OPTIMISM IN ISOLATION CAN **LEAVE YOU VULNERABLE**

ARTHUR KARAS
PORTFOLIO MANAGER

JUNE 2018

I'm not a huge fan of disaster movies. While as a genre they can be enjoyable to watch, they ultimately require suspension of disbelief, are overly reliant on dubious science and use excessive computer generated special effects. Disaster stories are much scarier when they are real.

My preferred brand of true catastrophe is books about financial disasters. Reading about the Enron fraud in "The Smartest Guys in the Room" by Bethany McLean or Roger Lowenstein's excellent account of the meltdown at Long Term Capital Management (LTCM) in "When Genius Failed" were highly informative in developing my view of the investment world. Both Enron and LTCM had terrifyingly huge impacts on markets. Understanding how the fraud at Enron was missed by so many and how extremely successful investment managers at LTCM nearly caused the collapse of the global financial system is essential reading for anyone seeking to understand how markets work.

"Those who cannot remember the past are condemned to repeat it." *George Santayana, philosopher and author*

Studying these financially catastrophic events provides perspective on how they developed, what the signposts were and, hopefully, how to avoid or mitigate them in the future. I also enjoy reading the success stories. I've ploughed through numerous books on Walmart, Nike, Amazon, Goldman Sachs, Alibaba and other winning companies. There is a lot to be learnt from studying massively successful enterprises. Reading about success can provide positive motivation and teaches us about the key ingredients of achievement in business. However, examining the failures provides a critical counterbalance. It reminds me to work actively to counteract an intuitive bias. That bias is optimism.

I've always believed that to be a successful equity investor requires optimism. I'm very optimistic by nature. I'm always excited by my work. I'm always awake to the possibility that the next company report that I read or conference I attend or management team that I meet could reveal another investment gem. I believe that most investors and most people in business are positively biased. It's difficult to imagine a confirmed pessimist holding Naspers shares over the past 10 years, on the back of the still nascent Chinese internet space, or buying Capitec post the African Bank collapse. Both are investments that we made at MacroSolutions.

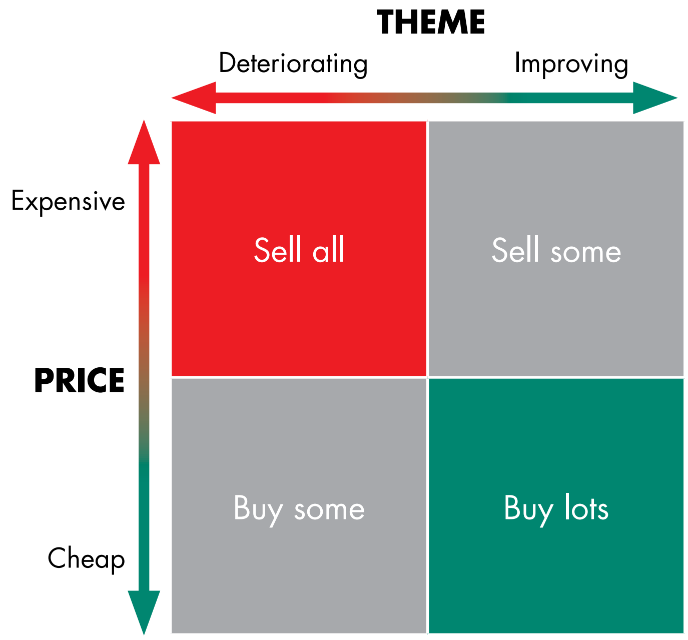
However, optimism in isolation can leave you vulnerable to investment traps – such as overhyped opportunities and overconfident management teams. A more balanced approach requires some counterweight, which comes in the form of healthy scepticism.

BUYER BEWARE

In practice, scepticism means applying a critical eye and a questioning mind to every element of the investment process. An example was when MacroSolutions was offered an opportunity to invest in a convertible bond issued by a listed construction company a number of years ago. A convertible bond is a hybrid investment consisting of a bond combined with an equity option. It allows the investor to earn a yield, usually higher than that of the underlying equity, with the potential of converting the instrument into equity at some point in the future. In order to value a convertible bond, you need to value both the lending slice and the equity slice. On the surface, the bond issue appeared to be underpinned by a healthy dollop of net asset value. However, further examination revealed that a substantial portion of the company's assets was uncertified revenue. When a construction company carries out work for a client, the client needs to sign off on the work and agree that it's in order and that the builder can be paid. The building and certification process may take some time and, in the interim, construction companies book a percentage of this uncertified revenue to their accounts as they complete various milestones of the project. Until the client certifies the works and pays, the outstanding amounts are carried on the balance sheet as a type of debtor asset. The risk with this type of asset, and indeed any debtor, is that you might never get paid. Construction companies generally don't have a good record in this regard. In this particular case, a large portion of the uncertified revenues related to one particular project that had been carried over for a number of years, while the client disputed what was owed on the project. To make matters worse, the portion on the balance sheet was only a part of the greater amount that was in dispute.

In simple terms, if we lent our clients' money to the company (by buying their bonds), our ultimate collateral was a disputed debt. The company appeared to be cheap, but its assets were possibly unrealisable and historic profits probably inflated. On top of that concern, construction is a cyclical industry where participants have a limited ability to drive their own sales performance. On behalf of our clients, we elected not to participate in the convertible issue. In the years since then, the company has had to write off about half of the uncertified revenue on its balance sheet, taking a significant hit to its net asset value in the process. Profits have also nosedived as available construction work has dwindled in South Africa and its other markets. It's been a disaster movie for its shareholders and lenders.

It's important to note that booking uncertified revenue is normal practice for construction companies, just like credit clothing retailers show profits from apparel that has been sold, while the debt has not yet been collected. Our job as investors is to decide what we're willing to pay for these unfulfilled promises.



MacroSolutions' investment process captures both theme and price. Mindful that reality can be scarier than fiction, by making our expected drivers of investment performance visible, we also make our behavioural biases more visible. While we don't know for sure whether an investment is going to be a disaster movie or success story, our process allows plenty of room to incorporate both optimistic and pessimistic viewpoints into any investment case. In the case of Naspers, the positive theme of Chinese internet gaming has outweighed the pricey valuation for years, whereas the construction company's bond was rendered unattractive by the negative theme of unrecoverable assets, notwithstanding the superficially cheap valuation.

MARKET COMMENTARY
AS AT THE END OF MAY 2018

Both US equities and bonds gained in value during May. Although renewed US sanctions on Iran and collapsing Venezuelan oil output caused the oil price to rise further, and trade tensions between the US and China escalated, the dominant global force during May was the diverging growth prospects between the US and Europe. This resulted in the US dollar rising, the US 10-year Treasury yields rising above 3% (before falling back again by month-end) and emerging market equities, bonds and currencies all falling. Furthermore, political uncertainty in Italy cast a shadow over the European equity market and led to German bund yields once again moving lower, while Italian and, by association, Spanish and Greek bond yields moved sharply higher.

May was a tough month for local investors – South Africa was unable to escape the emerging market sell-off, as local equity and property markets fell, our bond yields rose and the currency weakened against a strong US dollar. One of the few rays of light for local equity market investors was the performance of the diversified miners and Sasol during the month. Concerns around the state of the South African revival have surfaced, as recent data, such as mining and manufacturing production and retail sales, has been below expectations. This points to a softer first quarter GDP growth outcome than was initially expected. That said, Government continues to make progress in unwinding the well-established blockages in the system. Recent positive developments include significant progress on the public sector wage negotiations, the passing of the minimum wage bill and the passing of the labour legislation allowing for secret strike ballots.

OLD MUTUAL MAXIMUM RETURN FUND OF FUNDS

(Peter Brooke and Arthur Karas)

(Classification category: Worldwide — Multi-Asset — Flexible)

The local stock exchange continued to act like a yo-yo, reversing the previous months' gains. While this may be disconcerting to savers, as they watch from the sidelines, it is largely noise. What is more important is what's happening to the underlying fundamentals of the investments, which will drive the long-term returns. On this front, we had a number of companies release results and they broadly reflected how tough the economy was in 2017. The good news is this is creating a strong base for future returns. While the economy is taking time to recover, the outlook has improved and we have been pleasantly surprised by the speed of some of the reforms.

In May, the increase in fear and volatility, as foreign investors dumped emerging markets, meant local assets fell in price. However, lower equity markets, depressed earnings and some structural improvement in the economy are creating a much more positive outlook for the South African market. Therefore, we are happy to have a bit more exposure in South Africa, funded from the sale of offshore equity, which has performed well for our clients. It is critical to look forward instead of backward in generating strong, positive returns.

OLD MUTUAL FLEXIBLE FUND

(Peter Brooke and Arthur Karas)

(Classification category: South African — Multi-Asset — Flexible)

In a tough month for domestic investments, the Old Mutual Flexible Fund held up well compared with peers, but still underperformed its investment objective. Over 12 months, the fund has performed particularly well when measured against its peer group. The positive performance from global equities helped offset the strong US dollar impact on local markets.

The fund has continued to add selectively to South African focused companies. While it will take some time to see the impact of an improving local economy, many of these companies are cheap and have the potential of seeing better profits as well as expanding valuations. We are prepared to be patient, especially when it comes to mid- and small market cap shares, where we would prefer to be positioned well ahead of any turn in broad market sentiment.

We believe the combination of global equities and domestic exposure to a cyclical upturn is an optimal positioning for the fund in the months ahead.

OLD MUTUAL BALANCED FUND

(Graham Tucker and Warren van der Westhuizen)

(Classification category: South African – Multi-Asset – High Equity)

The low return environment, driven primarily by lower growth asset returns, continues to weigh on the absolute return generated by the fund over the medium term. Against this backdrop, the fund delivered a real return (above inflation) over a five-year period, but is slightly behind its target return. Relative to its peers, the fund has delivered competitive returns over meaningful periods, starting at one year and beyond.

Globally, our core position of global equity over global fixed income assets remains unchanged. Although recent data has disappointed, particularly in Europe, and political events have caused concerns in the minds of investors, we believe that synchronised global growth remains intact and should continue to support global equity. Against this better growth outlook, and given the inflation expectations, the gradual normalisation of global policy rates will continue, albeit from very low levels, and this will, in turn, curtail fixed income returns.

Our more constructive outlook on South Africa has been tested over the past few months. However, our view remains unchanged. While the data is expected to disappoint in the short term, we view ongoing developments as, on the whole, positive. As such, we continue to look for opportunities to add exposure to assets that will benefit from an improving local environment. The recent sell-off in markets, while understandably undesirable in the short term, does give us the opportunity to add exposure to our preferred assets at better prices. The local bond market is a case in point, with yields moving higher and, as such, we have added exposure during May.

Overall, the portfolio maintains a preference for growth assets (equities and property) and is tilted towards an improving South African environment through a reduced offshore allocation and increased exposure to local GDP beneficiaries. As we make our way through this cycle, we expect volatility to remain a feature of markets. We would encourage investors to engage with their advisers and to take a longer-term view. The historic evidence is clear – patience is important in investing.

OLD MUTUAL MODERATE BALANCED FUND

(John Orford and Alida Jordaan)

(Classification category: South African — Multi-Asset — Medium Equity)

Weaker equity markets weighed on returns over the past month. In addition, emerging markets could not escape the impact of a stronger US dollar. South Africa held up surprisingly well, with the rand not weakening as much as other emerging market currencies. These market conditions detracted from performance over the past month.

Exposure to local bonds, property and cash did not offset these negative returns and could not ensure a positive return for the month. The local currency provided some protection, as did the fund's overweight position to offshore equity. The fund's relative performance continues to be competitive when compared with the peer group. The equity building block experienced a good month in relative terms, beating the benchmark comfortably, but showing negative returns. As local companies reported results, it was clear that none of the optimism since December had found its way into improved earnings numbers. The local market was weak and shares that created the so-called "Ramaphoria" earlier in the year showed declines as market participants realised that a previously anticipated interest rate cut was probably off the table.

Exposure to retailers, banks and locally focused companies detracted from performance, but by the same token created outperformance where the fund does not own some of these names. Resources, barring platinum and gold mining, was the best performing sector in our market, supported by rising commodity prices and somewhat by a weaker currency. The biggest contributors to the fund's equity performance have been Glencore, Sasol, Rhodes Food Group, Nampak and Raubex. Exposure to The Foschini Group, STAR and Mpact detracted from performance.

During the month, the fund's exposure to local bonds was increased as yields became more attractive. The fund also took advantage of the weakness in the local equity market and added to shares with a local focus that are likely to benefit from an improved longer-term domestic outlook. The fund continues to have a meaningful position in local property, which is concentrated in locally focused property companies. The fund's overweight position in growth assets, specifically offshore equity, should continue to benefit from global economic growth. While global bond yields have been rising to more attractive levels, they have not yet been attractive enough to add to the portfolio.

OLD MUTUAL STABLE GROWTH FUND

(John Orford and Alida Jordaan)

(Classification category: South African — Multi-Asset — Low Equity)

Weaker equity markets weighed on returns over the past month. In addition, emerging markets could not escape the impact of a stronger US dollar. South Africa held up surprisingly well, with the rand not weakening as much as other emerging market currencies. These market conditions detracted from performance over the past month.

Exposure to local bonds, property and cash did not offset these negative returns and could not ensure a positive return for the month. The local currency provided some protection, as did the fund's overweight position to offshore equity. The fund's relative performance continues to be competitive when compared with the peer group. The equity building block experienced a good month in relative terms, beating the benchmark comfortably, but showing negative returns. As local companies reported results, it was clear that none of the optimism since December had found its way into improved earnings numbers. The local market was weak and shares that created the so-called "Ramaphoria" earlier in the year showed declines as market participants realised that a previously anticipated interest rate cut was probably off the table.

Exposure to retailers, banks and locally focused companies detracted from performance, but by the same token created outperformance where the fund does not own some of these names. Resources, barring platinum and gold mining, was the best performing sector in our market, supported by rising commodity prices and somewhat by a weaker currency. The biggest contributors to the fund's equity performance have been Glencore, Sasol, Rhodes Food Group, Nampak and Raubex. Exposure to The Foschini Group, STAR and Mpact detracted from performance.

During the month, the fund's exposure to local bonds was increased as yields became more attractive. The fund also took advantage of the weakness in the local equity market and added to shares with a local focus that are likely to benefit from an improved longer-term domestic outlook. The fund continues to have a meaningful position in local property, which is concentrated in locally focused property companies. The fund's overweight position in growth assets, specifically offshore equity, should continue to benefit from global economic growth. While global bond yields have been rising to more attractive levels, they have not yet been attractive enough to add to the portfolio.

OLD MUTUAL REAL INCOME FUND

(John Orford and Zain Wilson)

(Classification category: South African — Multi-Asset — Low Equity)

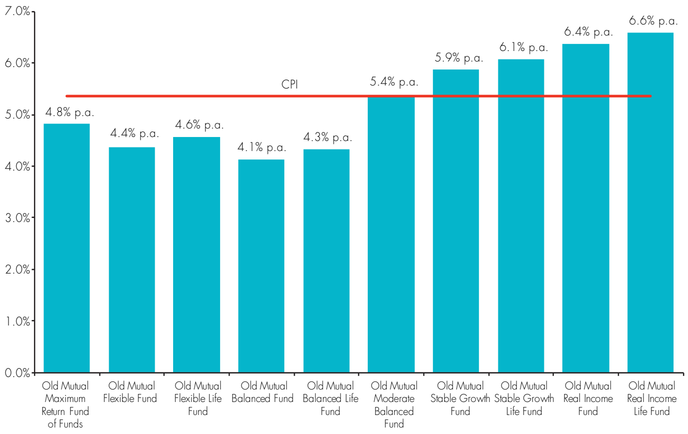
The fund aims to deliver an income that grows over time while preserving capital. The fund delivered a poor return in May, as risk assets were buffeted by escalating geopolitical risks and increasing trade concerns. The fund's return of 6.9% continues to exceed the mandated inflation target of CPI+1-2% over a year. Short-term performance, however, has pulled the annual return below cash returns of 7.4%.

While the pace of structural progress under President Ramaphosa has positively surprised, the recent slew of weak economic data in quarter one heightened fears of failing to realise a cyclical recovery in growth. As the core of the fund has remained invested in domestic money market assets, rather than domestic bonds, this partially protected the fund into the subsequent sell-off in South African yields. This was unfortunately not enough to offset the broad-based weakness of the growth asset exposure, with both domestic property and equity assets weighing on the fund's return over the month.

Although a trough in the inflation path and a more hawkish South African Reserve Bank have removed interest rate cuts as a "theme" driving earnings delivery in domestic assets, the acceleration in consumer and business confidence, alongside cleaner domestic balance sheets, underpins the foundations for a cyclical upturn in growth. However, the recovery will take time to transpire, particularly if core inflation remains contained and interest rates remain flat over the next 12 months, preventing a consumer squeeze. This optionality to a domestic growth recovery, furthermore, comes without sacrificing the delivery to the fund's income objective. The fund's forward-looking yield of 8.2% remains well above cash yields of 6.5%, and a medium-term inflation expectation of 5.5%.

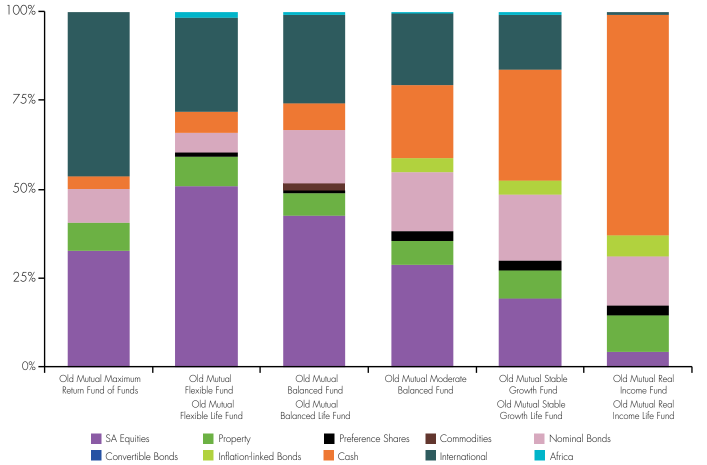
Source: Fund returns and rankings are sourced from Morningstar Direct. All other data is sourced from Deutsche Bank Equity Research and FactSet.

THREE-YEAR PERFORMANCE: (TO 31 MAY 2018)



Sources: Old Mutual Investment Group & Morningstar

ASSET ANALYSIS: (AS AT 31 MAY 2018)



Sources: Old Mutual Investment Group & Morningstar

Performance 31 May 2018	1 year	3 years (p.a.)	5 years (p.a.)	Highest[2]	Average[2]	Lowest[2]	Description	TER[1]	TC[1]
Old Mutual Maximum Return Fund of Funds	5.5%	4.8%		23.6%	9.9%	-3.8%		1.86%	0.11%
Benchmark[3]	5.5%	6.5%							
UT Peer Average	2.0%	3.8%					Worldwide - Multi-Asset - Flexible		
Old Mutual Flexible Fund	6.9%	4.4%	8.5%	54.0%	14.3%	-26.9%		1.64%	0.18%
Old Mutual Flexible Life Fund	7.1%	4.6%	8.8%						
Target: CPI + 5% to 7% p.a.	9.5%	10.4%	10.3%				CPI + 5% to 7% p.a. over rolling 3 years		
UT Peer Average	2.1%	2.3%	6.5%				South African - Multi-Asset - Flexible		
Old Mutual Balanced Fund	5.3%	4.1%	7.1%	45.5%	13.4%	-23.2%		1.64%	0.12%
Old Mutual Balanced Life Fund	5.5%	4.3%	7.4%						
Target: CPI + 4% to 5% p.a.	8.5%	9.4%	9.3%				CPI + 4% to 5% p.a. over rolling 3 years		
UT Peer Average	3.2%	3.6%	6.8%				South African - Multi-Asset - High Equity		
Old Mutual Moderate Balanced Fund A	6.8%	5.4%		12.7%	5.8%	0.7%		1.82%	0.22%
Target: CPI + 3% to 4% p.a.	7.5%	8.4%					CPI + 3% to 4% p.a. over rolling 3 years		
UT Peer Average	3.6%	3.9%					South African - Multi-Asset - Medium Equity		
Old Mutual Stable Growth Fund	6.9%	5.9%	6.9%	18.6%	8.5%	-5.3%		1.61%	0.06%
Old Mutual Stable Growth Life Fund	7.1%	6.1%	7.1%						
Target: CPI + 2% to 3% p.a.	6.5%	7.4%	7.3%				CPI + 2% to 3% p.a. over rolling 3 years		
UT Peer Average	4.7%	5.1%	6.5%				South African - Multi-Asset - Low Equity		
Old Mutual Real Income Fund	6.9%	6.4%	6.9%	15.4%	8.9%	-0.7%		1.41%	0.07%
Old Mutual Real Income Life Fund	7.1%	6.6%	7.0%						
Target: CPI + 1% to 2% p.a.	5.5%	6.4%	6.3%				CPI + 1% to 2% p.a. over rolling 3 years		
UT Peer Average	4.7%	5.1%	6.5%				South African - Multi-Asset - Low Equity		
CPI[4]	**4.5%**	**5.4%**	**5.3%**						

1 Total Expense Ratio is a historic measure and includes the annual service fee. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER may not necessarily be an accurate indication of future TERs. Transaction Cost (TC) is a necessary cost in administering the fund and impacts fund returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of fund, the investment decisions of the investment manager and the TER. TERs and TCs as at 31 March 2018.
2 Rolling 12-month returns (since inception).
3 Composite benchmark: 60% FTSE/JSE Capped Shareholder Weighted Index, 35% MSCI All Country World Index, 5% STeFI Composite Index.
4 The CPI figures are lagged by one month as the number was calculated before this month's inflation rate was released.

Sources: Morningstar and Old Mutual Wealth

FOR MORE INFORMATION, VISIT:
www.macrosolutions.co.za

Old Mutual Investment Group (Pty) Ltd
PO Box 878, Cape Town 8000
Tel: +27 21 509 5022 Fax: +27 21 509 4663
www.oldmutualinvest.com

OLDMUTUAL INVESTMENT GROUP

Statutory information applicable to collective investment portfolios listed in table above:

- You should ideally see the funds as medium- to long-term investments. The fluctuations of particular investment strategies affect how a fund performs. Your fund value may go up or down. Therefore, we cannot guarantee the investment capital or return of your investment. How a fund has performed in the past does not necessarily indicate how it will perform in the future.
- The fund fees and costs that we charge for managing your investment are disclosed in the relevant fund's minimum disclosure document or table of fees and charges, both available on Old Mutual Unit Trusts' public website or from its contact centre.
- Additional information of the proposed investment, including brochures, application forms and annual or quarterly reports, can be obtained, free of charge, from Old Mutual Unit Trust Managers (RF) (Pty) Ltd, from our public website at www.omut.co.za or our contact centre on 0860 234 234.
- The cut-off time for client instructions (e.g. buying and selling unit trusts) is at 15:00 each working day. This is also the time we value our funds to determine the daily ruling price. Daily prices for Old Mutual Unit Trust Managers (RF) (Pty) Ltd funds are available on the public website and in the media.
- Unit trusts are traded at ruling prices, may borrow to fund client disinvestments and may engage in scrip lending. The daily price is based on the current market value of the fund's assets plus income minus expenses (NAV of the portfolio) divided by the number of units in issue.
- Income funds derive their income primarily from interest-bearing instruments as defined. The yield is a current yield and is calculated daily.
- A fund of funds is a portfolio that invests in other funds that levy their own charges, which could result in a higher fee structure for the fund of funds.
- Some funds hold assets in foreign countries and therefore may have risks regarding liquidity, the repatriation of funds, political and macroeconomic situations, foreign exchange, tax, settlement, and the availability of information.
- The Net Asset Value to Net Asset Value figures are used for the performance calculations. The performance quoted is for a lump sum investment. The performance calculation includes income distributions prior to the deduction of taxes and distributions are reinvested on the ex-dividend date. Performances may differ as a result of actual initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. Annualised returns are the weighted average compound growth rates over the performance period measured. Performances are in ZAR and as at 31 May 2018.

Old Mutual Unit Trust Managers (RF) (Pty) Ltd is a registered manager in terms of the Collective Investment Schemes Control Act 45 of 2002. Old Mutual is a member of the Association for Savings and Investment South Africa (ASISA). Old Mutual Unit Trusts has the right to close the portfolio to new investors in order to manage it more efficiently in accordance with its mandate.

MacroSolutions is a boutique within Old Mutual Investment Group (Pty) Ltd (Reg No 1993/003023/07), a licensed financial services provider, FSP 604, approved by the Financial Sector Conduct Authority (www.fsca.co.za) to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. Old Mutual Investment Group (Pty) Ltd is wholly owned by Old Mutual Investment Group Holdings (Pty) Ltd and is a member of the Old Mutual Investment Group.

The investment portfolios may be market-linked or policy based. Investors' rights and obligations are set out in the relevant contracts. Unlisted investments have short-term to long-term liquidity risks and there are no guarantees on the investment capital nor on performance. It should be noted that investments within the fund may not be readily marketable. It may therefore be difficult for an investor to withdraw from the fund or to obtain reliable information about its value and the extent of the risks to which it is exposed. The value of the investment may fluctuate as the value of the underlying investments change. In respect of pooled, life wrapped products, the underlying assets are owned by Old Mutual Life Assurance Company (South Africa) Limited, who may elect to exercise any votes on these underlying assets independently of the Old Mutual Investment Group. In respect of these products, no fees or charges will be deducted if the policy is terminated within the first 30 days. Returns on these products depend on the performance of the underlying assets.