QC
Quarterly Commentary
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Lebanon's financial collapse

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COMMENTS FROM THE CHIEF OPERATING OFFICER

Rob Formby

In South Africa … there are some green shoots of hope as mining and agriculture prosper.

Even as vaccine roll-outs gather pace globally, and some countries begin to open up, the "what happens next?" question looms large. According to the World Economic Outlook, published by the International Monetary Fund (IMF), the global recovery is split into two groups: those who can look forward to further normalisation of activity following mass roll-out of the vaccine (almost all developed economies), and those who will still face resurgent infections in the face of slower vaccine programmes. However, as long as the virus circulates, the road to recovery remains uncertain for all.

A World Bank report echoes these sentiments, noting that while the global economy is poised to stage a recovery (although recent surveys are somewhat less bullish than those at the start of the year), the rebound is expected to be uneven. According to the report, emerging market and developing economies will suffer the long-term effects of a pandemic hangover – including erosion of skills from lost work and education, and the burden of debt.

In South Africa, despite the ongoing uncertainty and prevailing negative sentiment, there are some green shoots of hope as mining and agriculture prosper. Meanwhile, tax collections are rising, we are showing a current account surplus for the first time since 1994, and business conditions are slowly improving. Some reasons to be cheerful.

Focus on tangible facts

This, perhaps, all goes to show that trying to guess what will happen next is a fool's errand, and basing investment decisions purely on macroeconomic predictions can be problematic. At Allan Gray, we prefer to ground our investment decisions in fact and thorough research, hunting for companies that are undervalued by the market and likely to reach our estimate of their true value. In our view, the biggest risk investors face – regardless of macroeconomic circumstances – is paying too much for an asset.

But this doesn't mean that macroeconomic questions don't weigh heavily on investors' minds, along with other related questions on risk and opportunity, and environmental, social and governance factors. Tamryn Lamb draws on insights from experts across the business in an attempt to answer some of the common questions clients are asking.

Of course, we are not suggesting that one should ignore the broader context; you do so at your peril. Rami Hajjar demonstrates this using Lebanon's financial collapse to illustrate how things can go wrong at a country level. This acts as a valuable lesson for our thinking when approaching investment opportunities in African and frontier markets. While South Africa is in a very different position to Lebanon, the events outlined also act as a reminder of the importance of sound economic policy, fiscal discipline, and strong, independent institutions.

Portfolio positioning

In a world where uncertainty continues to be a key theme, investors should position their portfolios for multiple outcomes. This may mean including bonds. What is interesting at the moment is that emerging market bonds are offering exceptional yield, but you need to be willing to take on a fair amount of risk.

Developed market bonds, on the other hand, seem to be more popular, despite not offering investors much in the way of return. Most developed market government bond yields have fallen towards zero, and some are even negative, such as those of Germany and Switzerland. This exposes investors to other risks often underestimated: the risk that your investment will not keep up with inflation, and the risk that any interest rate increase will further reduce yields.

It's important to understand the relationship between risk and return in the fixed income context. Londa Nxumalo discusses factors to consider when looking at the opportunities and threats across jurisdictions, while Mark Dunley-Owen, from our offshore partner, Orbis, weighs in with a global perspective.

In a world where uncertainty continues to be a key theme, investors should position their portfolios for multiple outcomes.

Staying global, but turning to equities, we investigate the reasons behind Orbis' painful third quarter. After an encouraging start to the year, performance has been impeded by exposure to selected Chinese technology shares and the broad underperformance of value-oriented shares globally. John Christy, from Orbis, discusses the reasons behind the underperformance and explains why Orbis is optimistic about its current holdings.

Investing for retirement

Economic uncertainty and market volatility can make us feel we should put off saving for retirement until the picture is more certain and things improve. Already many of us grapple with balancing our future wants and needs, and the uncertainty may give us an excuse to shift priorities. However, time is a key ingredient in investing and delaying saving for retirement can leave our future selves out of pocket.

While we get this intuitively, long term is typically easier to believe in than to accomplish. Our guest writer, Morgan Housel, a partner at Collaborative Fund (US) and an expert in behavioural finance and investing history, explains what you have to come to terms with to do long term effectively.

... time is a key ingredient in investing and delaying saving for retirement can leave our future selves out of pocket.

But balancing the friction that exists between our present and future wants and needs is a real challenge. In this quarter's Investing Tutorial, Thandi Skade examines how "temptation-bundling" and reframing how we identify with our future selves can help us make better decisions and foster habits which promote better investment outcomes.

Orbis leadership appointments

I'd like to update you on some leadership appointments at our offshore partner, Orbis, which will become effective on 31 December 2021.

William Gray will hand over the day-to-day leadership of the firm to Adam Karr, who will lead the investment team while continuing in his role as a portfolio manager, and Darren Johnston, who will lead the business team. Adam will serve as president and portfolio manager and

Darren will serve as chief operating officer. Both will report to the Orbis Holdings Limited Board.

Both Adam and Darren have had a long involvement with Orbis. Adam joined Orbis in 2002 and currently leads the US investment team and is one of the stockpickers who direct client capital for the Orbis Global Equity Fund. He has also served on the Orbis board for 15 years. Darren joined Orbis in 2016 after being CEO of PwC in the Caribbean. He has over 30 years of experience in the financial services industry. He has worked closely with William, the Orbis Holdings Limited Board, and other leaders in managing and setting the strategic direction of the business.

William will remain closely involved. He will be appointed as chair of the Orbis Holdings Limited Board, continue as chair of the Orbis funds and maintain his existing directorships of the other asset managers in the Allan Gray and Orbis group, including his position on the Allan Gray Proprietary Limited Board. William will also actively support Orbis, Adam and Darren through the transition and beyond.

The Gray family will continue to serve as councillors of the Allan & Gill Gray Foundation, the majority owner of the various asset management businesses, which was established in 2015 to promote the commercial success, continuity and independence of the group, and to ensure that the distributable profits the Foundation receives from these firms are ultimately devoted exclusively to philanthropy.

This opportunity to refresh the leadership is a product of careful planning and a direct result of Orbis' ongoing process of developing leadership talent. Coupled with attractive investment prospects ahead, Orbis is excited about this transition and the potential for it to create further opportunities across the firm for others to step up and make a greater impact.

Kind regards

Rob Formby

LEBANON'S FINANCIAL COLLAPSE

Rami Hajjar

The Lebanese crisis is a good case in point of how things can go wrong when mismanagement of public policy and corruption are the order of the day ...

On 17 October 2019, angry demonstrators took to the streets of Lebanon to protest a US$6 per month WhatsApp communication tax. Little did they know that the financial collapse (which was inevitable) had just occurred. True, the tax proposal and the consequent protests were the straw that broke the camel's back, but few realised that the loss that had just materialised would make an irony of the tax burden that was to be imposed. It took only a matter of weeks for the Lebanese to appreciate that value in the financial system was artificial, and that their hard-earned lifetime savings were no more.

Rami Hajjar sheds light on the processes that led to the collapse. The Lebanese crisis is a good case in point of how things can go wrong when mismanagement of public policy and corruption are the order of the day, and acts as a valuable lesson for our thinking when approaching investment opportunities in African and frontier markets. While South Africa is in a very different position to Lebanon, the events outlined act as a reminder of the importance of sound economic policy, fiscal discipline, and strong, independent institutions in maintaining a functioning economic and financial system.

All too often, the root of a crisis lies in a country consistently spending beyond its means. In budgetary accounting, this is manifested in the famous "twin deficit", which denotes deficits in both the fiscal account and the current account.

The unsustainable twin deficit

The budget deficit

It would be useful to start with a brief background. Lebanon's crisis was born out of the financial and economic policies it undertook during the period after the 1975 - 1990 civil war. Central to the model was the need to attract large foreign inflows to finance the reconstruction of the country. To do so, the currency was pegged (providing confidence in the monetary system), high interest rates were provided, and capital movements were fully liberalised.

As the economy was coming off low grounds, and the tax base was tiny, the budget was financed with a large amount of debt. Early on, the government relied on domestic borrowing, amassed in local currency, to meet its overall financing need. Most of that came with very high interest rates, given the risk premium demanded by investors to finance a broken country. With high costs of borrowing, the overall fiscal deficit expanded rapidly over the years. From 2001 onwards, Lebanon successfully tapped international capital markets, backed at first by successive Paris donor conferences and continuous support by local banks.

Interestingly, starting 2001, the budget registered primary surpluses (i.e. excluding interest payments), as shown in **Graph 1**. Between 1993 and 2019, and including estimated off-budget operations, the fiscal accounts showed that the government earned a cumulative revenue of around US$170bn and cumulatively spent around US$260bn, resulting in a deficit of US$90bn. This is compared to an estimated cumulative interest payment of US$87bn, which means that interest was responsible for the full cumulative deficit. Markedly, it takes just a few years of reckless spending (1993 - 1998) to get stuck in a debt-overhang spiral.

Important to note is that the reconstruction project involved massive embezzlement of public money through nepotism in the awarding of contracts, an overt shift of wealth from the public to private entities, and tenders greatly exceeding project costs. Some estimates put the amount of waste at more than 50% of the total cost of reconstruction. In another instance of transfer of wealth, it has been argued that the government engaged in overborrowing and offered interest rates more than warranted by market fundamentals, which resulted in enormous rent being derived by a concentrated group of private players.

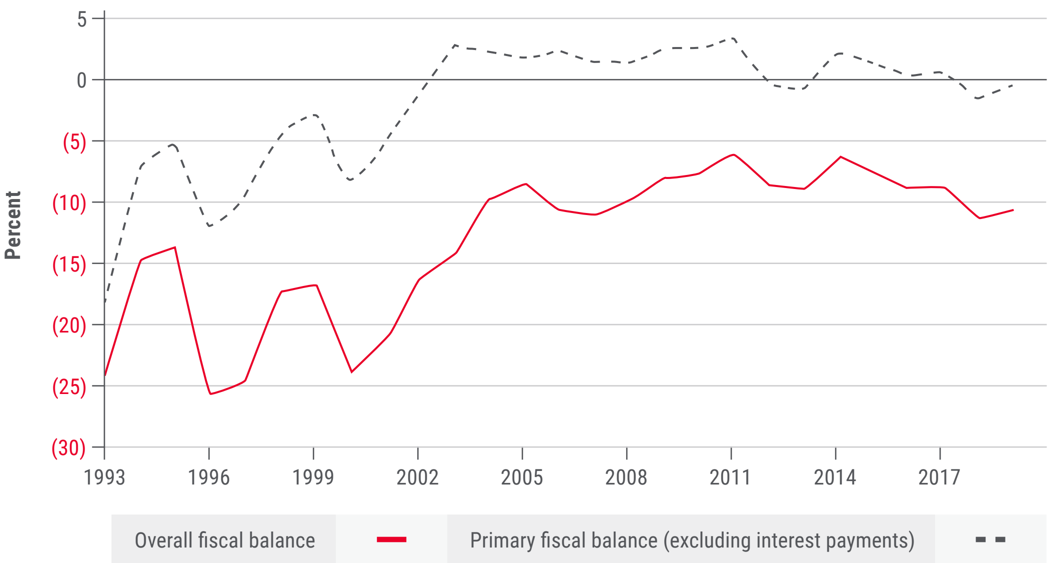
By 2019, Lebanon had one of the highest debt-to-GDP ratios in the world (**Graph 2**). As a consequence, interest payments consumed around 50% of government revenue by 2019.

Another point to note is that most of public spending went into consumption expenditure, which means that spending was not generating economic value – compared to when a government invests with the intention to boost economic potential and future revenue generation potential. As reflected in **Graph 3**, the two main sources of primary spending were public sector wages (a highly bloated public sector that served sectarian patronage), and subsidies to the broken state-owned Électricité du Liban (EDL), where deeply entrenched vested interests blocked any reform.

The current account deficit

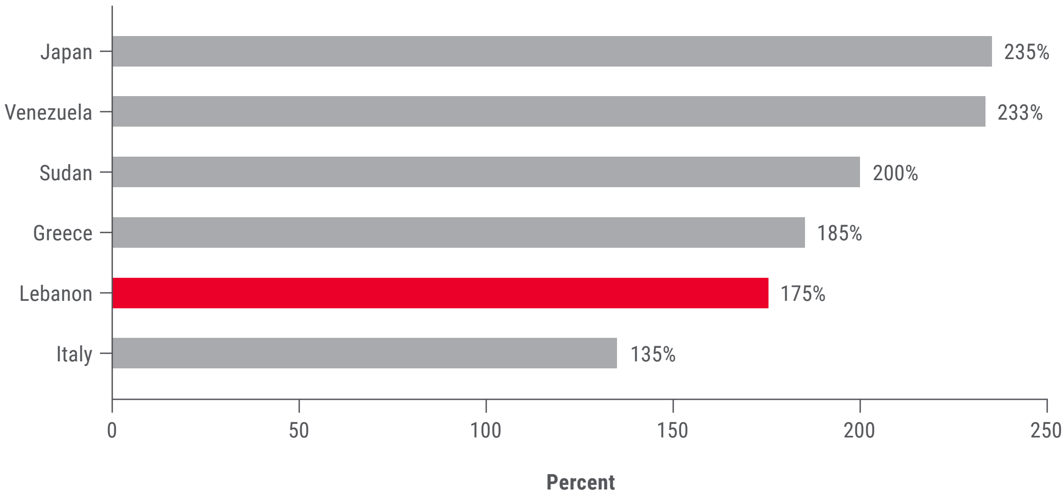
Lebanon consumes more than it produces and relies heavily on imports. The export base is tiny due to long-standing neglect of the productive sectors at the expense of the service sector, an overvalued exchange rate, and a commitment to open trade with no policies to protect domestic industries. For years, the country ran a huge current account deficit, equivalent to around 25% of GDP in some years.

Graph 1: Fiscal aggregates (% of GDP)



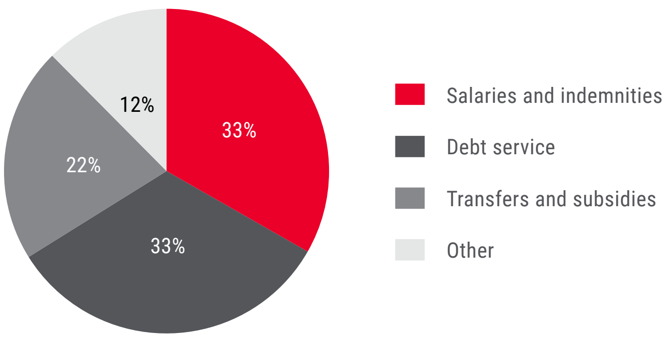
Sources: Association of Banks in Lebanon website, countryeconomy.com; some figures were estimated.

Graph 2: Government debt to GDP, 2019



Sources: World Bank data, tradingeconomics.com

Graph 3: Estimated split of total government spending, average 2009 - 2019



Sources: Association of Banks in Lebanon website, World Bank data

It is important to note the link between the budget deficit and the current account deficit. As discussed earlier, budget spending comprised three main items: interest expense, wages, and subsidies to EDL. Nearly half of interest expense was in US dollars, and most of the EDL costs were in foreign currency. As for wages, even if they were paid in local currency, consumption spending would automatically lead to US dollar outflows as the country relied on imports to meet 85% of its daily needs.

The financing model of the country

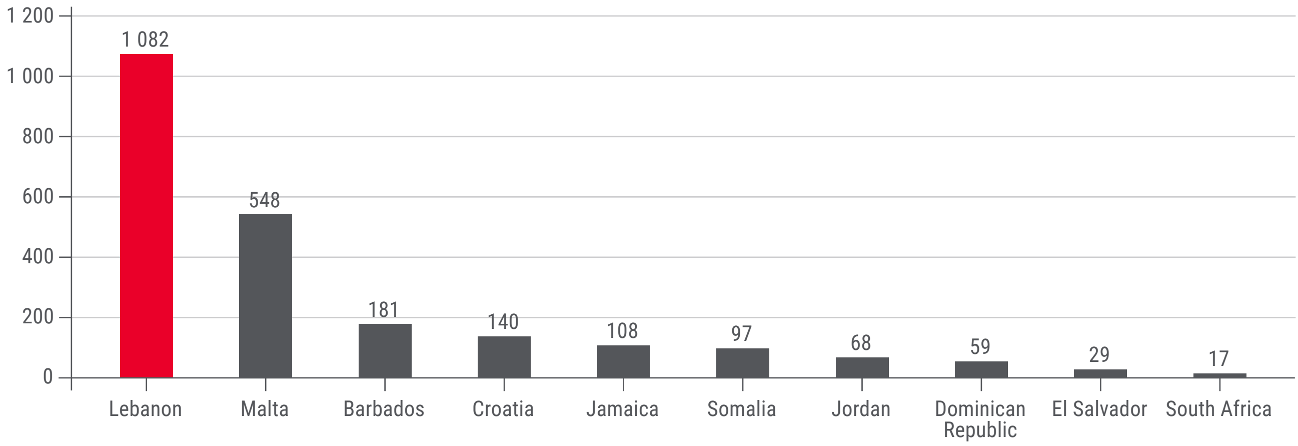
Main source of foreign exchange inflows

Each dollar that leaves a country as a result of private or public consumption needs to be financed by an incoming dollar. A sustainable way that countries usually finance capital outflows is through exports. An exporter will sell goods in foreign markets, bring dollars into the country and exchange part of these dollars into local currency to buy local inputs. These usually end up as reserves at the central bank. If more dollars come in in a given year than leave, the country registers a balance of payments surplus, which is usually reflected in higher central bank reserves or higher banks' foreign asset position. If less comes in, the country needs to bridge the gap either through external debt or by drawing down reserves, thereby reducing the net foreign asset position of the country.

In Lebanon's case, the main source of financing was unfortunately not exports. The country relied on the constant inflow of remittances from the Lebanese diaspora (there are an estimated 12 million Lebanese living abroad versus 6.5 million in Lebanon) that were channelled through a perceived strong banking sector – see **Graph 4** on page 8.

Remittances are not a sustainable way to finance a huge deficit. They are volatile in nature, as a large part

Graph 4: Remittances per capita (US$ per person, 2019) – one of the highest in the world



Sources: World Bank data, tradingeconomics.com

accumulate as liabilities on the banking sector's balance sheet, making them susceptible to sudden outflows.

The other source of financing, to a lesser extent, was foreign direct investments (FDIs), which mainly came from wealthy nationals of Gulf countries investing in real estate.

The banking sector's role as intermediary

Trust in the Lebanese banking system dates from the inception of Lebanon. Free movement of capital and a banking secrecy law were key pillars of the sector, and these, alongside a more developed financial sector compared to those of the nascent oil countries, caused a lot of oil money to be channelled through Lebanon. The trust persisted in the post-war period due to the perception that the sector was tightly regulated. Confidence in the currency peg (bolstered by a decent amount of central bank reserves) and high interest rates on both the US dollar and Lebanese pound (LBP) were also pull factors for foreign capital.

Large capital inflows from remittances and increased domestic borrowing supported the growth of the banking sector, making an anomaly of Lebanon in terms of banking asset penetration relative to the productive capacity of the country, as shown in **Graph 5**.

It is worth highlighting the significant interlinkage between the Lebanese financial system and Arab oil money. Most of the foreign exchange inflows were linked to the Gulf: diaspora money, FDI, Arab tourism, and foreign aid. This meant that even if Lebanon did not produce a drop of oil, financial flows were very much correlated to the oil price, making Lebanon a victim of the Dutch disease – large inflows of foreign currency that lead to an overvalued real exchange rate and a decline in the productive sectors of the economy.

The balance of payments

In the years leading to 2010, and despite a huge trade deficit, Lebanon was registering balance of payment (BOP) surpluses (net additions to foreign assets), meaning more dollars were coming into the country than leaving (see **Graph 6**). The large figures of 2008 - 2010 are related to diaspora money fleeing international banks to what was then perceived as a safe-haven Lebanese banking sector.

The period post 2010 coincided with lower oil prices compared to those of prior years. This, together with the repercussions of the Syrian civil war (outbreak 2011), had a major impact on the country's external accounts through the oil link, and because of disruption from Syria (Syria is an export destination for Lebanese goods and an export route to the Arab interior). This is reflected in the "change in net foreign assets" figure turning negative starting 2011, as shown in Graph 6.

The (dubious) role of the central bank, Banque du Liban

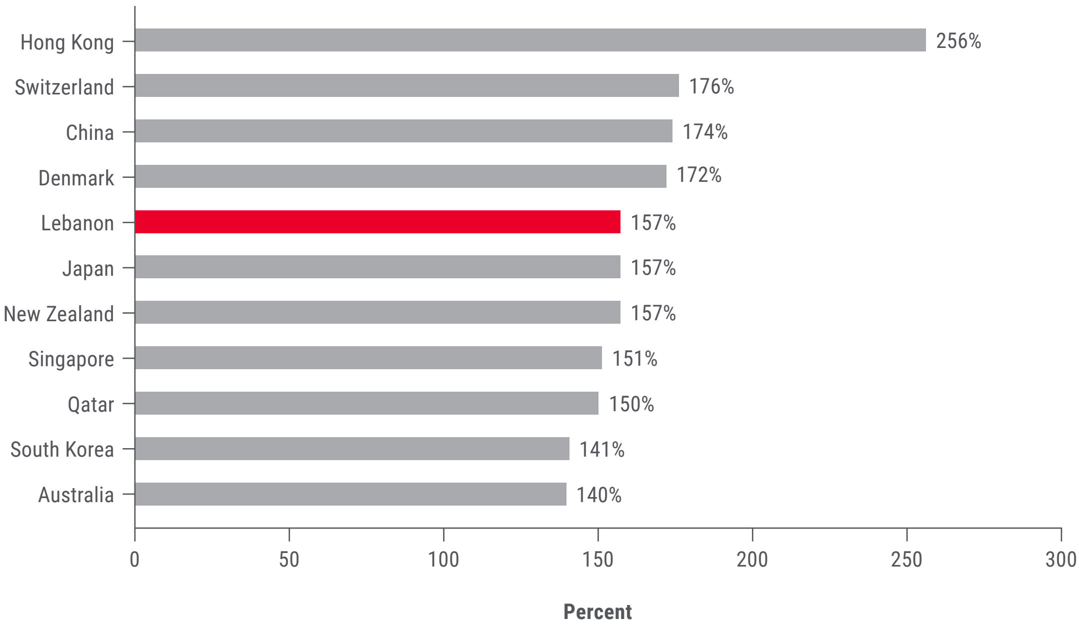
The value of foreign reserves appeared very comfortable throughout the years, as shown in **Graph 7** on page 10, reaching around 14 times months of imports (and more than 20 times if we account for gold). This was the main argument many used to justify their belief in the sustainability of the currency peg (which had been stable at LBP1 507.5/US$ since 1997).

What some failed to look at (deliberately or not) is the net reserve figure, which showed a totally different picture.

As Lebanon started to see diminishing inflows, which intensified in 2015, the central bank, Banque du Liban, underwent a series of transactions dubbed "financial engineering". The scheme involved three steps among the central bank, ministry of finance and private banks that were meant to solve serious problems each had been facing: the central bank's foreign exchange shortage, the funding needs of the treasury, and the insufficient capital and liquidity of private banks.

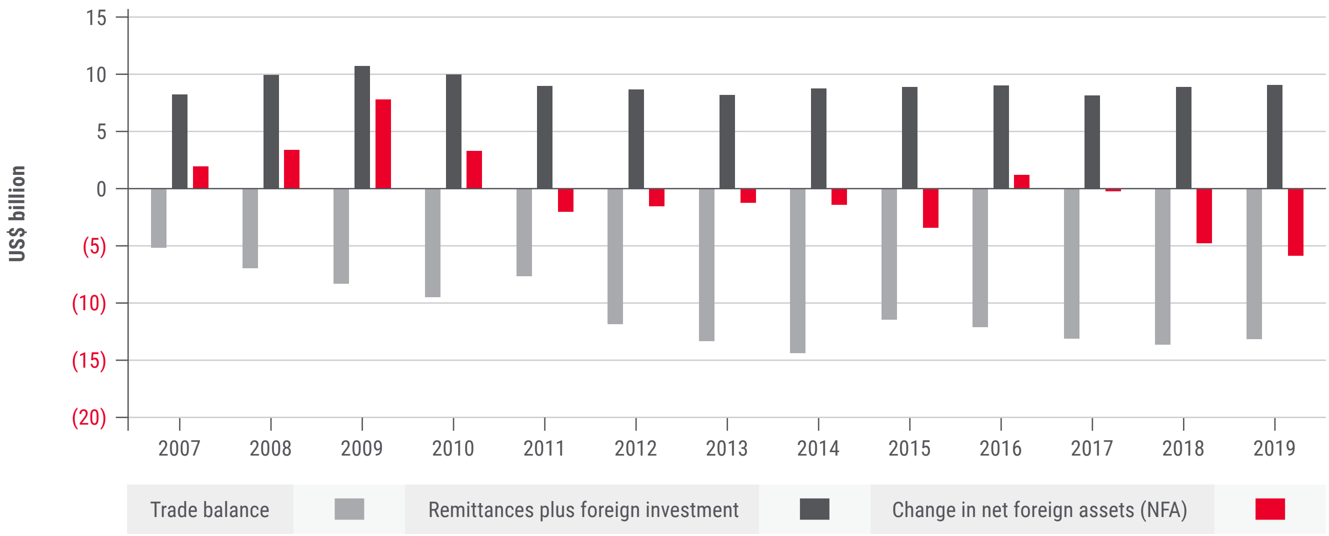
The details of the scheme will not be dwelled upon here but, in short, the central bank paid banks an exorbitant return on dollar deposits, effectively around 15%, to bolster its dollar reserves.

Graph 5: Bank assets as a % of GDP, 2017 estimate



Sources: theglobaleconomy.com, tradingeconomics.com

Graph 6: Lebanon external balance



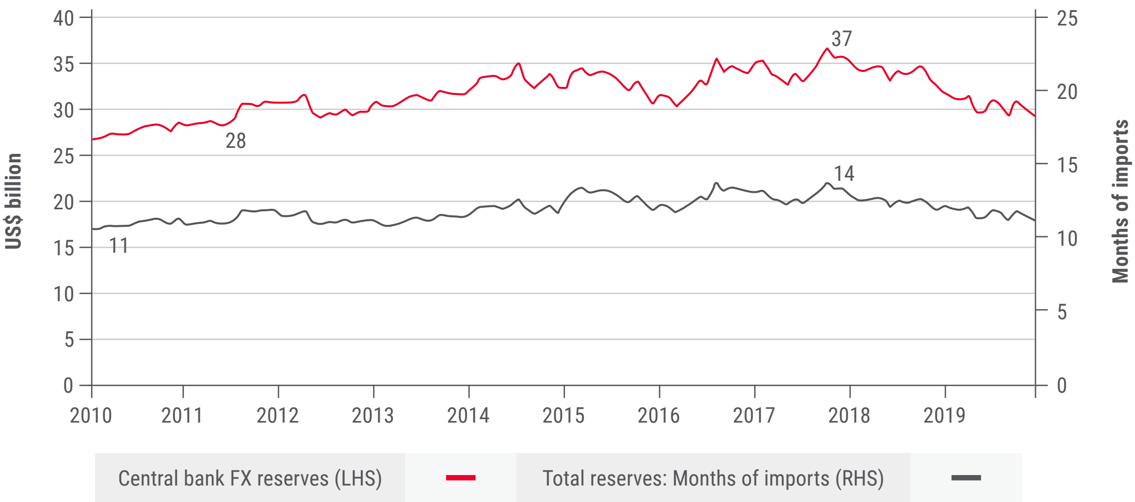
Source: Banque du Liban website

This provided a windfall boost to bank earnings and capital (effectively a money-financed capital injection without any equity stake in return – i.e. a direct transfer of taxpayer money to a few wealthy bankers). To maximise the benefit from the scheme, banks were incentivised to attract new dollar inflows by offering high rates to expats (and as a concomitant significantly reduced lending to the real economy, exacerbating the problem).

As of the end of June 2019, the banks' exposure to the sovereign (central bank plus government) increased to around 70% of their total assets, estimated at more than eight times Tier 1 capital. See **Graph 8**.

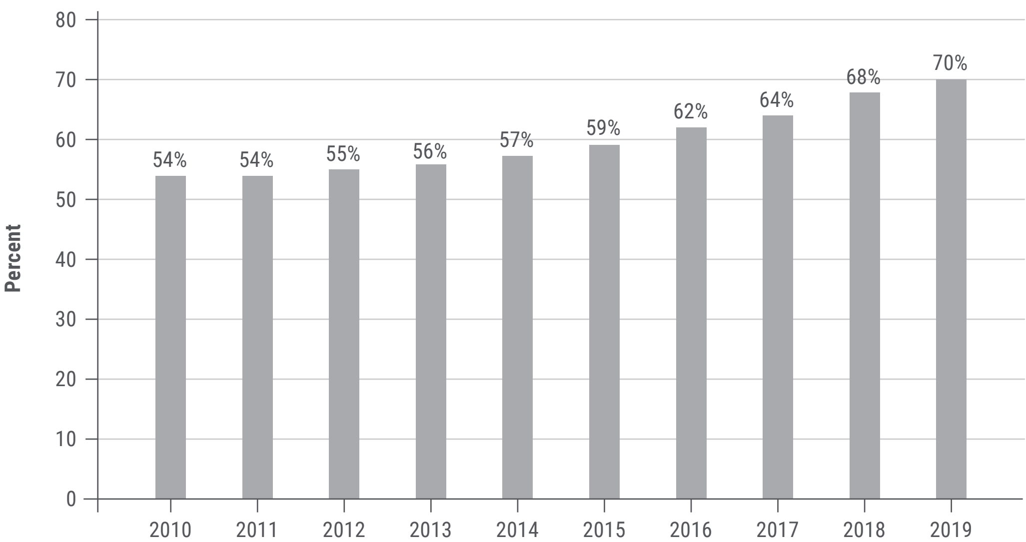
The effect of this was the strengthening of the central bank's gross reserves in the short term. The central bank, in turn, was using that money to finance both the current account (i.e. continue supporting the currency peg) and the government (which at that point was struggling to raise foreign exchange debt on the market). The net reserve figure (which accounts for liabilities – and was never published) turned red at some point and continued widening.

Graph 7: Central bank gross reserves



Source: Banque du Liban website

Graph 8: Lebanese banking sector estimated sovereign exposure as a % of total assets



Sources: Association of Banks in Lebanon website, Banque du Liban website, Allan Gray calculations

The collapse

"'How did you go bankrupt?' Bill asked. 'Two ways,' Mike said. 'Gradually and then suddenly.'" (From Ernest Hemingway's novel The Sun Also Rises*)*

Things gradually worsened with continued net outflows, no reforms whatsoever (which would otherwise have set forth up to US$11bn in easy loans by CEDRE, an international conference hosted in Paris in 2018 in support of Lebanon development and reforms), and an unwillingness of traditional foreign backers to support the country.

Basically, a large Ponzi scheme was at play. The central bank was paying very high interest to banks and banks to customers by crediting accounts (computer entries) without generating the return on the cash.

On the ground, this was being reflected by ever-increasing interest rates, banks making it more complicated to transfer money out (although you technically still could) and offering all sorts of enticements to keep sceptical customers and to bring in new money. Interest of up to 10% on dollar deposits was offered, and more than that for large amounts coming from abroad. This is compared to global yields near 0% back then. Most of that money was ending up in the central bank, which used it to roll over the government's dollar debt and continue supporting the peg.

Basically, a large Ponzi scheme was at play. The central bank was paying very high interest to banks and banks to customers by crediting accounts (computer entries) without generating the return on the cash. On the contrary, the central bank was spending the money and relying on new money to finance outflows.

At some point, just before the collapse, there was (very roughly) around US$150bn's worth of deposits chasing around US$50bn's worth of real dollars (i.e. around two-thirds of deposits in the system were not backed by real money). The role of the psychology of crowds in averting/precipitating crises is fascinating, and this is a very good case in point: As long as people did not know that a devious scheme was taking place and confidence existed, the scheme could continue. In theory, and assuming continued confidence, it could have continued up to the point where the country's reserves were depleted.

On 17 October 2019, the WhatsApp communication tax proposed by the government triggered large protests that carried on for weeks. The banks (which were partly a target of the protests, blamed for generating superprofits over the years, and not paying a fair share to the fiscus) closed their branches for a week. Confidence was lost. As they opened again, a run on the banks occurred, particularly from expat holders of dollar accounts. The banks could not meet that demand. Unofficial capital controls were immediately put in place and the system collapsed.

There was a sudden stop in financial flows into the country. The traditional sources of inflows relied on confidence in the banking sector, and this suddenly crumbled. Lebanon was left with the central bank's reserves and the small remaining amount private banks held with their correspondent banks to keep going.

As the maturity of the US$1.2bn March 2020 Eurobond came, the choice was between paying creditors or buying more time to keep subsidising basic goods. The country defaulted for the first time since its independence in 1943 and lost the reputation of a flawless track record in debt repayment. And a sovereign default meant a de facto banking sector default.

So, Lebanon ended up with a three-pronged crisis: a balance of payment/currency crisis, a sovereign debt crisis, and a banking crisis.

Could you have stayed until one minute to midnight?

In the months prior to the crisis, I would ask the average financially educated person in Lebanon whether they still held the majority of their savings in a deposit account in Lebanon, and most did. While they understood that the country's metrics were worryingly grave, they were complacent about the situation, arguing that it had always been the case and that trust in the system would continue no matter what. Until it did not, and this happened overnight.

The study of when an unsustainable credit boom actually becomes unsustainable is relevant subject matter in behavioural finance, but as Gordon Pepper (one of Margaret Thatcher's advisers) put it amusingly: "When you think you see something that is unsustainable, rationally work out the maximum period you think it can be sustained, then double it and take off a month." His multiple needs to be adjusted after looking at Lebanon (it was much more than double), but the idea is clear.

I would summarise it as follows: The sustainability of an unsustainable credit situation is dependent on the willingness of a lender to continue to bankroll the borrower, and that, in turn, depends on the belief of the lender that other lenders will continue to do the same – i.e. a belief in others' beliefs. The timing of the loss of this "aggregate belief", if I may call it that, is something that is very difficult to foresee.

Looking forward

As bleak as the outcome of this has been on the real economy and therefore on social life, a comforting reality is that the crisis is financial and not real in nature, i.e. it does not involve a loss of physical capital or human lives. This means that the "cost to rebuild" lies in virtual measures that need to be taken to restore confidence and kick-start the economy – and these are not constrained by physical or time limits. But will those responsible release their hold of the state and its institutions?

Rami joined Allan Gray as an equity analyst in 2015 after having worked in various investment roles in Beirut and Paris. He was appointed as a portfolio manager in 2020 and manages a portion of the African equity portfolio. Rami holds a Bachelor of Arts degree in Economics from the American University of Beirut and a Master of Science degree in Financial Economics from HEC Paris.

AFRICA MARKET BOND EXPOSURE: UNDERSTANDING THE RISKS AND OPPORTUNITIES

Londa Nxumalo

For all their risks, African bonds have historically delivered good returns for long-term investors.

Is it worth taking on a bit more risk to achieve potential return? Londa Nxumalo explains the relationship between risk and return in the fixed income context and discusses factors to consider when looking at the opportunities and threats across Africa. The situation in the developed market fixed income world looks very different from that in emerging markets, which Mark Dunley-Owen, from our offshore partner, Orbis, unpacks in his article on page 19.

The relationship between risk and return is well documented. In short, investors should demand a higher return from investments that carry a higher risk. In fixed income, the potential for returns – in the form of coupons and capital gains – is captured by the bond yield (which is the coupon amount/price). A high yield signifies a high potential return. A high potential return generally comes with high risk, and therefore a higher yield would point to higher risk. Low return in itself can be a risk – but many investors seem to be ignoring this factor, opting for safety even if it means no yield. Because bond prices move inversely to yields, investors who buy bonds at abnormally low yields would be exposed to capital losses in the event that those yields normalise.

Graph 1 on page 14 shows the hard currency yields of three developed countries and six major African bond issuers. There is a clear negative relationship between the credit quality of a country (the willingness and ability to repay interest and capital in full and on time) and the yield on its bonds. In other words, the lower the credit quality, the higher the yield.

Developed countries have better credit ratings (or lower credit risk) and therefore offer lower yields. These are often considered safe havens. On the other hand, the African countries offer increasing yields as the credit quality deteriorates. Zambia, which defaulted on its hard currency bonds in November 2020, offers the highest yield. Perhaps unsurprisingly, given the country's upper-middle-income status, South African bonds are located between those of developed and those of other African countries.

Interestingly, the perceived credit risk does not map neatly to a country's debt levels, as can be seen in **Graph 2**. With the exception of Zambia, all the African countries have a lower debt-to-GDP ratio than the US and the UK. But why are these countries seen as riskier despite having lower debt?

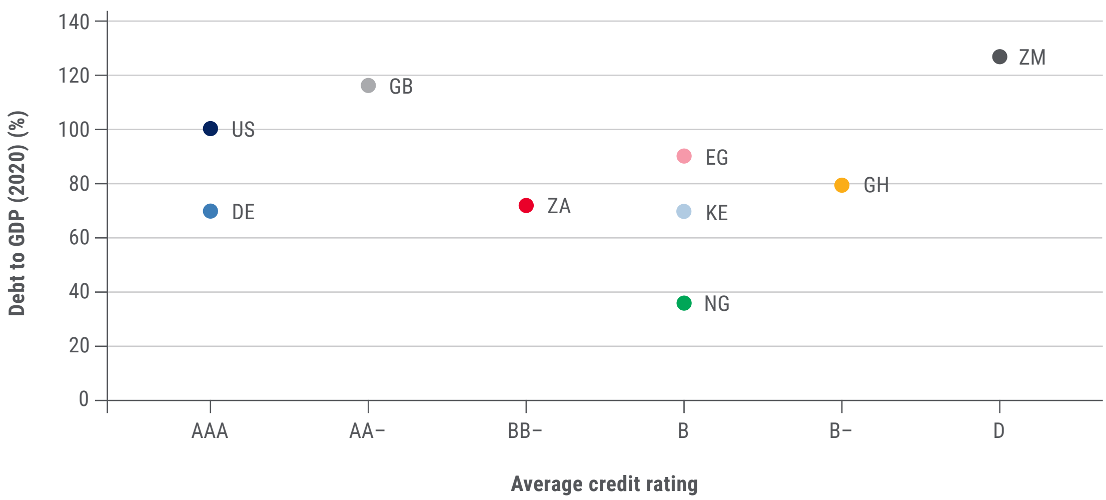
The answer lies in their debt-carrying capacity – that is, their resilience relative to their debt levels, which determines the extent to which they can repay debt despite setbacks.

Developing countries tend to have more vulnerable economies and weaker institutions than developed countries, meaning a lesser ability to manage internal or external shocks such as adverse weather, sociopolitical upheaval, commodity price crashes, war, and many others. Because of this, most African countries simply do not have the buffers to handle the proportion of debt that developed countries can get away with. Although lower debt levels are a good thing, they are not enough.

Graph 1: Hard currency risks and returns*

*DE yield is in euros, GB yield is in pounds, and yields of all other countries are in US dollars.
Sources: Refinitiv Eikon, Bloomberg, Allan Gray calculations

Graph 2: Debt level vs. credit ratings



Sources: Fitch Connect, Allan Gray calculations

US = United States, DE = Germany, GB = United Kingdom, ZA = South Africa, EG = Egypt, KE = Kenya, NG = Nigeria, GH = Ghana, ZM = Zambia

What about local currency debt?

So far, the key discussion points have been illustrated using foreign currency debt. Local currency debt is broadly subject to the same concerns and also includes others. Inflation can erode the returns on local currency fixed income instruments through its effect on the exchange rate. Purchasing power parity suggests that if two countries have different rates of inflation, the currency of the country with higher inflation will depreciate over time.

African countries tend to have higher inflation than developed countries, as can be seen in **Graph 3**. The reasons for this are manifold, and can include supply chain inefficiencies, central bank money-printing, and high import dependency with depreciating exchange rates. Given these countries' higher inflation rates, it is therefore unsurprising that African currencies tend to depreciate over time, as shown in **Graph 4** on page 16.

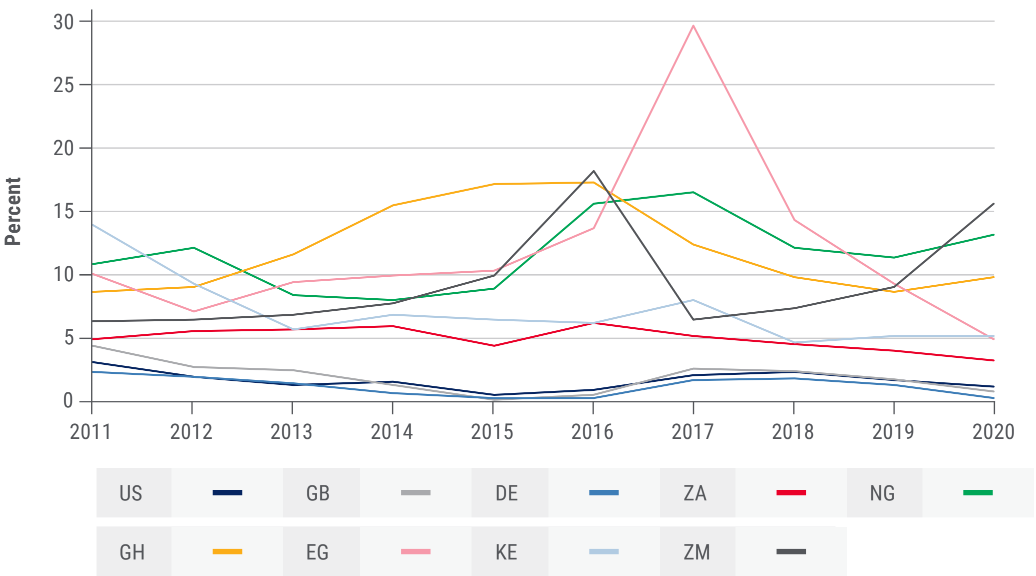
For a foreign investor, local currency depreciation erodes US dollar returns. So over and above the credit risk (the risk of non-payment), local currency bonds also carry currency risk (the risk of currency depreciation). These risks are not uniform across similarly rated countries. A simplistic way to compare potential local currency returns in a currency-agnostic way is to look at real yields[1], which can be seen in **Graph 5** on page 16.

It is useful to look at Graphs 3, 4 and 5 in conjunction to understand the relationship between nominal yields, inflation and currency risk. For example, Zambia and Ghana offer the highest nominal yields, but historically have also had higher inflation – and their currencies have performed the most poorly. Nonetheless, both countries still offer attractive real yields.

Except for Nigeria, all the African countries offer positive real yields. The same cannot be said for the developed countries, which all have negative real yields – meaning that investors are not even being compensated for inflation. Mark Dunley-Owen, from Orbis, touches on this on page 19 and gives an overview of how Orbis thinks about fixed income in a global context.

As mentioned earlier, South African bonds show up between those of developed and those of other African countries. In our previous Quarterly Commentary, Thalia Petousis offered a detailed description of how we navigate the South African fixed interest landscape. In short, we believe that long-dated bonds offer attractive real yields, albeit

Graph 3: Annual inflation rates



Source: Fitch Connect

[1] The real yield is equal to the nominal yield after stripping out inflation.
US = United States, GB = United Kingdom, DE = Germany, ZA = South Africa, NG = Nigeria, GH = Ghana, EG = Egypt, KE = Kenya, ZM = Zambia

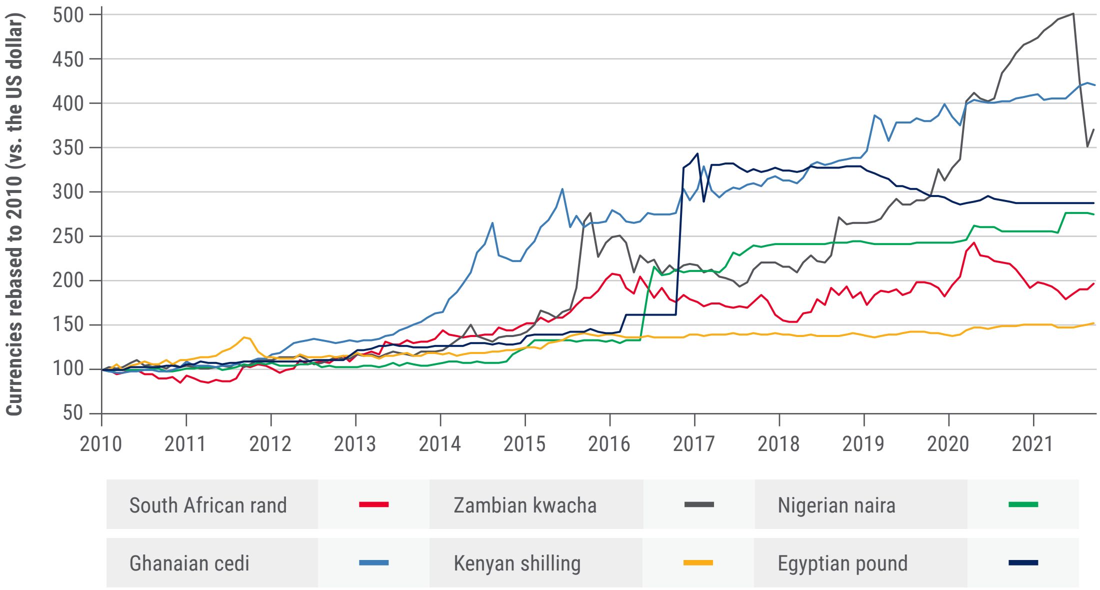
against the backdrop of elevated fiscal risks due to a moribund economy and historically high government debt.

Corporate bonds

Although sovereign bonds make up the vast majority of the African fixed income investment universe, there *are* some corporate issuers to be found. The case for corporate bonds hinges on sustainable cash flow compared to a company's debt load.

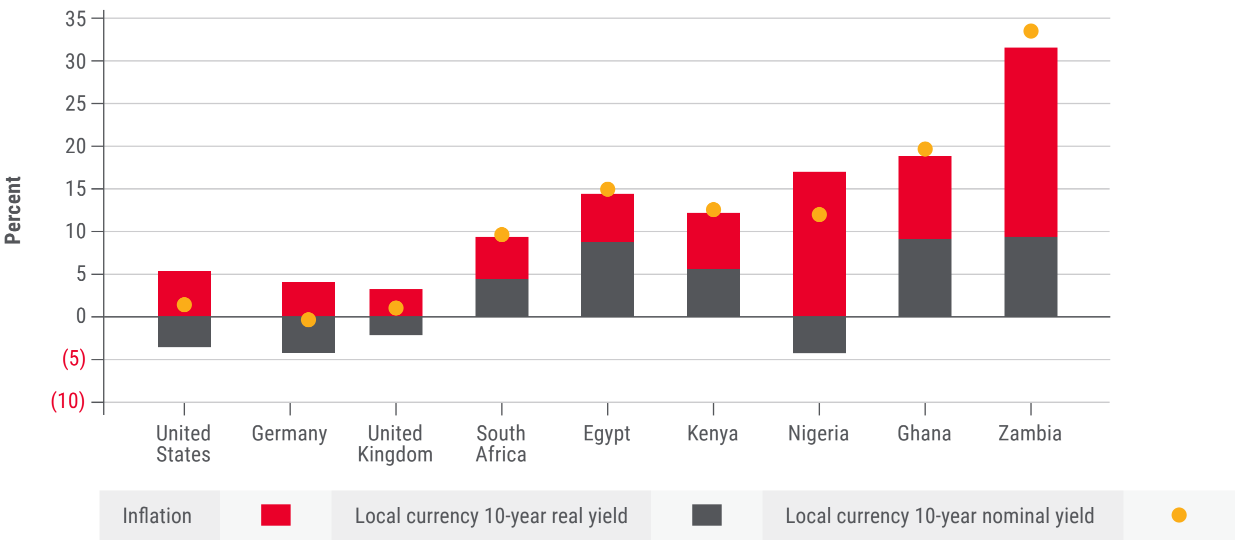
Companies operating in developing countries often have a high cost of funding due to the real or perceived risks of operating in these jurisdictions. In the case of corporate bonds issued outside South Africa, the usual credit risks would be overlaid by the currency risk of the underlying instrument. Sovereign risk feeds into corporate credit risk as the sovereign's actions impact a company's ability to service debt through taxes, inflation, service delivery, capital controls and other policy consequences.

Graph 4: African currency values over time



Sources: IRESS, Allan Gray calculations

Graph 5: Local currency yields



Sources: Refinitiv Eikon, Allan Gray

Graph 6 shows aggregated African ex-SA sovereign and corporate bond yields over the past decade. Bar a few brief periods before 2015, corporate bond yields have historically traded below sovereign bonds. This implies that the market sees corporates as being less risky than sovereigns.

This makes sense in some ways. Libertarian economic theory asserts that private enterprises are better run than governments; better-run borrowers should carry a lower risk premium. Another reason why corporate yields have tended to be lower is structural: Sovereigns tend to issue very long-duration bonds (10 - 40 years), while corporates tend to favour medium-term bonds (less than 10 years). Longer-dated bonds have a higher yield because default risk rises over longer periods of time.

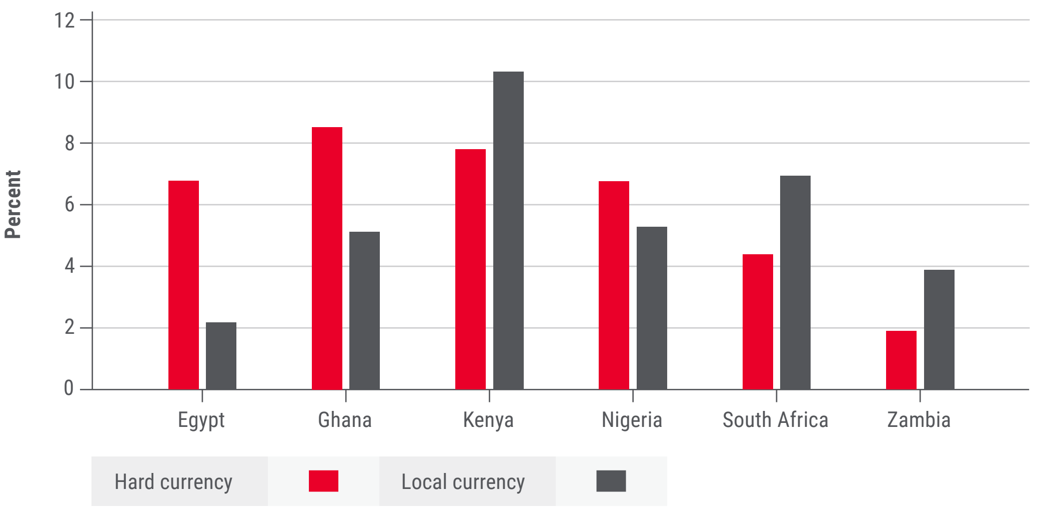
Performance of Africa bonds

Graph 7 shows the annualised US dollar total rate of return (TRR) over five years until end September 2021 for medium-term African hard currency bonds and local

Graph 6: Africa ex-SA Eurobond yields

Sources: Standard Bank, Bloomberg

Graph 7: Annualised five-year US$ total rate of return (Sept 2016 - Sept 2021)



Sources: Bloomberg, Allan Gray calculations currency bonds respectively. Zambian Eurobonds have delivered a positive TRR despite the government defaulting last year. This is a testament to the very high coupon rates often associated with riskier credits. Even South Africa has held its own, with the local currency bonds beating those of higher-yielding countries like Egypt, Ghana and Zambia.

… in a relatively risk-free investment, your returns may not keep up with inflation …

The Allan Gray Africa Bond Fund ("the Fund") has delivered an annualised US dollar return of 7.5% since its inception in 2013. These strong returns have only been possible over the long term. The annualised volatility of the Fund has been 9.2%, meaning that sometimes returns can be negative. However, our long-term focus has enabled us to buy or hold instruments through market dislocations – with the Fund benefiting from the subsequent recovery, not to mention the high coupons that compound over time.

For all their risks, African bonds have historically delivered good returns for long-term investors.

Bonds in your portfolio

Fixed income makes up an integral part of any diversified portfolio. You can gain exposure to the asset class mainly through multi-asset funds or specialist bond funds. Funds that comply with Regulation 28 of the Pension Funds Act, which limits the extent to which retirement funds may invest in various assets, can invest up to 100% in bonds issued or guaranteed by the South African government, or up to 75% in any other bonds. Furthermore, Regulation 28 allows for 30% of a fund to be invested outside South Africa, with an extra 10% in Africa outside South Africa. These foreign investment limits can be used to invest in international bonds.

If you prefer a building-block approach, you can invest directly in various bond funds. These can be local or foreign investments and are categorised according to their features. Some are based on credit quality, such as funds that reference the FTSE World Government Bond Index (WGBI), which is made up of investment-grade government bonds, including those of most developed countries and some emerging markets; other funds may have a specific geographic focus, such as emerging markets or Africa. Lastly, specialist bond funds may invest in local currency bonds, foreign currency bonds, or both.

Various Allan Gray funds invest directly in African (including South African) bonds.

How much exposure you should have to bonds, and which bonds you decide to invest in, depend on your goals and personal circumstances, as well as your ability to take on risk.

It's important to understand the different types of risk, and which will impact you most. Remember that in a relatively risk-free investment, your returns may not keep up with inflation, so you will face the risk of your investment losing real value over time. For tailored advice, we recommend you talk to a good, independent financial adviser.

Londa joined Allan Gray as a credit analyst in 2017 and was appointed as a portfolio manager in 2019. She manages the bond portfolio, as well as portions of the fixed interest component of the balanced portfolios and the Africa fixed interest portfolio. Londa holds a Bachelor of Accountancy degree from Rhodes University and a Master of Commerce degree in Development Finance from the University of Cape Town Graduate School of Business. She is a qualified Chartered Accountant.

ORBIS: OUR PERSPECTIVE ON DEVELOPED MARKET BOND YIELDS

Mark Dunley-Owen

... we own assets that ... offer higher long-term returns than developed market bonds, as well as better yield and diversification benefits.

Bonds are typically included in an investment portfolio to provide diversification and deliver yield. Developed market bonds are currently offering much lower yields than their emerging market counterparts, yet are perceived as less risky and are therefore more popular. But is the safe option the best one? Mark Dunley-Owen, from our offshore partner, Orbis, offers a view on developed market bonds, whereas Londa Nxumalo, in her article on page 13, provides us with a different perspective on the bond market in Africa.

At Orbis, our investment principles include limiting the assumptions we make about the future and ignoring the short term. We try to get the big things right over the long term. This is unusual in fixed income, where many investors rely on macroeconomic predictions over the coming months. Our investment philosophy, across all asset classes, including bonds, is the opposite of this thinking.

Graph 1 on page 20 is a remarkable reminder why getting the big things right matters. It shows the yield on the US government 10-year bond since 1970. Bond prices move in the opposite direction to bond yields, hence consistently lower yields have resulted in consistently higher prices. A US bond investor in the 1980s needed to get one thing right, namely that inflation and therefore yields would fall, and stick to this conviction for the following 40 years.

This downward yield trend has not been restricted to US government bonds; most developed market government bond yields have fallen towards zero, and negative for safe havens such as Germany and Switzerland. Even Greece, which appeared likely to default on its debt obligations following the global financial crisis, now pays less than 1% for its government debt.

Corporate bonds have experienced similar yield compression, often irrespective of underlying fundamentals. The Bank of America US High Yield Index tracks US corporate debt rated below investment grade, more commonly known as junk bonds. Junk bonds offered around 10% yield for much of the 1990s and 2000s. Investors were rewarded for taking on the "junk" credit risk. Today, in many ways a more challenging period than the 2000s, these bonds offer a historically low 4% nominal yield, and negative real yield.

Graph 1: US 10-year government bond yield

Source: Bloomberg

Low yields mean fewer opportunities

Undiscriminating low yields pose a problem for long-term fixed income investors such as us. Most importantly, in contrast to opportunities in Africa, as discussed by Londa Nxumalo on page 13, low yields mean there are fewer opportunities with attractive probable return. They also nullify two of the reasons we hold bonds in a balanced portfolio, namely to earn the carry ("the carry" is the return accruing to an investor from holding the bond) and diversification.

The S&P dividend yield and long-duration US government bond yields are similar, making it difficult to justify holding bonds for the carry. As for diversification, we believe the zero lower bound on yields skews the upside/downside potential from bonds. Simplistically, bond prices may fall more than equity prices rise in risk-on scenarios and rise less than equity prices fall in risk-off scenarios.

Limited value, low carry and questionable diversification leave us with few reasons to own bonds. We are fortunate that we are not forced to fill a bond bucket or mimic a benchmark and are able to have low fixed income exposure in our funds. Instead, we own assets that are underpriced relative to their cash flow and provide diversification by behaving differently to mainstream equities. These include cash, gold, energy exposure and a basket of cheap, idiosyncratic companies. We believe these offer higher long-term returns than developed market bonds, as well as better yield and diversification benefits.

Mark joined Allan Gray as an equity analyst in 2009. He started managing a portion of the fixed interest portfolios in July 2011, and a portion of the stable portfolios in May 2013. He was appointed as a portfolio manager in January 2012. In September 2020, Mark joined Orbis as a member of the Bermuda investment team. He is also a director of Allan Gray Bermuda Limited and part of the investment team for the Allan Gray Africa Bond Fund. Mark holds a Bachelor of Business Science (Honours) degree in Finance and Information Systems from the University of Cape Town.

ORBIS: THE THREE STAGES OF RECENT PERFORMANCE EXPLAINED

John Christy

Over the long term, it is an approach that has served our clients well, but also one that can be uncomfortable for fairly long periods of time.

The past quarter has been painful. After an encouraging start to the year, the performance of our offshore partner, Orbis, has been impeded by its exposure to selected Chinese technology shares and the broad underperformance of value-oriented shares globally. John Christy, from Orbis, discusses the reasons behind the underperformance and explains why Orbis is optimistic about its current holdings.

While we try not to dwell on quarterly results, the past few years have also been disappointing. As co-investors in the Orbis funds, we share the frustration that some of you may be feeling.

As painful as they may be, times like these are an inevitable consequence of our bottom-up approach. Labels such as "value" and "growth" are often used to bucket groups of stocks together according to shared quantitative characteristics or "factors". But we focus on the risk/reward proposition of each individual investment opportunity, with risk defined as that of permanent capital loss rather than of looking foolish in the short or medium term. For better or worse, clients should expect this approach to produce an idiosyncratic pattern of relative returns that is uniquely our own. Over the long term, it is an approach that has served our clients well, but also one that can be uncomfortable for fairly long periods of time.

Three distinct stages

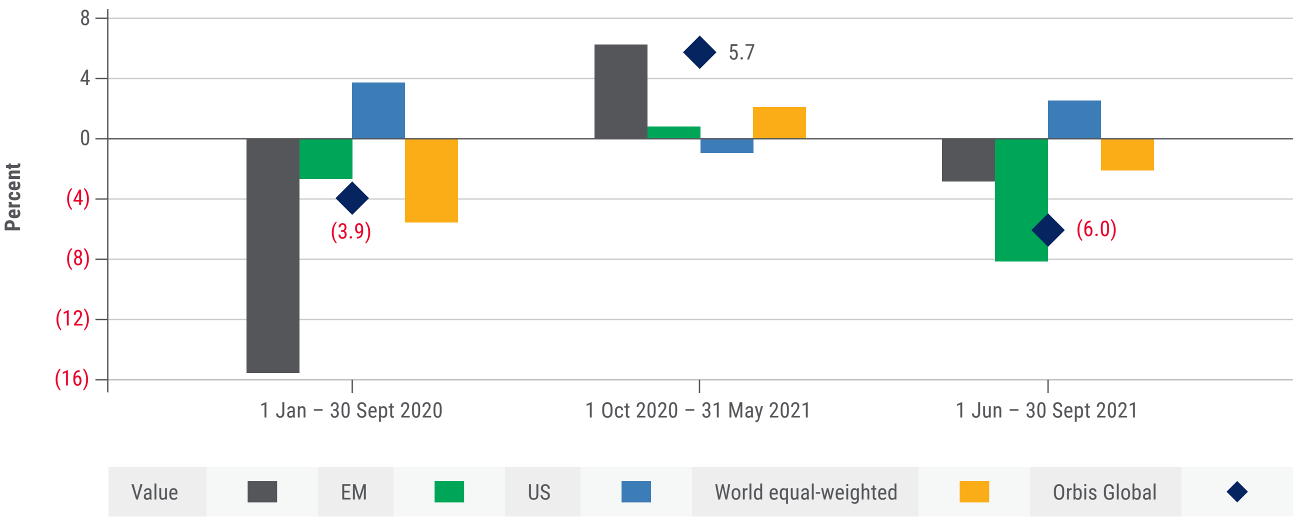
The past few years have been a reminder of what those difficult periods can look like up close. As shown in **Graph 1** on page 22, it helps to break it down into three distinct stages.

1 January 2020 - 30 September 2020

Heading into 2020, the market was characterised by massive dislocations between the valuations of shares belonging to the value and growth factor buckets. But there's a big difference between picking a few attractive stocks that happen to fall into a particular bucket and buying the entire bucket itself. We do the former, not the latter. For example, we owned shares such as BMW, Honda, and several Japanese trading companies – all of which were trading at or below their book value. Since book value is often used as a metric in factor definitions, our bottom-up stock selections resulted in a portfolio biased towards the value factor.

Graph 1: A painful reversal in recent months

Factor and region performance relative to MSCI AC World Index*, and Orbis Global Equity Strategy (after fees) relative to the FTSE World Index



Sources: Refinitiv. *MSCI All Country World Index. Value: MSCI All Country World Value Index; World equal-weighted: MSCI All Country World Equal Weighted; US: S&P 500; EM: MSCI Emerging Markets. Past performance is not a reliable indicator of future results.

But we believed that our selections from the value bucket were significantly more attractive and resilient than the rest of their peers. As the pandemic unfolded, the broader value bucket was hit particularly hard as investors sought shelter in higher-quality and often more expensive areas of the market. We felt our share of the pain as well, but during the first nine months of 2020, the Orbis Global Equity Fund ("the Fund") held up much better than the value factor – and many other value investors – thanks to our holdings elsewhere in the portfolio, notably in the US and China.

1 October 2020 - 31 May 2021

As a group, value shares came roaring back from last October through May of this year – driven largely by vaccine news and the prospect of the world returning to "normal" sooner than expected. Many of our stock selections benefited from that tailwind, but actually did a bit better than exposure to any particular factor would suggest. In recent months, it has cut the other way, driven in part by a few stocks in China.

1 June 2021 - 30 September 2021

Leaving political risk aside, the Chinese equities that we own in the portfolio look extremely compelling and are trading well below our assessment of their intrinsic value. But we don't have the luxury of investing in a vacuum. Indeed, escalating geopolitical and regulatory risks were our primary motivation for reducing the Fund's aggregate exposure to China in the second half of last year – trimming it from 20% at 30 June 2020 to 15% at 31 December 2020. With the benefit of hindsight, we should have trimmed more.

As tempting as it may be to take a more aggressive stance in China at today's valuations, we are increasingly mindful of the risks. At 9% of the portfolio at 30 September 2021, which includes Naspers (that derives nearly all of its value from its stake in Tencent), we believe our position sizing in China is appropriate in light of the risks.

China opportunity

We remain enthusiastic about selected businesses in the area. The largest of these positions is NetEase, which is the second largest holding in the Fund and best contributor to its long-term relative performance. NetEase has a leading online game franchise in China, a highly impressive founder CEO who is well aligned with shareholders, underappreciated upside coming from other businesses such as music and education, and opportunities to expand globally. NetEase has been a fantastic business, compounding earnings per share at a rate greater than 25% per annum since 2003. A US$10 000 investment in NetEase back then would be worth more than US$500 000 today.

None of this has mattered in recent months. NetEase shares are nearly 40% below their peak in February amid increasingly intense regulatory scrutiny in China – in particular, strict measures to limit the amount of time that kids can spend playing video games to just three hours per week in designated time slots. Our view has been that NetEase will be able to cope with the new regulations given that its customers are predominantly adults, and that it has successfully navigated regulatory headwinds in the past.

At current prices, we believe NetEase's valuation remains attractive at 17 times core gaming earnings, and we are comfortable with the position size. That said, we cannot rule out more stringent measures in the future.

… it is worth remembering that leaning into political risk has also worked in our favour.

Leaning into political risk

As painful as these developments have been, it is worth remembering that leaning into political risk has also worked in our favour. As we discussed in September 2020, on the eve of the US presidential election, our holdings in managed care organisations (MCOs) such as UnitedHealth Group and Anthem are uniquely sensitive to political risk.

We first bought into the MCOs in 2008 amid fears about "Obamacare", and were presented with another opportunity when Bernie Sanders proposed "Medicare for All" in the 2020 presidential campaign. The doomsday scenario is always the same – that the MCOs will be put out of business by a nationalised healthcare model – but the pandemic also brought fresh fears of a surge in COVID-19-related claims.

As a result of these fears, these businesses have rarely traded at demanding valuations. Despite attractive fundamentals, UnitedHealth has on average traded at a 6% discount to the S&P 500, and Anthem has traded at a 22% discount – and both have been even more attractive when uncertainty is most extreme. We took advantage of the extreme pessimism to build a larger position. At 30 September, our positions in UnitedHealth and Anthem accounted for 5% of the portfolio.

Since President Biden took office, he has not made any notable moves in healthcare and appears to be devoting political capital to infrastructure and climate issues instead. History has also shown that the most important reforms tend to be tackled in the first year of a new presidency, when momentum is strongest. There are some initiatives being discussed that would affect prescription drug pricing, but none of these are transformational for the system, nor do they appear materially negative for the MCOs.

We continue to believe that the services of UnitedHealth and Anthem will be in even greater demand in the future as the US grapples with the challenges of providing better healthcare to an ageing and growing population at a manageable cost. We fully expect their share prices to remain volatile, but we continue to believe that they offer compelling long-term value.

Importantly, UnitedHealth and Anthem have nothing to fear from Chinese regulators, just as NetEase will never need to care about US healthcare policy. From a fundamental perspective, these businesses are completely uncorrelated. When we assemble a whole portfolio of opportunities like this, we end up with a collection that is truly differentiated. Historically, our analysis shows that less than half of the Fund's long-term relative performance can be attributable to its factor exposures. In both good times and bad, our results have been overwhelmingly driven by our bottom-up stock selections.

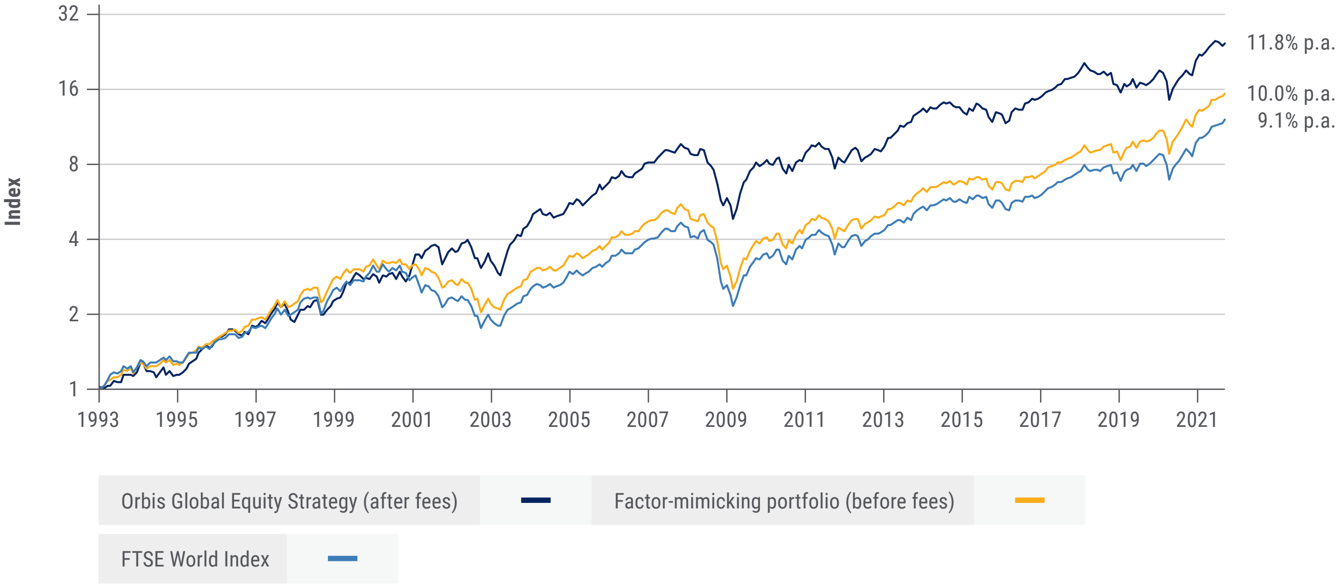
Prospects look promising

As a thought exercise, imagine going back in time to the early days of Orbis and setting up shop across the street from us. But instead of hiring a bunch of analysts to pore over financial statements and meet with management teams, you developed an investment approach based solely on mimicking the factor exposures of the Fund. These days, it would be even easier to do with a selection of widely available and low-cost exchange-traded funds. Interestingly, you could have beaten the World Index – an impressive feat – but you would have been unable to replicate the performance of the Orbis Global Equity Fund over its history (see **Graph 2** on page 24).

Only time will tell if our current selections can repeat this performance in the future. We are optimistic. If we aspire to deliver higher returns than global stock markets without greater risk, a good starting point is to buy better-than-average companies at lower-than-average prices. That's exactly what we are able to do today. When compared to the averages of their World Index peers, the companies held in the Fund are growing faster and yet trade at significantly lower valuations. To us, that's pretty exciting – especially at a time when one can easily pay more than 50 times revenue for an unproven software business, or US$1 million for a digital picture of a rock.

Graph 2: Idiosyncratic stock selection has driven our long-term outperformance

Returns of Orbis Global, a factor-mimicking portfolio for Orbis Global, and the FTSE World Index



Sources: Refinitiv, CFA Institute, Orbis. January 1993 to August 2021. The returns-based analysis is performed using rolling three-year betas, therefore the first data point is 1 January 1993. Past performance is not a reliable indicator of future results.

Orbis
Invest Differently

John joined Orbis in 2010 and is a member of the team of Investment Counsellors, which is responsible for servicing Orbis' institutional clients and investment consultants. His responsibilities include oversight of the firm's strategic and investment communications. John holds a Bachelor of Arts degree in Economics from Fordham University and a Master of Business Administration from Carnegie Mellon University. He is also a CFA® charterholder.

KEY QUESTIONS THAT ADVISERS AND CLIENTS ARE ASKING

Tamryn Lamb

... it feels increasingly difficult for investors to connect the dots between what has happened and how to invest now for what the future may hold.

Uncertainty is a fact of life, and ever present in investing. There are times, however, when uncertainty seems to dominate sentiment and news flow – and arguably we are in one of those periods. Tamryn Lamb draws on some of the points discussed at the 2021 Allan Gray Investment Summit to answer five key questions that advisers and many clients are asking.

As we emerge from this pandemic, and grapple with the aftermath of both the health crisis and the responses by government to combat it, it feels increasingly difficult for investors to connect the dots between what has happened and how to invest now for what the future may hold. If this describes you, then you are by no means alone.

We are privileged to be able to meet and interact with many independent financial advisers and investors across the country. In these discussions, common themes have emerged from frequently asked questions. We have aimed to give our take on five of these important questions:

1. South Africa's macroeconomic situation seems dire – are there any green shoots of hope?
2. Are there great investment opportunities to be found in South Africa, given all the risks we face?
3. How should we be structuring portfolios to protect against some of these risks?
4. Where are the best opportunities to invest offshore?
5. How do you incorporate ESG thinking into your portfolios locally?

1. South Africa's macroeconomic situation seems dire – are there any green shoots of hope?

The most common question we receive, and what feels top of mind for almost every South African, is: How bad is the economic situation?

There is no shortage of negative news to feed fears and sentiment, and it is difficult to filter through the daily noise. I asked our senior portfolio manager and economist, Sandy McGregor, to share his thoughts. These are captured overleaf.

The South African economy is gradually recovering from the pandemic. It had a setback in June/July as a consequence of the third COVID-19 wave and the unrest in KwaZulu-Natal and Gauteng, but the recovery is now back on track. The past year has seen a remarkable commodity boom, with mining and agriculture prospering as never before. For the first time since 1994, we have enjoyed a substantial current account surplus. While export revenues will now contract following a sudden slowdown in China – which has triggered a dramatic decline in iron ore and platinum group metal prices – the global economy should be fairly buoyant over the next year as the pandemic recedes.

South Africa's economy has always been leveraged off its exports, so despite the Chinese slowdown, the necessary conditions for stronger growth are in place. It seems that the desire to travel has survived the pandemic and, as the remaining restrictions are lifted, the tourism sector, which has been decimated by shutdowns, will also recover.

The principal cause of the prevailing gloom about South Africa's future has been the failure of the Ramaphosa administration to reverse the economic stagnation of the Zuma years. Government lacks the skills to do this. The ANC has sunk into chaos and has been unable to provide the necessary political leadership. It appears that only the private sector has the skills and resources to fix things.

There have been tentative steps to get greater involvement of private business in activities previously reserved for the state. For example, the leadership of both Eskom and Transnet now say that the private sector must play a greater role in both electricity generation and transport. This change of attitude is partly due to South Africa's fiscal crisis caused by a bloated public sector wage bill, which rapidly compounded to unsustainable levels under former president Zuma. Government borrowing now absorbs most of SA's savings, leaving little for investment by business.

However, in the past year, tax collections have surprised on the upside, mainly due to the mining boom, and the government has been trying to contain its spending. The deficit is still too large, but it is declining.

Stanley Lewis, the entrepreneur who created the modern Foschini Group, was fond of saying that "things are never as good as you think, and they are never as bad as you think". This is true of South Africa today. Conditions are improving, and businesses will take advantage of this. The consequent economic recovery will happen despite and not because of the government.

2. Are there great investment opportunities to be found in South Africa, given all the risks we face?

As investors, we shouldn't pretend we operate in a vacuum that is nicely insulated from macroeconomic and political trends. However, as Rory Kutisker-Jacobson, one of our portfolio managers, explained at our recent Investment Summit, it is equally important to distinguish between the economic environment and the prices you are paying for assets in that environment. While the underlying value of the assets we invest in can be impacted by tough economic conditions, if sentiment is low and those assets are already pricing in a poor economic outcome, they can still generate healthy investment returns. If changes in price and sentiment are more volatile than changes in value, there could be great opportunities on offer for patient, long-term investors.

The past year has seen a remarkable commodity boom, with mining and agriculture prospering as never before.

As both Sandy and Rory note, we are not bulls on the South African economy, and it is incredibly hard to predict the future. We don't have a crystal ball that tells us what South Africa will look like 10 or 15 years from now. However, while we don't believe in making long-term economic forecasts, we can make inferences based on history and what we see prevailing today. Based on this, and on a balance of probabilities, we would expect that South Africa will experience more of the same: relatively muted growth and scoring the odd own goal.

However, within this context, we believe it is possible to find a number of companies that are either positioned to do well despite a poor macro backdrop, or pricing in a sufficiently dire outlook in today's share price, so that even if the economy continues to be dire, the investment returns from that company can be very healthy.

One area where we are finding value is the domestic banks, whose share prices remain below where they were at the end of 2019. Our biggest exposure is to Standard Bank, which has an excellent long-term track record and trades well below historic multiples. At today's share price, Standard Bank can deliver muted earnings growth and still generate good investment returns.

Meanwhile, there are a number of companies that are listed on the JSE, but whose fortunes are completely divorced from the state of the domestic economy – either because they are multinational corporations, which happen to be listed here, or because they derive the majority of their income from exports or services supplied in offshore jurisdictions.

One example is Glencore, which we believe is out of favour with the market given its large exposure to coal production. However, Glencore is also a major producer of copper, nickel, cobalt and zinc, among other commodities. These commodities are heavily used in wind, solar and battery technology and, as a result, are well positioned to benefit from the growing demand of renewable energy. Over time, the contribution from coal will decline and the contribution from these other commodities will increase. Today, you can buy Glencore for less than 10 times our estimate of normal earnings.

As always, it is a question of price: How much am I paying? How large is my margin of safety? And to what degree am I being compensated for the downside risks? Currently, on the JSE, we believe you can find a number of companies whose prices are sufficiently low that the odds are skewed in your favour.

3. How should we be structuring portfolios to protect against some of these risks?

There are a number of factors that obscure the view of how global markets may play out over the next 10 years – not least of which are the unprecedented monetary and fiscal interventions by developed market governments. We believe it is important that investors be mindful of the risks that abound globally, but also aim to position their portfolios for a range of potential future outcomes, rather than taking a big bet on one scenario prevailing.

As our chief investment officer, Duncan Artus, recently outlined at the Summit and in an article, we should also be careful to believe that what has worked since the global financial crisis will continue to do so. History shows us that these themes can last for a number of years, until they don't. In a world that feels dominated by big trends riding the wave of popular opinion, we believe independent thinking is going to be increasingly important, with detailed, bottom-up research key to identifying good-quality opportunities that don't rely on the status quo continuing to prevail.

With this in mind, Duncan noted that when it comes to asset allocation in our portfolios today, we prefer the following:

- Very little or no exposure to developed market sovereign bonds and high-yield instruments whose spreads are compressed relative to history and their intrinsic risk factors
- To be underweight technology stocks where valuations have outpaced fundamentals
- Exposure to producers of metals used in the energy transition, such as Glencore
- Exposure to precious metals and precious metal suppliers (this is a good potential hedge against inflation)
- To use our bottom-up process to find those idiosyncratic ideas that don't rely on the big things discussed above, e.g. the opportunity presented through omnichannel retailers like Country Road, or low-value retailers, which can capture some of the beneficiaries of additional government spending, e.g. Pepkor
- To look beyond the "big five" of Naspers, Prosus, Richemont, BHP and Anglo, which all have meaningful exposure to China, towards other opportunities, e.g. British American Tobacco, which has zero exposure to China, or AB InBev, which has great potential
- To focus on all aspects of environmental, social and governance (ESG) factors and search beyond the best ESG companies that everyone is buying for the companies that are improving their ESG the most

4. Where are the best opportunities to invest offshore?

When it comes to decision frameworks around offshore versus local investing, South African investors seem to routinely fall into the trap of making panic-stricken moves offshore in response to deteriorating local sentiment and rand weakness. We believe that investing offshore should always form part of an investor's investment strategy, but it should be done with clear objectives in mind and a long-term focus, and be in keeping with your individual circumstances, risk tolerance and goals.

So where is the long-term global opportunity?

Knowing *when* to invest is, of course, a different question than knowing *where* to invest. The global opportunity set is not without risk. Developed markets have had an extremely long period of low rates and abundant liquidity, which have created distortions in bond markets and supported equity valuations overall. In particular, investors have flocked to businesses that have demonstrated high levels of growth, causing the prices of those businesses to surge, which, in turn, has been exacerbated by tracker funds being forced to hold larger stakes in these companies to replicate the index, as Orbis discusses in a recent piece on their website.

Meanwhile, the companies that have been deemed by the market to be unexciting or risky have languished – such that the gap between the most expensive and the cheapest companies in the market has widened to unusual levels. Investors are faced with a tough choice: remain invested in the most expensive parts of the market in the hope that recent trends will continue, or start diversifying into other areas where the bad news may already be priced in.

With this backdrop in mind, Graeme Forster, from Orbis, shared some interesting insights at the Summit. He discussed that it is natural to be fascinated by exciting and emerging technologies such as artificial intelligence, quantum computing, blockchains, virtual reality and gene editing, to name just a few, as these innovations have the potential to change the world in ways that we can't begin to imagine, but that the world changes in more subtle ways too: Even the most mundane businesses can also produce exciting investment opportunities. This is where Orbis prefers to look for long-term opportunities – and commodities – despite their seemingly "old-school" reputation.

… we believe independent thinking is going to be increasingly important, with detailed, bottom-up research key to identifying good-quality opportunities …

According to Graeme, companies, governments and, most importantly, consumers are starting to care a lot more about how and where products are sourced. Whether it's the beans used to make coffee or the materials used to build cars or iPhones, it is a trend that is here to stay and will likely intensify. Secondly, and just as important, technology is making it easier than ever to reliably track goods back to their origin.

Orbis believes that the combination of these two developments – a greater desire to identify the origin of what we consume and the ability to do so with precision – will lead to both structurally higher prices for certain commodities such as aluminium and greater price differentiation.

Shares of commodity producers have been one of the few investments to lose money over the last two decades. Almost everything else has been in a long-term bull market as liquidity has sloshed around the system. More recently, commodity producer earnings started to recover strongly off a very low base. This is partly due to economies starting to open up in the wake of the pandemic, but Orbis also sees clear evidence of subdued supply response as externalities are driving up costs.

Most interestingly, the market does not appear to believe that these earnings will be sustained. Valuations in the sector remain very low, with free cash flow yields in the teens for many producers. Sustainable positive change coupled with deep scepticism is typically a very favourable combination for investors.

5. How do you incorporate ESG thinking into your portfolios locally?

Environmental, social and governance (ESG) issues have dominated headlines for the last few years and are front of mind for many investors as they start to think more critically about the environmental and social impacts of companies in which they invest and demand more purpose-driven, sustainable and stakeholder-centric behaviour.

Although integrating ESG factors into our research has always been an intrinsic part of our investment philosophy, we work on improvements to our ESG approach, research and engagement processes year-on-year. As Raine Naudé, one of our ESG analysts, explained at our recent Summit, as long-term investors, we spend a lot of time trying to understand what a company's sustainable free cash flow will be. In our view, companies that operate unethically or do not appropriately manage their social or environmental externalities face a greater risk of cash flow erosion over the long term. This can manifest in multiple ways, including regulatory fines, loss of an environmental permit or social licence to operate, or reduced demand for products due to reputational damage or shifting societal preferences.

Because ESG factors can be material to the investment case, our investment analysts are responsible for ESG research in relation to the stocks they cover. However, we also have three ESG analysts who assist with monitoring individual companies and conduct thematic and detailed company-specific research. We focus our research and engagement efforts on ESG issues that are most material to each company, rather than applying a cookie-cutter approach. Every company research report we write includes an ESG section and, when material, we try to quantify ESG risks or opportunities in our fundamental valuations. We may also limit the size of our holding in a company, or choose not to invest in it, if the ESG risks are significant.

We further integrate ESG into our engagement with company boards and management teams and by making carefully considered proxy voting recommendations to our clients. Our portfolio managers are ultimately accountable for managing the ESG risks in our clients' portfolios, but we also report to our board of directors biannually.

... companies that operate unethically or do not appropriately manage their social or environmental externalities face a greater risk of cash flow erosion over the long term.

Of course, it is easy for us, and other managers, to explain how we incorporate ESG factors into our analysis and process; it is harder to apply this consistently over time. We would caution against investors taking undue notice of attention-grabbing headlines, which tend to oversimplify what is a multilayered issue.

There are many ways in which ESG, as a growing global theme, could impact future stockpicking and our clients' portfolios. As outlined above, an accelerated global energy transition could increase the demand for certain metals, while single-use plastic bans could dampen demand for oil and alter demand for certain packaging materials. In addition, the ESG theme has the potential to materially impact investment flows. For example, the Net Zero Asset Managers initiative – recently launched internationally to commit to investment portfolios aligned with net-zero greenhouse gas emissions by 2050 or sooner – could impact flows into both low- and high-carbon emitting industries.

In this debate, however, the intersection of the environmental and social pillars should be appropriately weighed up. As Raine noted, so far, environmental considerations have been in the driving seat; however, reducing the E has an impact on the S, and the COVID-19 pandemic has further accentuated deep inequalities in many countries, with potentially severe consequences, as the July riots and looting in South Africa showed. Overlooking the social aspect of ESG is as much of a global risk as failure to act on environmental issues.

The role of the investment industry and overcoming challenges

As an investment industry, we must be honest about what we are and what we are not. For example, we are not experienced policymakers. Many of these complex problems require coherent policy and regulatory development and enforcement, far above investor engagement, to be effectively addressed. This would also avoid unintended consequences.

An example here has been the growth in asset owners announcing divestments from fossil fuels, particularly thermal coal. As a result, many listed companies have rushed to unbundle or privatise these assets. But once sold, they remain in operation and in fact often increase production. The climate is no better off, while lesser disclosure requirements mean that society generally has less insight into the site's environmental management than before.

ESG factors are also often still lightly or inconsistently reported by issuers, particularly in less developed stock markets, making meaningful evaluation and comparability difficult. At Allan Gray, we try to address this by engaging with issuers on a case-by-case basis to improve their disclosures and by using multiple sources for ESG research: Apart from company reporting, we look at non-governmental organisations and academic, regulatory and news reports.

ESG is further complicated by the fact that we tend to view these matters through the lens of our own personal value set. The EU is leading the way in regulation attempting to address some of the interpretation issues, and regulators elsewhere, including here in South Africa, are watching closely.

At Allan Gray, we participate proactively in industry initiatives that bring more regulatory clarity to ESG. This includes providing detailed feedback to industry consultations, such as on National Treasury's draft Green Finance Taxonomy and the revised Code for Responsible Investing in South Africa (CRISA) earlier this year.

Don't forget about the G

Finally, we pay particularly close attention to the governance pillar. This is because, as shareholders on behalf of our clients, we are not involved in the day-to-day running of companies and therefore rely on executive management and boards to act responsibly. We assess management's alignment with long-term shareholders by evaluating how they are incentivised through executive remuneration schemes. We also consider the board's expertise and independence to be able to provide effective oversight. Finally, studies show that stronger governance is generally associated with stronger company environmental and social performance.

Need more detail?

Our recent Allan Gray Investment Summit offered independent financial advisers and investors a rare glimpse into the minds of top fund managers and forward-thinking thought leaders. Our aim was to share a range of perspectives to help make sense of the noise and connect the dots between the challenges we face today and the opportunities that lie ahead.

Many of the questions raised during the event have been dealt with briefly in this article; if you would like more detail, you can view a selection of presentations from the Summit on the event portal www.investmentsummit.co.za.

Of course, as an individual investor, it is important to remember that there is no one-size-fits-all when it comes to structuring your investment portfolio. For personalised advice, we recommend you speak to a good, independent financial adviser.

Tamryn is head of Retail Distribution. She joined Orbis in London in 2006 as an investment analyst, covering European equities. After spending several years in both investment and client-facing roles, she joined Allan Gray in the Institutional Clients team in 2013. Tamryn holds a Bachelor of Business Science degree from the University of Cape Town and is a qualified Chartered Accountant and a CFA® charterholder.

HOW TO DO LONG TERM

Morgan Housel

The few (very few) things that never change are candidates for long-term thinking. Everything else has a shelf life.

Adopting a long-term mindset sits at the heart of our investment philosophy. But what does it really mean and how can one do this effectively? We are pleased to share this contribution on long-term thinking from guest writer Morgan Housel, who aptly captures some of the behaviours and pitfalls inherent to this approach. Morgan was a presenter at the recent virtual Allan Gray Investment Summit. He is a partner at Collaborative Fund (US) and an expert in behavioural finance and investing history.

"Nothing will ever separate us. We will probably be married another ten years." – Elizabeth Taylor, five days before filing for divorce.

Long-term thinking is easier to believe in than accomplish. Most people know it's the right strategy in investing, careers, relationships – anything that compounds. But saying "I'm in it for the long run" is a bit like standing at the base of Mount Everest, pointing to the top, and saying, "that's where I'm heading". Well, that's nice. Now comes the test.

Long term is harder than most people imagine, which is why it's more lucrative than many people assume. Everything worthwhile has a price, and the prices aren't always obvious. The real price of long term – the skills required, the mentality needed – is easy to minimise, often summarised with simple phrases like "be more patient", as if that explains why so many people can't.

To do long term effectively, you have to come to terms with a few points:

The long run is just a collection of short runs you have to put up with. Saying you have a 10-year time horizon doesn't exempt you from all the nonsense that happens during the next 10 years. Everyone has to experience the recessions, the bear markets, the meltdowns, the surprises and the memes at the same time.

So rather than assuming long-term thinkers don't have to deal with nonsense, the question becomes: *How can you endure a never-ending parade of nonsense?*

Long-term thinking can be a deceptive safety blanket that people assume lets them bypass the painful and unpredictable short run. But it never does. It might be the opposite: The longer your time horizon, the more calamities and disasters you'll experience. Baseball player Dan Quisenberry once said: "The future is much like the present, only longer."

Dealing with that reality requires a certain kind of alignment that's easy to overlook:

Your belief in the long run isn't enough; your investors, co-workers, spouses and friends have to sign up for the ride. An investment manager who loses 40% can tell their investors "it's OK, we're in this for the long run", and believe it. But the investors may not believe it. They might bail. The firm might not survive. Then, even if the manager turns out to be right, it doesn't matter – no one's around to benefit.

Doing long-term thinking well requires identifying when you're being patient or just stubborn.

The same thing happens when you have the guts to stick it out, but your spouse doesn't.

Or when you have a great idea that will take time to prove, but your boss and co-workers aren't as patient.

These are not rarities. They're some of the most common outcomes in investing.

A lot of it comes from the gap between what you believe and what you can convince other people of – intelligence versus storytelling.

People mock how much short-term thinking there is in the financial industry, and they should. But I also get it: The reason so many financial professionals stray towards short-termism is because it's the only way to run a viable business when clients flee at the first sign of trouble. But the reason clients flee is often because investment managers have done such a poor job communicating how investing works, what their strategy is, what clients should expect as investors, and how to deal with inevitable volatility and cyclicality.

Eventually being right is one thing. But can you eventually be right *and* convincing to those whose support you rely on? That's completely different, and easy to overlook.

Patience is often stubbornness in disguise. Things happen almost daily now that would have been inconceivable just a decade ago (budget deficits, interest rates, meme stock valuations, retail investor participation, etc.). The world changes, which makes changing your mind not just helpful but crucial.

But changing your mind is hard, because fooling yourself into believing a falsehood is so much easier than admitting a mistake.

Long-term thinking can become a crutch for those who are wrong but don't want to change their minds. They say "I'm just early" or "everyone else is crazy" when they can't let go of something that used to be true, but the world moved on from.

Doing long-term thinking well requires identifying when you're being patient or just stubborn. Not an easy thing to do. The only solution is knowing the very few things in your industry that will never change and putting everything else in a bucket that's in constant need of updating and adapting. The few (very few) things that never change are candidates for long-term thinking. Everything else has a shelf life.

... the odds of success fall deepest in your favour when you mix a long time horizon with a flexible end date – or an indefinite horizon.

It's hard to know how you'll react to decline. If I say, "how would you feel if stocks fell 30%?", you'll probably picture a world where everything is the same as it is today except stock prices are 30% lower. And in that world, it's easy to say, "that would be fine, I'd even see it as an opportunity".

But the reason stocks fall 30% is because there's a terrorist attack, or the banking system is about to collapse, or there's a pandemic that might kill your whole family.

In *that* context, you might feel differently. You might switch from an opportunistic mindset to a survival mindset. You might not have the endurance you once imagined.

Long term is less about time horizon and more about flexibility. If it's 2010 and you say, "I have a 10-year time horizon", your target date is 2020. Which is when the world fell to pieces. If you were a business or an investor, it was a terrible time to assume the world was ready to hand you the reward you had been patiently awaiting.

A long time horizon with a firm end date can be as reliant on chance as a short time horizon.

Far superior is just flexibility.

Time is compounding's magic whose importance can't be minimised. But the odds of success fall deepest in your favour when you mix a long time horizon with a flexible end date – or an indefinite horizon.

Ben Graham said: "The purpose of the margin of safety is to render the forecast unnecessary." The more flexibility you have, the less you need to know what happens next.

And never forget Keynes: "In the long run we are all dead."

Morgan is a partner at Collaborative Fund, a US venture capital firm. Previously, he was a columnist at *The Wall Street Journal* and The Motley Fool. He is a two-time winner of the Best in Business Award from the Society of American Business Editors and Writers and was selected by the *Columbia Journalism Review* for *The Best Business Writing* anthology. In 2013 and 2016, he was a finalist for the Gerald Loeb Award and Scripps Howard Award respectively. Morgan has authored three books.

HOW TO MAKE INVESTING FOR RETIREMENT FEEL LESS LIKE A SACRIFICE

Thandi Skade

The more we can connect our present selves with our future selves and goals, the more likely it is that we will align our present-day behaviours ... with those goals.

With all the financial demands of present-day life, it can be difficult to stay focused on investing for our longer-term financial goals. Balancing the friction that exists between our present and future wants and needs is key, but how can we go about this? Thandi Skade examines how "temptation-bundling" and psychologically reframing how we identify with our future selves can help us make better decisions and foster habits which promote improved investment outcomes.

Temptation-bundling is the idea of combining two particular types of activities: one that is beneficial, but that you often put off actioning because it's not much fun, and one you enjoy doing, but that is not the most productive use of your time or resources. It is a term coined by behaviour researcher and Wharton School of the University of Pennsylvania professor Katherine Milkman, who argues that we are more likely to change our behaviour and form good and long-lasting habits when we are immediately rewarded for completing an action or task that we perceive to be a sacrifice.

In her 2014 study, Milkman set out to determine whether coupling the act of working out with a reward or temptation would improve exercise activity among study participants. A cohort of students were tempted with the promise of accessing the next chapter of an addictive, "must-read" audiobook, but the catch was that they could only listen to the book while working out at the gym. The other group of students was not offered a reward for exercising. The study results showed a significant increase in exercise activity among the participants who were incentivised.

The group of students who received no reward for attending the gym, but who did so in any event, drew on internal willpower to keep them motivated and on track to achieve their fitness goals. The other group, like many of us, required extra motivation to get it done.

Easing the trade-off dilemma

Temptation-bundling can be a powerful tool to generate willpower, which could ultimately be harnessed to alleviate some of the psychological pain that we associate with the things we perceive to be a sacrifice. Investing for retirement is a good case in point.

Most of us accept that we need to make provision for a future income during our working years to afford ourselves the opportunity to retire later on in life. Yet simply understanding the why does little to ease the psychological tension that arises from having to make trade-offs today for the sake of tomorrow.

Dr. Hal Hershfield, associate professor of marketing, behavioural decision-making and psychology at the UCLA Anderson School of Management, contends that this is because our brains are wired to prioritise our present self over our future self. Our brains also tend to view our present and future selves as two different people, which makes a sacrifice like investing for retirement difficult to rationalise. This disconnect between the two versions of the self is the root cause of the pain we feel.

Using rewards to create smart investment habits

The value of temptation-bundling lies in its ability to be applied as a behaviour change technique. By linking a reward to a difficult task, what you are really doing is reframing your perception of a task into something you can look forward to, instead of something you'd rather avoid.

Take meeting with a financial adviser as an example. For some investors, their annual or biannual check-ins with their financial adviser can be an anxiety-inducing exercise. Therefore, instead of delaying this beneficial activity, why not consider making the engagement less formal by meeting at a restaurant or your favourite leisure spot (the reward) to plan for your financial future (the task that "ought to" be done).

The key to effectively applying temptation-bundling to achieving long-term financial goals is finding a way to include rewards in the process so that it becomes an instantly gratifying experience – and a foundation from which good habits can be formed.

Bridging the divide

There are several ways we can begin to bridge the gap between our present and future selves. The first is critical and involves creating a vivid image in our mind of what our future self looks like. Consider things like the physical appearance, needs, goals and desires of your future self, and the kind of life you want to live in the future.

The act of visualising our future self enables us to start building an emotional connection and identifying with this "stranger". The more we can connect our present selves with our future selves and goals, the more likely it is that we will align our present-day behaviours and decision-making processes with those goals.

Hershfield suggests that another way to strengthen the emotional relationship with our future self is by writing a letter from our future to our current self. In changing our natural pattern of time travel by going to the future and working backwards, we are forced to step into the shoes of the individual we may become and view things from "their" perspective.

Reframing perceptions

If we truly want to succeed in changing our behaviour and attitudes towards long-term investing, we need to psychologically reframe the idea of saving into something that minimises the perceived pain associated with not succumbing to our desire to spend everything on ourselves now.

For instance, it is naturally overwhelming to think of the large amount we will ultimately need to see us through retirement, but if we rather focus on a monthly amount we can afford, and commit to a regular debit order that escalates annually, it suddenly feels more manageable. Being confronted with a smaller, more palatable figure makes it psychologically easier to commit to making the sacrifices required to benefit our future selves.

It is typically less painful to tackle a new goal by starting small. This could mean supplementing your pension fund benefit provided by your employer with monthly contributions to a retirement annuity or tax-free investment, or setting up a monthly debit order to a unit trust – suitable for most of your investment goals. Starting with a small contribution and gradually increasing it over time can make it easier to commit to automatic, annual debit order increases.

Beyond these behavioural interventions, consider seeking the services of an independent financial adviser who can help you overcome biases and encourage you to remain committed to your financial goals.

Thandi joined Allan Gray as a communications specialist in the Marketing team in 2020. She holds a Bachelor of Social Science degree in Media & Writing and Politics from the University of Cape Town.

NOTES

Allan Gray Balanced and Stable Fund asset allocation as at 30 September 2021

	Balanced Fund % of portfolio			Stable Fund % of portfolio		
	Total	SA	Foreign*	Total	SA	Foreign*
Net equities	70.9	51.0	19.8	37.6	25.8	11.7
Hedged equities	6.3	1.5	4.8	10.8	2.7	8.2
Property	1.0	0.7	0.3	1.9	1.7	0.2
Commodity-linked	3.0	2.3	0.7	2.8	2.0	0.8
Bonds	13.3	10.0	3.3	37.1	30.0	7.1
Money market and bank deposits	5.6	3.1	2.4	9.8	5.4	4.3
Total	**100.0**	**68.6**	**31.4**	**100.0**	**67.7**	**32.3**

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 2021

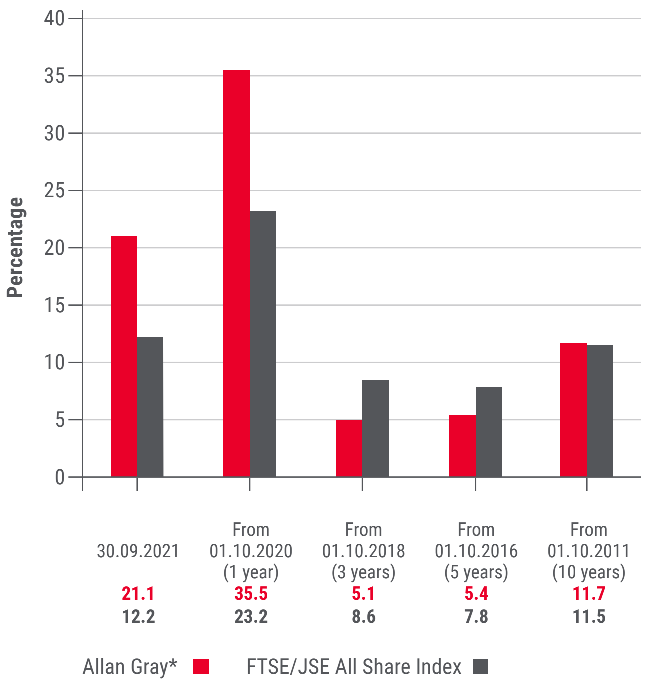
Security (Ranked by sector)	Market value (R million)	% of Fund	FTSE/JSE ALSI weight (%)
South Africa	**25 959**	**69.2**	
South African equities	**24 929**	**66.4**	
Resources	**5 890**	**15.7**	**32.6**
Glencore	1 793	4.8	
Sasol	1 007	2.7	
Sibanye-Stillwater	770	2.1	
Northam Platinum	412	1.1	
Impala Platinum	297	0.8	
Sappi	279	0.7	
Positions less than 1%[1]	1 333	3.6	
Financials	**8 335**	**22.2**	**21.8**
Standard Bank	1 346	3.6	
Remgro	1 117	3.0	
Old Mutual	921	2.5	
Nedbank	890	2.4	
FirstRand	847	2.3	
Reinet	643	1.7	
Investec	456	1.2	
Rand Merchant Investment[2]	425	1.1	
Ninety One	293	0.8	
Positions less than 1%[1]	1 397	3.7	
Industrials	**10 704**	**28.5**	**45.6**
Naspers[2]	2 584	6.9	
British American Tobacco	1 843	4.9	
Woolworths	1 238	3.3	
AB InBev	860	2.3	
Life Healthcare	621	1.7	
KAP Industrial	422	1.1	
Super Group	404	1.1	
MultiChoice	313	0.8	
Positions less than 1%[1]	2 420	6.4	
Commodity-linked securities	**213**	**0.6**	
Positions less than 1%[1]	213	0.6	
Cash	**816**	**2.2**	
Africa ex-SA	**1 139**	**3.0**	
Equity funds	**1 139**	**3.0**	
Allan Gray Africa ex-SA Equity Fund	1 139	3.0	
Foreign ex-Africa	**10 439**	**27.8**	
Equity funds	**10 414**	**27.7**	
Orbis Global Equity Fund	5 428	14.5	
Orbis SICAV International Equity Fund[3]	3 125	8.3	
Allan Gray Frontier Markets Equity Fund Limited	1 293	3.4	
Orbis SICAV Emerging Markets Equity Fund	388	1.0	
Orbis SICAV Japan Equity (Yen) Fund	181	0.5	
Cash	**25**	**0.1**	
Totals	**37 537**	**100.0**	

[1] JSE-listed securities include equities, property and commodity-linked instruments.
[2] Includes holding in stub certificates or Prosus N.V., if applicable.
[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 15.6)	−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	−8.0	−8.5	0.5
2019	6.2	12.0	−5.8
2020	−3.5	7.0	−10.5
2021 (to 30.09)	**21.1**	**12.2**	**8.9**

Returns annualised to 30.09.2021



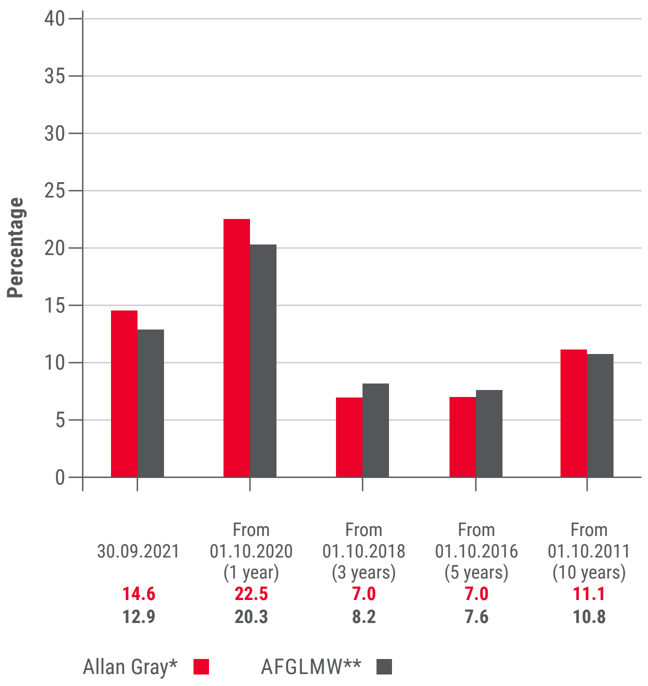
An investment of R10 000 made with Allan Gray on 15 June 1974 would have grown to R263 644 316 by 30 September 2021. By comparison, the returns generated by the FTSE/JSE All Share Index over the same period would have grown a similar investment to R11 942 295. Returns are before fees.

*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.
Note: Listed property included from 1 July 2002. Inward listed included from November 2008 to November 2011.

Investment track record – balanced returns

Allan Gray Proprietary Limited global mandate total returns vs Alexander Forbes Global Large Manager Watch			
Period	Allan Gray*	AFGLMW**	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	−1.4	−2.1	0.7
2019	6.5	10.9	−4.4
2020	5.3	6.3	−1.0
2021 (to 30.09)	**14.6**	**12.9**	**1.7**

Returns annualised to 30.09.2021



An investment of R10 000 made with Allan Gray on 1 January 1978 would have grown to R30 104 760 by 30 September 2021. The average total performance of global mandates of Large Managers over the same period would have grown a similar investment to R6 694 322. 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 2021 is an estimate. The return from 1 April 2010 is the average of the non-investable Alexander Forbes Global 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 2021 (net of fees)

	Assets under management (R billion)	Inception date	Since inception	10 years	5 years	3 years	1 year	Highest annual return[5]	Lowest annual return[5]
High net equity exposure (100%)									
Allan Gray Equity Fund (AGEF) Average of South African - Equity - General category (excl. Allan Gray funds)[1]	37.5	01.10.1998	19.9 14.4	10.3 10.1	5.2 5.3	4.8 7.5	30.3 30.3	125.8 73.0	−24.3 −37.6
Allan Gray SA Equity Fund (AGDE) FTSE/JSE All Share Index including income	3.7	13.03.2015	5.1 6.6	– –	4.1 7.8	4.0 8.6	34.2 23.2	57.3 54.0	−32.0 −18.4
Allan Gray-Orbis Global Equity Feeder Fund (AGOE) FTSE World Index	25.5	01.04.2005	14.5 14.7	18.5 20.0	11.3 16.1	10.3 15.8	15.9 16.2	78.2 54.2	−29.7 −32.7
Medium net equity exposure (40% - 75%)									
Allan Gray Balanced Fund (AGBF) **Allan Gray Tax-Free Balanced Fund (AGTB)** Average of South African - Multi Asset - High Equity category (excl. Allan Gray funds)[2]	149.8 1.6	01.10.1999 01.02.2016	15.3 6.9 11.6/6.7	10.0 – 9.4	6.0 6.0 6.5	6.1 5.9 7.4	21.7 20.4 19.4	46.1 31.7 41.9/30.7	−14.2 −13.4 −16.7/−10.3
Allan Gray-Orbis Global Balanced Feeder Fund (AGGF)[3] 60% MSCI World Index with net dividends reinvested and 40% J.P. Morgan GBI Global Index[3]	14.9	03.02.2004	10.5 11.6	13.1 15.2	7.0 11.1	6.2 12.4	11.1 4.0	55.6 38.8	−13.7 −17.0
Low net equity exposure (0% - 40%)									
Allan Gray Stable Fund (AGSF) Daily interest rate of FirstRand Bank Limited plus 2%	46.4	01.07.2000	11.4 8.6	8.3 6.9	6.8 7.0	5.9 6.3	15.4 4.6	23.3 14.6	−7.4 4.6
Very low net equity exposure (0% - 20%)									
Allan Gray Optimal Fund (AGOF) Daily interest rate of FirstRand Bank Limited	0.8	01.10.2002	7.0 6.1	5.5 4.8	3.2 4.9	1.7 4.2	9.2 2.5	18.1 11.9	−8.2 2.5
Allan Gray-Orbis Global Optimal Fund of Funds (AGOO) Average of US$ bank deposits and euro bank deposits	0.7	02.03.2010	6.2 5.8	6.7 6.0	−0.1 2.6	−1.2 2.6	1.0 −10.7	39.6 35.6	−12.4 −19.1
No equity exposure									
Allan Gray Bond Fund (AGBD) FTSE/JSE All Bond Index (Total return)	5.7	01.10.2004	8.9 8.6	8.5 8.3	8.9 8.5	8.4 9.1	10.9 12.5	18.0 21.2	−2.6 −5.6
Allan Gray Money Market Fund (AGMF) Alexander Forbes Short-Term Fixed Interest (STeFI) Composite Index[4]	23.9	03.07.2001	7.8 7.6	6.5 6.2	6.9 6.4	6.3 5.8	4.3 3.8	12.8 13.3	4.3 3.8

[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 of the Allan Gray Balanced Fund 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 May 2021, this Fund was called the Allan Gray-Orbis Global Fund of Funds and its benchmark was 60% of the FTSE World Index and 40% of the J.P. Morgan GBI Global Index. From 1 June 2021, the Fund's investment mandate was changed from a fund of funds structure to a feeder fund structure investing solely into the Orbis SICAV Global Balanced Fund. To reflect this, the Fund was renamed and the benchmark was changed.
[4] 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.
[5] This is the highest or lowest consecutive 12-month return 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 2021

	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	1.13%	−0.48%	0.04%	0.05%	0.74%	0.10%	0.84%
Allan Gray SA Equity Fund	1.00%	−0.84%	0.01%	0.03%	0.20%	0.11%	0.31%
Allan Gray Balanced Fund	1.06%	−0.23%	0.04%	0.09%	0.96%	0.08%	1.04%
Allan Gray Tax-Free Balanced Fund	1.33%	N/A	0.04%	0.14%	1.51%	0.10%	1.61%
Allan Gray Stable Fund	1.05%	−0.27%	0.03%	0.08%	0.89%	0.07%	0.96%
Allan Gray Optimal Fund	1.00%	0.00%	0.02%	0.15%	1.17%	0.10%	1.27%
Allan Gray Bond Fund	0.25%	0.19%	0.01%	0.07%	0.52%	0.00%	0.52%
Allan Gray Money Market Fund	0.25%	N/A	0.00%	0.04%	0.29%	0.00%	0.29%
Allan Gray-Orbis Global Equity Feeder Fund	1.49%	−0.52%	0.05%	0.00%	1.02%	0.09%	1.11%
Allan Gray-Orbis Global Balanced Feeder Fund	1.45%	−0.45%	0.06%	0.00%	1.06%	0.09%	1.15%
Allan Gray-Orbis Global Optimal Fund of Funds	1.00%	−0.01%	0.08%	0.00%	1.07%	0.12%	1.19%

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, Share Transactions Totally Electronic (STRATE) and FSCA Investor Protection Levy and VAT thereon) are shown separately. Transaction costs are necessary costs 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 (TIC).

Foreign domiciled funds annualised performance (rand) in percentage per annum to 30 September 2021 (net of fees)

	Inception date	Since inception	10 years	5 years	3 years	1 year	Highest annual return[5]	Lowest annual return[5]
High net equity exposure								
Orbis Global Equity Fund	**01.01.1990**	**17.7**	**18.6**	**11.4**	**10.3**	**15.9**	**87.6**	**–47.5**
FTSE World Index		13.9	20.1	16.1	15.7	16.7	54.2	–46.2
Orbis SICAV Japan Equity (Yen) Fund	**01.01.1998**	**14.6**	**15.5**	**10.5**	**9.0**	**14.0**	**94.9**	**–40.1**
Tokyo Stock Price Index		9.8	15.6	11.2	9.0	8.5	91.0	–46.4
Orbis SICAV Emerging Markets Equity Fund (US$)[6]	**01.01.2006**	**13.1**	**13.7**	**6.3**	**7.8**	**3.9**	**58.6**	**–34.2**
MSCI Emerging Markets Equity (Net) (US$)[6]		13.5	14.9	10.8	10.9	6.6	60.1	–39.7
Allan Gray Africa ex-SA Equity Fund (C class)	**01.01.2012**	**12.5**	**–**	**14.4**	**6.6**	**42.0**	**65.6**	**–24.3**
Standard Bank Africa Total Return Index		7.5	–	9.9	13.2	15.0	41.4	–29.4
Allan Gray Australia Equity Fund	**04.05.2006**	**14.1**	**14.8**	**9.7**	**6.8**	**27.8**	**99.5**	**–55.4**
S&P/ASX 300 Accumulation Index		12.8	14.5	11.2	12.1	19.0	55.6	–45.1
Allan Gray Frontier Markets Equity Fund (C class)	**03.04.2017**	**9.2**	**–**	**–**	**10.4**	**20.6**	**25.4**	**–11.0**
MSCI Frontier Emerging Markets Index		5.7	–	–	5.1	8.4	15.9	–12.0
Medium net equity exposure								
Orbis SICAV Global Balanced Fund	**01.01.2013**	**14.1**	**–**	**7.4**	**6.5**	**12.6**	**54.4**	**–9.8**
60% MSCI World Index with net dividends reinvested and 40% J.P. Morgan GBI Global Index		15.0	–	10.9	12.1	3.8	40.2	–8.4
Allan Gray Australia Balanced Fund	**01.03.2017**	**9.0**	**–**	**–**	**7.1**	**13.0**	**29.1**	**–5.3**
The custom benchmark comprises the S&P/ASX 300 Accumulation Index (36%), S&P/ASX Australian Government Bond Index (24%), MSCI World Index (net dividends reinvested) expressed in AUD (24%) and J.P. Morgan GBI Global Index expressed in AUD (16%).		11.2	–	–	11.1	5.1	25.1	–5.8
Low net equity exposure								
Allan Gray Australia Stable Fund	**01.07.2011**	**10.3**	**9.7**	**5.7**	**6.0**	**1.5**	**32.7**	**–8.9**
Reserve Bank of Australia cash rate		6.0	5.3	1.7	2.7	–9.0	28.8	–15.5
Very low net equity exposure								
Orbis Optimal SA Fund (US$)	**01.01.2005**	**8.4**	**7.9**	**0.8**	**0.1**	**2.6**	**48.6**	**–15.7**
US$ Bank deposits		7.6	7.3	3.1	3.4	–9.6	57.9	–25.6
Orbis Optimal SA Fund (Euro)	**01.01.2005**	**6.7**	**5.2**	**–0.5**	**–1.9**	**0.6**	**44.1**	**–19.3**
Euro Bank deposits		5.8	4.7	2.0	1.5	–11.3	40.2	–20.9
No equity exposure								
Allan Gray Africa Bond Fund (C class)[7]	**27.03.2013**	**13.8**	**–**	**12.9**	**11.0**	**5.0**	**28.9**	**–7.4**
FTSE 3-Month US T Bill + 4% Index[7]		6.4	–	5.9	9.2	1.9	24.7	–12.3

Performance as calculated by Allan Gray

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

[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] From inception to 31 December 2020, this Fund was called the Allan Gray Africa ex-SA Bond Fund and its benchmark was the J.P. Morgan GBI-EM Global Diversified Index. From 1 January 2021, the Fund's investment mandate was broadened to include South African investments. To reflect this, the Fund was renamed and the benchmark was changed.

IMPORTANT INFORMATION FOR INVESTORS

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Performance figures are provided by the Investment Manager and are for lump sum investments with income distributions reinvested. Where annualised performance is mentioned, this 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 applicable taxes. Movements in exchange rates may also cause the value of underlying international investments to go up or down. Certain unit trusts 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 the Management Company by 11:00 each business day for the Allan Gray Money Market Fund, and by 14:00 each business day for any other Allan Gray unit trust to receive that day's price. Unit trust prices are available daily on www.allangray.co.za. Permissible deductions may 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 Allan Gray.

Benchmarks

FTSE/JSE All Share Index and FTSE/JSE All Bond Index

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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 fees in its feeder funds or funds 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 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, Allan Gray Pension Preservation Fund, Allan Gray Provident Preservation Fund and Allan Gray Umbrella Retirement Fund (comprising the Allan Gray Umbrella Pension Fund and Allan Gray Umbrella Provident Fund) are all administered by Allan Gray Investment Services (Pty) Ltd, an authorised administrative financial services provider and approved pension funds administrator under section 13B of the Pension Funds Act 24 of 1956. Allan Gray (Pty) Ltd, also an authorised financial services provider, is the sponsor of the Allan Gray retirement funds. The Allan Gray Tax-Free Investment Account, Allan Gray Living Annuity and Allan Gray Endowment are administered by Allan Gray Investment Services (Pty) Ltd, an authorised administrative financial services provider, and underwritten by Allan Gray Life Ltd, also an authorised financial services provider and a registered insurer licensed to provide life insurance products as defined in the Insurance Act 18 of 2017. 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) and life-pooled investments.

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 (Pty) Ltd at 2nd Floor, Building 2, Central Square, New CBD, Gaborone, where investors can obtain a prospectus and financial reports.

About the paper

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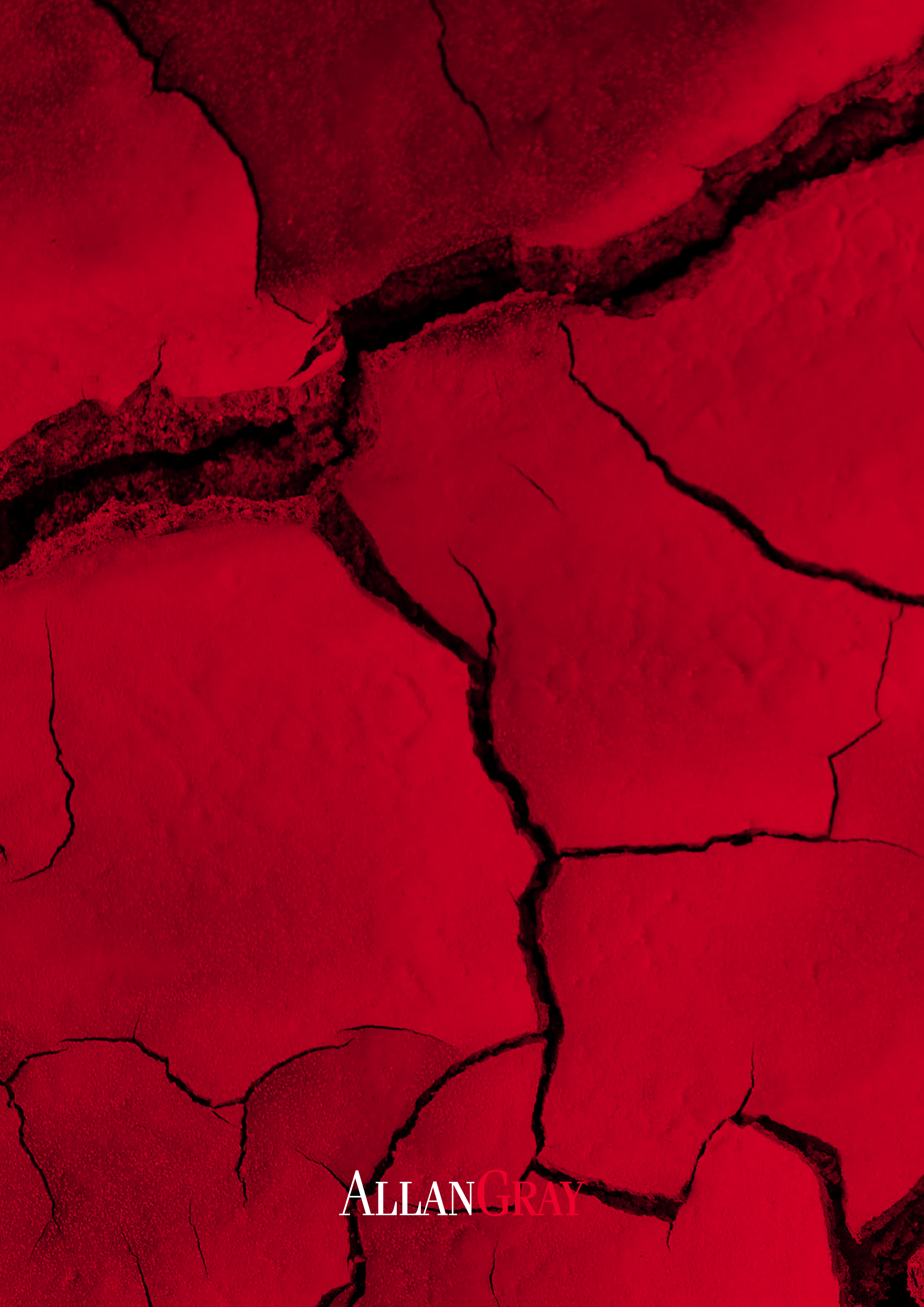
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