 1: NetEase: Earnings growth drives the share price

NetEase ADR price and trailing 12-month earnings per share, with estimates, 2008 to 2021

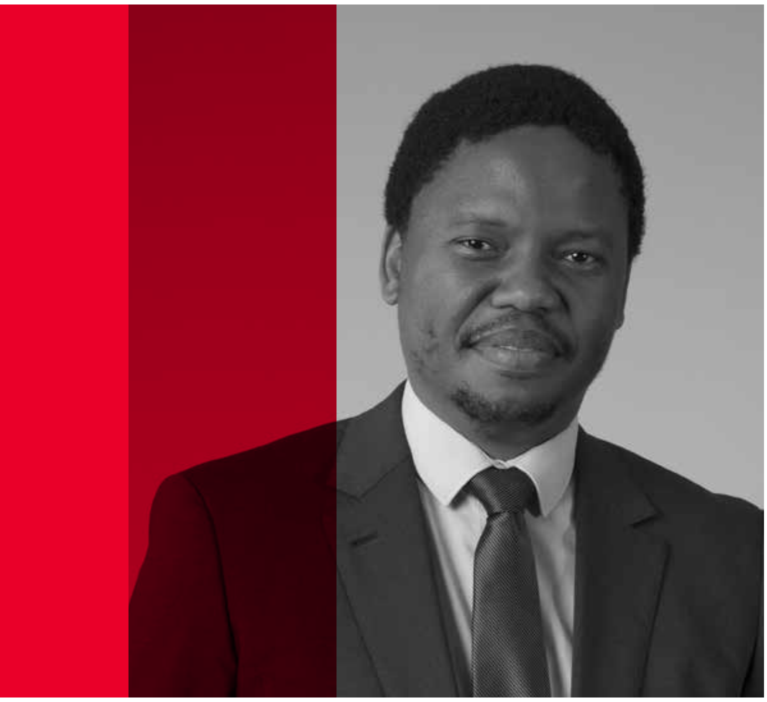


Source: Capital IQ, Orbis

Stefan joined Orbis in 2003. Based in Hong Kong, he leads the Emerging Markets investment team and is one of the stockpickers who direct client capital in the Orbis Global Equity Strategy. Stefan previously worked in the investment banking and private equity departments at Morgan Stanley. He has a Master of Science in Business and Economics (Stockholm School of Economics; graduate studies at the University of St. Gallen and University of Melbourne), completed an Advanced Management Program (Harvard Business School) and is a Chartered Financial Analyst.

SKILLED INVESTING: SEPARATING THE WHEAT FROM THE CHAFF

Vuyo Nogantshi



It is important to assess your manager's behaviour relative to their philosophy through several market cycles.

The difference between skilled and lucky investment managers is that over extended periods, skill should prevail in delivering good investment outcomes, while luck can only persist for so long before it becomes undone. It is important to distinguish between the two and to focus on the right factors when choosing an investment manager. Vuyo Nogantshi discusses some important aspects to consider when making your decision.

Michael Mauboussin, a well-known contributor to the pool of literature on skill in investing, characterises investing as an activity that sits somewhere on the spectrum between pure skill (no luck) and pure luck (no skill). If you think about activities that require skill and those that require luck, a key aspect to focus on is *intention*.

If you can deliberately drive the outcome of the activity and repeat this, then more skill is involved. For example, consider chess, where it is considerably less likely that a grandmaster is luckily outdone over the course of a game.

Is past performance the only means to assess skill?

Past performance is a good means of assessing manager skill. This is especially the case when you measure performance over a longer period and over many investment cycles. Less weight should be put on short-term measures as this can be misleading. However, even longer-term performance has its pitfalls and as an investor, you must be cognisant of the perils that exist in basing conclusions solely on this factor. Performance can be distorted by things such as 1) appropriate benchmarks, 2) the opportunity to outperform, 3) how the investment is constrained, and 4) market factors.

Appropriate benchmarks

A benchmark is a point of comparison. Investment managers set benchmarks to measure the performance of their funds. While benchmark selection is complex – and we cannot go into the detail in this piece – a benchmark should be appropriate to the nature and form of the investor's objective.

For instance, while Everton F.C. is an English Premier League football team, it makes little sense to benchmark Real

Madrid C.F. against Everton. However, if we did choose to go ahead and benchmark in this way, we would not be able to tell much from the result, other than to say that Real Madrid was able to beat Everton. In order to assess how good Real Madrid is, we would need to position an opponent that was representative of skill against Real Madrid and assess how consistent their performance was over time.

Similarly, for manager performance, if the benchmark set is not appropriate, it can appear as if a manager has skill, when in fact the true conclusion to be made is that the benchmark selection was poor.

The opportunity to outperform

Debate on active versus passive investing generally focuses on the concept of the zero-sum game (active investors in aggregate earn the same average return, before fees, as passive), but another important factor is whether the opportunity for active management to "work" exists.

One indicative lens used to assess the state of a market is "cross-sectional volatility". This measure tests whether stocks in a market are moving together or diverging. For opportunities for outperformance to exist for an active manager, the market should be diverging (i.e. a higher cross-sectional volatility measure). This measure is a good tool (among others) to assess whether the environment structurally allows your active manager to add value.

Bear in mind that different markets present different opportunities for outperformance (alpha) and that this will impact the performance signature of investment managers in those markets. This is why it is important to assess performance over time.

How are different investment managers constrained?

Investors tend to see two sets of performance from two different portfolios and immediately draw conclusions about the superiority of one over the other. But beware of "comparing apples with pears" (or "grandmothers with toads", as the Serbian saying goes). Without clear knowledge of what constrains each portfolio (e.g. offshore allowance, asset allocation limits, mandate limits), some conclusions may be questionable. Make sure that your comparisons are fair.

Market factors

The history of South Africa's stock markets is not complete without a discussion about the dominance of certain sectors and large shares over time. As Ruan Stander discusses, Naspers currently dominates the market, representing over 20% of the top 40 shares in issue, while previously, the conversation focused on the resources sector. Situations such as these can distort investment outcomes since managers could simply be winners or losers by holding or not holding a dominant share. When assessing performance, you need to ensure that performance was not the result of a single big bet.

What other factors point to a skilled manager?

It's important to know and understand your manager and consider qualitative measures, such as the trusted Ps: philosophy, process and people. This will allow you a better sense of their intention and the subsequent outcome, which in turn will allow you to better judge skill over luck.

The philosophy is how an investment manager thinks about investments and how they invest. If you understand your manager's philosophy, you should also be able to understand their decisions. But investment philosophies are only as good as their application. It is important to assess your manager's behaviour relative to their philosophy through several market cycles.

Process is how the investment philosophy is implemented in client portfolios. A well-worded philosophy has very little value if it is not backed by a robust process that guarantees that positive outcomes can be repeated. A weak process is one indicator of the lack of skill involved.

Investment management is a business of people – the third P. Having the right people with the necessary experience is crucial for the implementation of the philosophy and process.

Lastly, remember that investment outcomes are the translation of your manager's intentions into a balance of wins and losses. What you need is for those wins to outweigh the losses to deliver outperformance. Better understanding managers' track records, processes, philosophies and people will give you a better sense of which managers are more dependent on skill and which are more dependent on luck.

Vuyo is joint head of Institutional Client Services. He joined Allan Gray in 2016 and has over 15 years of experience working in various financial services firms. Vuyo holds a Bachelor of Economic Science from the University of the Witwatersrand and is an actuary.

WHAT DOES THE PRICE OF A UNIT TRUST MEAN?

Ray Mhere

It's easier to just look at price, but ultimately, being thorough before you invest generally leads to better outcomes.

When you buy a product or a service, the price you pay for that item tells you something about it. An apple that costs R50 (suspiciously expensive) or an Apple computer that costs R500 (suspiciously cheap) might make you doubtful. So what does the price of a unit trust tell you? Does a unit trust that costs R2 have less quality or more value than one that costs R20? To answer these questions, Ray Mhere delves into how unit trusts are priced before looking at what this means for you as an investor.

A unit trust is a type of investment that provides you with easy and affordable access to financial markets. Your money is combined with the money of other investors who have similar investment goals. Our investment managers use the pool of money to buy underlying investments to build a portfolio, which is then split into equal portions called "units". Units are allocated to you according to the amount of money you invest and the price of the units on the day you buy them.

How a unit is priced

The way a unit in a unit trust is priced is a simple equation:

$$\text{Unit price} = \frac{\text{Assets } \textbf{minus} \text{ operating expenses}}{\text{Number of units}}$$

The assets of the unit trust are the shares, bonds, cash and/or property that the unit trust owns on behalf of investors. The value of these assets is generally updated daily, but sometimes weekly, depending on the unit trust.

The operating expenses comprise fund management fees, operating costs – which include trustee and custodian fees, audit fees or their service fee, and bank charges – transactional costs for buying and selling shares, and VAT. Once operating expenses are subtracted from assets, this sum is then divided by the total number of units bought by investors.

The problem with exclusively using unit prices to compare unit trusts is that it says nothing about the value of the unit trust as a whole. If we have two unit trusts both with assets of R1 000, but one has 50 units and the other five, their prices would be R20 and R200 respectively. An investor would be mistaken in thinking that one is 10 times more valuable than the other by virtue of its price.

Unit trusts are priced differently to shares

Investors also often make the mistake of thinking unit trust prices are analogous to share prices. But there is a vast difference. The share price of a stock is the price that buyers and sellers agree to at a given time, which usually has a wavering relationship with the actual value of the business behind the stock.

Sometimes the share price is a wild guestimate based on sentiment, mood and herd behaviour. The price of a unit trust comes from the actual value of the investments within it. Sentiment and mood play no direct role. Put another way: If stock market investors fall in love with a stock and then buy it in excess, the price of that stock will be driven up, but if unit trust investors love a unit trust and buy lots of its units, it will do nothing to influence the unit price.

What changes the price of a unit trust?

The variables that move a unit trust's price are the value of the assets within it and its operating expenses. When the shares inside an equity unit trust do well, then the pool of assets of the unit trust increases in value and the price of an individual unit increases as well. The same happens when your unit trust manager lowers any part of operating expenses: Lower expenses lead to a bigger pool of assets being divided between unit holders.

Investors are sometimes tempted to try to take advantage of this price movement by attempting to time the market – buying when the price is low and selling when the price is high, just as some traders do with shares. But, just as with shares, timing unit trust purchases is difficult. In fact, trying to time the exact right moment to buy or sell a unit trust may be even more difficult because it involves not just one investment, but a large number of investments, and the price of each investment may move independently of one another.

Most unit trusts are not designed to be traded frequently, and doing so will likely result in a lower return. Their strength is in the accumulation of wealth over time, as time smoothes out the rough-and-tumble of volatile price movements.

How should you compare unit trusts?

Looking at price is a simple but misleading heuristic for comparing unit trusts. So what should you do instead?

The correct way to assess a unit trust is to:

- See how the price per unit has grown over time; this will give you an indication of the track record that the investment manager has for creating wealth. You can get the same information by looking at the performance over different time periods on our factsheets.
- Examine the operating expenses to see that these are not excessive. Typically, investment management fees should be fair relative to the performance delivered.

In addition to these hard measures related to performance and costs, you should:

- Think about what you need from your investment and the risk you are comfortable with.
- Find an investment manager whose philosophy resonates with you.
- Assess their performance over a long enough time frame, through different market cycles.
- Ensure that you understand the mandate of the unit trust and that it aligns with your needs.

It's easier to just look at price, but as Vuyo Nogantshi discusses on page 20, being thorough before you invest generally leads to better outcomes.

Monitoring a unit trust

Watching the unit price daily, weekly or even monthly is like watching bombastic daily business reports on the market – fun to do, but almost meaningless to a long-term investor. It is akin to watching the rev meter on your dashboard to see if you are getting closer to your destination. Rather review your investments at reasonably set intervals to see if they still meet your needs, and to check that they are performing as they should.

Where can I see price information?

Allan Gray unit trust prices and factsheets are available on our website. Most other managers include prices on their websites as well, and they are also quoted on various financial news websites. Prices are typically quoted in cents.

Ray joined Allan Gray in 2010 and is currently the Johannesburg regional manager. He holds a BCom degree in Economics and Law from the University of Cape Town and a postgraduate diploma in Financial Planning from the University of the Free State.

Allan Gray Balanced and Stable Fund asset allocation as at 30 September 2018

	Balanced Fund % of portfolio			Stable Fund % of portfolio		
	Total	SA	Foreign*	Total	SA	Foreign*
Net equities	62.7	45.3	17.4	38.7	25.5	13.3
Hedged equities	8.9	0.6	8.3	7.0	0.2	6.8
Property	1.7	1.2	0.5	4.3	3.8	0.4
Commodity-linked	3.2	2.7	0.5	1.9	1.2	0.7
Bonds	13.4	9.4	4.0	25.9	18.0	7.9
Money market and bank deposits	10.1	8.2	1.9	22.2	19.5	2.7
Total	**100.0**	**67.5**	**32.5**	**100.0**	**68.2**	**31.8**

Note: There might be slight discrepancies in the totals due to rounding. *This includes African ex-SA assets.

Allan Gray Equity Fund net assets as at 30 September 2018

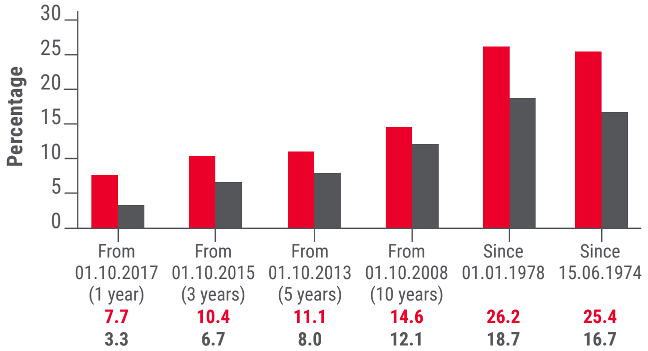
Security (Ranked by sector)	Market value (R million)	% of Fund	FTSE/JSE ALSI weight (%)
South Africa	**29 391**	**68.5**	
South African equities	**28 404**	**66.2**	
Resources	**7 007**	**16.3**	**25.2**
Sasol	3 475	8.1	
Glencore	1 202	2.8	
BHP Billiton	497	1.2	
Impala Platinum	360	0.8	
Sappi	291	0.7	
Positions less than 1%[1]	1 182	2.8	
Financials	**8 906**	**20.8**	**25.4**
Standard Bank	1 798	4.2	
Old Mutual	1 622	3.8	
Investec	1 435	3.3	
Reinet	874	2.0	
RMI	440	1.0	
Quilter PLC	435	1.0	
MMI	286	0.7	
Positions less than 1%[1]	2 015	4.7	
Industrials	**12 282**	**28.6**	**49.4**
Naspers[2]	2 727	6.4	
British American Tobacco	2 309	5.4	
Remgro	1 470	3.4	
Life Healthcare	731	1.7	
Netcare	717	1.7	
Woolworths	686	1.6	
KAP Industrial	594	1.4	
Super Group	499	1.2	
Nampak	343	0.8	
Positions less than 1%[1]	2 206	5.1	
Other securities	**209**	**0.5**	
Positions less than 1%[1]	209	0.5	
Commodity-linked securities	**156**	**0.4**	
Positions less than 1%[1]	156	0.4	
Money market and bank deposits	**831**	**1.9**	
Foreign ex-Africa	**12 601**	**29.4**	
Equity Funds	**12 315**	**28.7**	
Orbis Global Equity Fund	8 314	19.4	
Orbis SICAV International Equity Fund[3]	3 148	7.3	
Orbis SICAV Emerging Markets Equity Fund	681	1.6	
Allan Gray Frontier Markets Equity Fund[3]	172	0.4	
Money market and bank deposits	**286**	**0.7**	
Africa ex-SA	**885**	**2.1**	
Equity funds	**885**	**2.1**	
Allan Gray Africa ex-SA Equity Fund	885	2.1	
Totals	**42 878**	**100.0**	

[1] JSE-listed securities include equities, property and commodity-linked instruments.
[2] Including stub certificates.
[3] This fund is not approved for marketing in South Africa. Reference to this fund is solely for disclosure purposes and is not intended for, nor does it constitute, solicitation for investment. **Note:** There may be slight discrepancies in the totals due to rounding. For other fund-specific information, please refer to the monthly factsheets.

Investment track record – share returns

Allan Gray Proprietary Limited global mandate share returns vs FTSE/JSE All Share Index			
Period	Allan Gray*	FTSE/JSE All Share Index	Out-/Under-performance
1974 (from 15.06)	–0.8	–0.8	0.0
1975	23.7	–18.9	42.6
1976	2.7	–10.9	13.6
1977	38.2	20.6	17.6
1978	36.9	37.2	–0.3
1979	86.9	94.4	–7.5
1980	53.7	40.9	12.8
1981	23.2	0.8	22.4
1982	34.0	38.4	–4.4
1983	41.0	14.4	26.6
1984	10.9	9.4	1.5
1985	59.2	42.0	17.2
1986	59.5	55.9	3.6
1987	9.1	–4.3	13.4
1988	36.2	14.8	21.4
1989	58.1	55.7	2.4
1990	4.5	–5.1	9.6
1991	30.0	31.1	–1.1
1992	–13.0	–2.0	–11.0
1993	57.5	54.7	2.8
1994	40.8	22.7	18.1
1995	16.2	8.8	7.4
1996	18.1	9.4	8.7
1997	–17.4	–4.5	–12.9
1998	1.5	–10.0	11.5
1999	122.4	61.4	61.0
2000	13.2	0.0	13.2
2001	38.1	29.3	8.8
2002	25.6	–8.1	33.7
2003	29.4	16.1	13.3
2004	31.8	25.4	6.4
2005	56.5	47.3	9.2
2006	49.7	41.2	8.5
2007	17.6	19.2	–1.6
2008	–13.7	–23.2	9.5
2009	27.0	32.1	–5.1
2010	20.3	19.0	1.3
2011	9.9	2.6	7.3
2012	20.6	26.7	–6.1
2013	24.3	21.4	2.9
2014	16.2	10.9	5.3
2015	7.8	5.1	2.7
2016	12.2	2.6	9.6
2017	15.6	21.0	–5.4
2018 (to 30.09)	**–1.6**	**–3.8**	**2.2**

Returns annualised to 30.09.2018

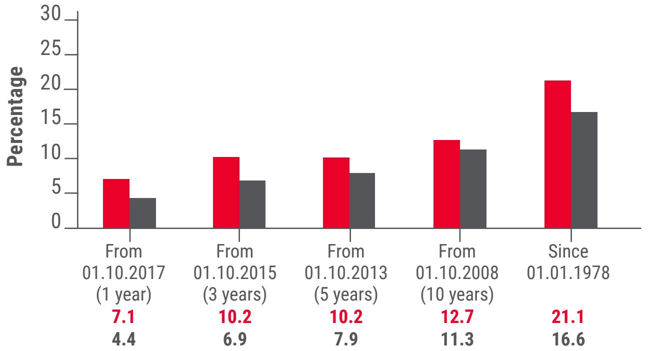


An investment of R10 000 made with Allan Gray on 15 June 1974 would have grown to R227 323 320 by 30 September 2018. By comparison, the returns generated by the FTSE/JSE All Share Index over the same period would have grown a similar investment to R9 328 821. Returns are before fees.

Investment track record – balanced returns

Allan Gray Proprietary Limited global mandate total returns vs Alexander Forbes Global Manager Watch			
Period	Allan Gray*	AFLMW**	Out-/Under-performance
1974	–	–	–
1975	–	–	–
1976	–	–	–
1977	–	–	–
1978	34.5	28.0	6.5
1979	40.4	35.7	4.7
1980	36.2	15.4	20.8
1981	15.7	9.5	6.2
1982	25.3	26.2	–0.9
1983	24.1	10.6	13.5
1984	9.9	6.3	3.6
1985	38.2	28.4	9.8
1986	40.3	39.9	0.4
1987	11.9	6.6	5.3
1988	22.7	19.4	3.3
1989	39.2	38.2	1.0
1990	11.6	8.0	3.6
1991	22.8	28.3	–5.5
1992	1.2	7.6	–6.4
1993	41.9	34.3	7.6
1994	27.5	18.8	8.7
1995	18.2	16.9	1.3
1996	13.5	10.3	3.2
1997	–1.8	9.5	–11.3
1998	6.9	–1.0	7.9
1999	80.0	46.8	33.1
2000	21.7	7.6	14.1
2001	44.0	23.5	20.5
2002	13.4	–3.6	17.1
2003	21.5	17.8	3.7
2004	21.8	28.1	–6.3
2005	40.0	31.9	8.1
2006	35.6	31.7	3.9
2007	14.5	15.1	–0.6
2008	–1.1	–12.3	11.2
2009	15.6	20.3	–4.7
2010	11.7	14.5	–2.8
2011	12.6	8.8	3.8
2012	15.1	20.0	–4.9
2013	25.0	23.3	1.7
2014	10.3	10.3	0.0
2015	12.8	6.9	5.9
2016	7.5	3.7	3.8
2017	11.9	11.5	0.4
2018 (to 30.09)	**3.5**	**2.0**	**1.5**

Returns annualised to 30.09.2018



An investment of R10 000 made with Allan Gray on 1 January 1978 would have grown to R24 598 825 by 30 September 2018. The average total performance of global mandates of Large Managers over the same period would have grown a similar investment to R5 243 260. Returns are before fees.

*Allan Gray commenced managing pension funds on 1 January 1978. The returns prior to 1 January 1978 are of individuals managed by Allan Gray, and these returns exclude income. Returns are before fees. **Consulting Actuaries Survey returns used up to December 1997. The return for September 2018 is an estimate. The return from 1 April 2010 is the average of the non-investable Alexander Forbes Large Manager Watch. **Note:** Listed property included from 1 July 2002. Inward listed included from November 2008 to November 2011.

Allan Gray South African unit trusts annualised performance (rand) in percentage per annum to 30 September 2018 (net of fees)

	Assets under management (R billion)	Inception date	Since inception	10 years	5 years	3 years	1 year	Highest annual return[4]	Lowest annual return[4]
High net equity exposure (100%)									
Allan Gray Equity Fund (AGEF)	**42.9**	**01.10.1998**	**22.4**	**12.7**	**9.7**	**9.3**	**6.5**	**125.8**	**−20.7**
Average of South African - Equity - General category (excl. Allan Gray funds)[1]			15.5	11.0	5.9	4.2	0.1	73.0	−37.6
Allan Gray-Orbis Global Equity Feeder Fund (AGOE)	**20.9**	**01.04.2005**	**15.4**	**16.2**	**15.0**	**17.0**	**8.2**	**78.2**	**−29.7**
FTSE World Index			14.4	14.9	17.3	15.0	16.4	54.2	−32.7
Medium net equity exposure (40% - 75%)									
Allan Gray Balanced Fund (AGBF)	**154.6**	**01.10.1999**	**16.8**	**11.6**	**9.2**	**9.1**	**5.8**	**46.1**	**−8.3**
Average of South African - Multi Asset - High Equity category (excl. Allan Gray funds)[2]			12.3	9.8	7.0	5.8	3.3	41.9	−16.7
Allan Gray-Orbis Global Fund of Funds (AGGF)	**14.3**	**03.02.2004**	**11.4**	**12.5**	**12.0**	**11.6**	**4.6**	**55.6**	**−13.7**
60% of the FTSE World Index and 40% of the JP Morgan Global Government Bond Index			11.5	12.5	13.4	9.8	11.0	38.8	−17.0
Low net equity exposure (0% - 40%)									
Allan Gray Stable Fund (AGSF)	**50.9**	**01.07.2000**	**12.3**	**9.4**	**9.0**	**9.5**	**8.1**	**23.3**	**2.8**
Daily interest rate of FirstRand Bank Limited plus 2%			9.0	7.7	7.6	8.1	7.9	14.6	6.2
Very low net equity exposure (0% - 20%)									
Allan Gray Optimal Fund (AGOF)	**1.2**	**01.10.2002**	**8.1**	**7.0**	**8.6**	**8.1**	**10.5**	**18.1**	**−1.5**
Daily interest rate of FirstRand Bank Limited			6.5	5.5	5.4	5.9	5.8	11.9	4.1
Allan Gray-Orbis Global Optimal Fund of Funds (AGOO)	**1.2**	**02.03.2010**	**8.9**	**–**	**7.0**	**4.8**	**-1.0**	**39.6**	**−12.4**
Average of US$ bank deposits and euro bank deposits			6.9	–	5.8	1.7	4.6	35.6	−19.1
No equity exposure									
Allan Gray Bond Fund (AGBD)	**1.5**	**01.10.2004**	**9.0**	**9.2**	**8.2**	**9.2**	**9.7**	**18.0**	**−2.6**
JSE All Bond Index (Total return)			8.5	8.6	7.2	7.7	7.1	21.2	−5.6
Allan Gray Money Market Fund (AGMF)	**16.7**	**03.07.2001**	**8.0**	**7.0**	**7.1**	**7.7**	**7.8**	**12.8**	**5.2**
Alexander Forbes Short-Term Fixed Interest (STeFI) Composite Index[3]			7.9	6.8	6.8	7.3	7.3	13.3	5.2

[1] From inception to 28 February 2015, the benchmark was the FTSE/JSE All Share Index including income (source: IRESS).
[2] From inception to 31 January 2013, the benchmark was the market value-weighted average return of the funds in both the Domestic Asset Allocation Medium Equity and Domestic Asset Allocation Variable Equity sectors of the previous ASISA Fund Classification Standard, excluding the Allan Gray Balanced Fund.
[3] From inception to 31 March 2003, the benchmark was the Alexander Forbes 3-Month Deposit Index. From 1 April 2003 to 31 October 2011, the benchmark was the Domestic Fixed Interest Money Market Collective Investment Scheme sector excluding the Allan Gray Money Market Fund.
[4] This is the highest or lowest consecutive 12-month returns since inception. All rolling 12-month figures for the Fund and the benchmark are available from our Client Service Centre on request.

Allan Gray total expense ratios and transaction costs for the 3-year period ending 30 September 2018

	Fee for benchmark performance	Performance fees	Other costs excluding transaction costs	VAT	Total expense ratio	Transaction costs (incl. VAT)	Total investment charge
Allan Gray Equity Fund	1.10%	0.91%	0.01%	0.24%	2.26%	0.08%	2.33%
Allan Gray-Orbis Global Equity Feeder Fund	1.50%	0.42%	0.05%	0.00%	1.97%	0.13%	2.10%
Allan Gray Balanced Fund	1.09%	0.46%	0.02%	0.15%	1.71%	0.08%	1.80%
Allan Gray-Orbis Global Fund of Funds	1.42%	0.57%	0.06%	0.00%	2.04%	0.12%	2.17%
Allan Gray Stable Fund	1.07%	0.39%	0.02%	0.14%	1.61%	0.08%	1.69%
Allan Gray Optimal Fund	1.00%	0.47%	0.00%	0.21%	1.67%	0.13%	1.81%
Allan Gray-Orbis Global Optimal Fund of Funds	1.00%	0.78%	0.06%	0.00%	1.83%	0.14%	1.97%
Allan Gray Bond Fund	0.25%	0.38%	0.00%	0.09%	0.72%	0.00%	0.72%
Allan Gray Money Market Fund	0.25%	N/A	0.00%	0.04%	0.29%	0.00%	0.29%

The total expense ratio (TER) is the annualised percentage of the Fund's average assets under management that has been used to pay the Fund's actual expenses over the past three years. The TER includes the annual management fees that have been charged (both the fee at benchmark and any performance component charged), VAT and other expenses like audit and trustee fees. Transaction costs (including brokerage, Securities Transfer Tax (STT), STRATE and FSCA Investor Protection Levy and VAT thereon) are shown separately. Transaction costs are a necessary cost in administering the Fund and impact Fund returns. They should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. Since Fund returns are quoted after the deduction of these expenses, the TER and transaction costs should not be deducted again from published returns. As unit trust expenses vary, the current TER cannot be used as an indication of future TERs. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. Instead, when investing, the investment objective of the Fund should be aligned with the investor's objective and compared against the performance of the Fund. The TER and other funds' TERs should then be used to evaluate whether the Fund performance offers value for money. The sum of the TER and transaction costs is shown as the total investment charge.

Foreign domiciled funds annualised performance (rand) in percentage per annum to 30 September 2018 (net of fees)

	Inception date	Since inception	10 years	5 years	3 years	1 year	Highest annual return[4]	Lowest annual return[4]
High net equity exposure								
Orbis Global Equity Fund[5] FTSE World Index	**01.01.1990**	**18.5** 13.7	**16.3** 14.9	**14.8** 17.2	**16.9** 15.1	**7.6** 16.3	**87.6** 54.2	**–47.5** –46.2
Orbis SICAV Japan Equity (Yen) Fund Tokyo Stock Price Index	**01.01.1998**	**15.3** 9.9	**15.2** 12.7	**14.2** 15.4	**16.1** 14.1	**10.8** 15.0	**94.9** 91.0	**–40.1** –46.4
Orbis SICAV Emerging Markets Equity Fund (US$)[6] MSCI Emerging Markets Index (Net) (US$)[6]	**01.01.2006**	**14.4** 14.3	**14.5** 13.9	**9.1** 13.2	**8.9** 12.6	**-4.0** 4.0	**58.6** 60.1	**–34.2** –39.7
Allan Gray Africa ex-SA Equity Fund Standard Bank Africa Total Return Index	**01.01.2012**	**15.1** 5.0	**–** –	**6.5** -0.3	**10.1** 4.4	**16.3** 5.5	**65.6** 33.6	**–24.3** –29.4
Allan Gray Australia Equity Fund S&P/ASX 300 Accumulation Index	**04.05.2006**	**15.9** 13.0	**15.6** 12.4	**14.2** 10.1	**23.9** 14.2	**11.9** 10.1	**99.5** 55.6	**–55.4** –45.1
Medium net equity exposure								
Orbis SICAV Global Balanced Fund 60% MSCI World Index with net dividends reinvested and 40% JP Morgan Global Government Bond Index	**01.01.2013**	**18.3** 16.5	**–** –	**13.2** 13.3	**12.3** 9.6	**5.2** 11.1	**54.4** 40.2	**–0.7** –8.4
Low net equity exposure								
Allan Gray Australia Stable Fund Reserve Bank of Australia cash rate	**01.07.2011**	**12.3** 7.5	**–** –	**8.4** 3.7	**10.9** 3.4	**1.9** -2.0	**32.7** 28.8	**–7.4** –12.6
Very low net equity exposure								
Orbis Optimal SA Fund-US$ Class US$ Bank deposits	**01.01.2005**	**10.4** 8.6	**8.5** 6.1	**8.2** 7.8	**5.1** 1.9	**0.3** 6.7	**48.6** 57.9	**–15.7** –25.5
Orbis Optimal SA Fund-Euro Class Euro Bank deposits	**01.01.2005**	**8.7** 6.9	**6.2** 3.8	**4.3** 3.6	**4.6** 1.7	**-3.4** 2.6	**44.1** 40.2	**–19.3** –20.9

South African institutional portfolios[7] annualised performance (rand) in percentage per annum to 30 September 2018

	Assets under management (R billion)[8]	Inception date	Since inception	10 years	5 years	3 years	1 year
Local portfolios[9] (before local fees)							
Domestic Equity Composite (Minimum net equity 75% - 95%) **Domestic Equity Pooled Portfolio (Minimum net equity 95%)** FTSE/JSE All Share Index	**57.1** **5.1**	**01.01.1990** **01.02.2001**	**19.8** **20.0** 14.0/14.2	**13.6** **14.0** 12.1	**10.3** **10.6** 8.0	**9.8** **10.1** 6.7	**7.6** **7.8** 3.3
Domestic Balanced Composite **Domestic Balanced Pooled Portfolio** Mean of Alexander Forbes SA Large Manager Watch (Non-investable)[11]	**33.8** **3.2**	**01.01.1978** **01.09.2001**	**21.3** **17.2** 16.8/14.1	**12.3** **12.4** 10.9	**10.0** **10.0** 6.9	**10.2** **10.2** 6.0	**7.3** **7.4** 2.9
Domestic Stable Composite **Domestic Stable Pooled Portfolio** Alexander Forbes Three-Month Deposit Index plus 2%	**2.3** **1.5**	**01.12.2001** **01.12.2001**	**12.8** **13.1** 9.9	**9.8** **9.9** 8.6	**9.8** **9.9** 8.6	**10.4** **10.6** 9.1	**10.0** **10.0** 9.0
Global portfolios[9], limited to 25% foreign exposure (before local, but after foreign fees)							
Global Balanced Composite **Global Balanced Pooled Portfolio** **Global Balanced (RRF) Portfolio[10]** Mean of Alexander Forbes Global Large Manager Watch (Non-investable)[11,12]	**61.6** **4.0** **31.8**	**01.01.1978** **01.09.2000** **01.09.2000**	**21.1** **17.5** **17.5** 16.6/13.5	**12.7** **12.8** **12.8** 11.4	**10.2** **10.2** **10.2** 7.9	**10.2** **10.2** **10.3** 6.9	**7.1** **6.6** **7.3** 4.4
Global Stable Composite **Global Stable Pooled Portfolio** Alexander Forbes Three-Month Deposit Index plus 2%	**8.4** **7.1**	**15.07.2004** **15.07.2004**	**12.6** **12.6** 9.2	**10.3** **10.4** 8.6	**10.0** **10.0** 8.6	**10.7** **10.6** 9.1	**9.7** **9.6** 9.0
Global Absolute Composite **Global Absolute Pooled Portfolio** Mean of Alexander Forbes Global Large Manager Watch (Non-investable)[11]	**12.0** **4.0**	**01.03.2004** **01.03.2004**	**14.6** **14.8** 13.9	**10.6** **10.8** 11.4	**9.0** **9.1** 7.9	**8.8** **9.0** 6.9	**6.9** **7.3** 4.4
Foreign only portfolios[9] (after fees)							
Orbis Global Equity Pooled Portfolio FTSE World Index	**0.5**	**18.05.2004**	**15.2** 14.2	**16.3** 14.9	**14.7** 17.2	**16.9** 15.1	**7.7** 16.3
Foreign Balanced (Rands) Composite[13] **Foreign Balanced Pooled Portfolio** 60% of the MSCI World Index[14] and 40% of the JP Morgan Global Government Bond Index	**4.7** **0.1**	**23.05.1996** **23.01.2002**	**14.3** **9.1** 12.0/8.0	**12.2** **12.1** 12.4	**11.1** **11.0** 13.2	**12.0** **11.5** 9.8	**6.7** **5.1** 10.5

Performance as calculated by Allan Gray

4 This is the highest or lowest consecutive 12-month returns since inception. All rolling 12-month figures for the Fund and the benchmark are available from our Client Service Centre on request.

5 The total assets under management for the Fund are shown, which include institutional and retail clients that invest directly with Orbis.

6 From inception to 31 October 2016, this Fund was called the Orbis SICAV Asia ex-Japan Equity Fund and its benchmark was the MSCI Asia ex-Japan Index. From 1 November 2016, the Fund's investment mandate was broadened to include all emerging markets. To reflect this, the Fund was renamed and the benchmark was changed.

7 The composites not listed here include: Domestic Balanced Absolute, Domestic Balanced Low Equity, Domestic Balanced Stable Namibia, Domestic Equity MSCI SA, Domestic Equity Namibia, Domestic Money Market, Domestic Optimal, Domestic Tax Paying, Global Balanced High Foreign, Global Balanced Namibia 35% High Foreign, Global Tax Paying and Non-Discretionary Foreign.

8 The assets under management for institutional portfolios not listed here amount to R95.9bn.

9 The composite assets under management figures shown include the assets invested in the pooled portfolios where appropriate.

10 The returns prior to 1 August 2015 are those of the Allan Gray Life Global Balanced Portfolio.

11 The return for the period ending September 2018 is an estimate as the relevant survey results have not yet been released.

12 From inception to 31 December 1997, the Consulting Actuaries Survey returns were used.

13 From inception to 31 August 2001, the foreign carve-out returns of the Global Balanced Composite were used.

14 Morgan Stanley Capital International All Country World Index.

IMPORTANT INFORMATION FOR INVESTORS

Information and content

The information in and content of this publication are provided by Allan Gray as general information about the company and its products and services. ("Allan Gray" means Allan Gray Proprietary Limited and all of its subsidiaries and associate companies, and "the company" includes all of those entities.) Allan Gray does not guarantee the suitability or potential value of any information or particular investment source. The information provided is not intended to nor does it constitute financial, tax, legal, investment or other advice. Before making any decision or taking any action regarding your finances, it is recommended that you consult an independent, qualified financial adviser regarding your specific situation. Nothing contained in this publication constitutes a solicitation, recommendation, endorsement or offer by Allan Gray; it is merely an invitation to do business.

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Allan Gray Unit Trust Management (RF) Proprietary Limited (the "Management Company") is registered as a management company under the Collective Investment Schemes Control Act 45 of 2002, in terms of which it operates unit trust portfolios under the Allan Gray Unit Trust Scheme, and is supervised by the Financial Sector Conduct Authority (FSCA). Allan Gray Proprietary Limited (the "Investment Manager"), an authorised financial services provider, is the appointed investment manager of the Management Company and is a member of the Association for Savings & Investment South Africa (ASISA). Collective investment schemes in securities (unit trusts or funds) are generally medium- to long-term investments. Except for the Allan Gray Money Market Fund, where the Investment Manager aims to maintain a constant unit price, the value of units may go down as well as up. Past performance is not necessarily a guide to future performance. The Management Company does not provide any guarantee regarding the capital or the performance of its unit trusts. Funds may be closed to new investments at any time in order for them to be managed according to their mandates. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending.

Performance

Performance figures are for lump sum investments with income distributions reinvested. Where annualised performance is mentioned, it refers to the average return per year over the period. Actual investor performance may differ as a result of the investment date, the date of reinvestment and dividend withholding tax. Movements in exchange rates may also be the cause of the value of underlying international investments going up or down. The Equity, Balanced, Stable and Optimal funds each have more than one class of units and these are subject to different fees and charges. Unit trust prices are calculated on a net asset value basis, which is the total market value of all assets in the Fund, including any income accruals and less any permissible deductions from the Fund, divided by the number of units in issue. Forward pricing is used and fund valuations take place at approximately 16:00 each business day. Purchase and redemption requests must be received by 14:00 each business day to receive that day's price. Unit trust prices are available daily on www.allangray.co.za. Permissible deductions include management fees, brokerage, securities transfer tax, auditor's fees, bank charges and trustee fees. A schedule of fees, charges and maximum commissions is available on request from the Management Company.

Benchmarks

The FTSE/JSE All Share Index is calculated by FTSE International Limited ("FTSE") in conjunction with the JSE Limited ("JSE") in accordance with standard criteria. The FTSE/JSE All Share Index is the proprietary information of FTSE and the JSE. All copyright subsisting in the FTSE/JSE All Share Index values and constituent lists vests in FTSE and the JSE jointly. All their rights are reserved. FTSE is a trademark of the London Stock Exchange Group of Companies. The FTSE World Index is calculated by FTSE in accordance with standard criteria and is the proprietary information of FTSE. All copyright subsisting in the FTSE World Index values and constituent lists vests in FTSE. All its rights are reserved.

Understanding the funds

Investors must make sure that they understand the nature of their choice of funds and that their investment objectives are aligned with those of the fund(s) they select. The Allan Gray Equity, Balanced, Stable and rand-denominated offshore funds may invest in foreign funds managed by Orbis Investment Management Limited, our offshore investment partner.

A feeder fund is a unit trust that invests in another single unit trust which charges its own fees. A fund of funds is a unit trust that invests in other unit trusts, which charge their own fees. Allan Gray does not charge any additional fee in its feeder fund or fund of funds.

The Allan Gray Money Market Fund is not a bank deposit account. The Fund aims to maintain a constant price of 100 cents per unit. The total return an investor receives is made up of interest received and any gain or loss made on instruments held by the Fund. While capital losses are unlikely, they can occur if, for example, one of the issuers of an instrument defaults. In this event, investors may lose some of their capital. To maintain a constant price of 100 cents per unit, investors' unit holdings will be reduced to the extent of such losses. The yield is calculated according to the applicable ASISA standards. Excessive withdrawals from the Fund may place it under liquidity pressure. If this happens, withdrawals may be ring-fenced and managed over a period of time.

Additional information for retirement fund members and investors in the tax-free investment account, living annuity and endowment

The Allan Gray Retirement Annuity Fund, the Allan Gray Pension Preservation Fund and the Allan Gray Provident Preservation Fund are all administered by Allan Gray Investment Services Proprietary Limited, an authorised administrative financial services provider and approved under section 13B of the Pension Funds Act as a benefits administrator. The Allan Gray Tax-Free Investment Account, Allan Gray Living Annuity and Allan Gray Endowment are underwritten by Allan Gray Life Limited, also an authorised financial services provider and licensed under the Long-Term Insurance Act 52 of 1998. The underlying investment options of the Allan Gray individual life and retirement products are portfolios of collective investment schemes in securities (unit trusts or funds).

Tax note

In accordance with section 11(i) of the Botswana Income Tax Act (Chapter 52;01), an amount accrued to any person shall be deemed to have accrued from a source situated in Botswana where it has accrued to such person in respect of any investment made outside Botswana by a resident of Botswana, provided that section 11(i) shall not apply to foreign investment income of non-citizens resident in Botswana. Botswana residents who have invested in the shares of the Fund are therefore requested to declare income earned from this Fund when preparing their annual tax returns. The Facilities Agent for the Fund in Botswana is Allan Gray (Botswana) (Proprietary) Limited at 2nd Floor, Building 2, Central Square, New CBD, Gaborone, where investors can obtain a prospectus and financial reports.

About the paper

The Allan Gray Quarterly Commentary is printed on LumiSilk, a paper made from trees grown specifically for paper manufacturing. The paper is certified by the Forest Stewardship Council (FSC), an organisation which promotes responsible management of the world's forests.

NOTES

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