



FUTUREGROWTH

/ ASSET MANAGEMENT

Monthly Review

April 2017

Contents

Page 3

Economic and market review

Page 4-6

Market summary

Page 7-11

Product information and performance

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Market review

Economic and market review

Bond market made up some lost ground in April

April turned out to be a month of consolidation following a turbulent end to the first quarter. The yield of the benchmark 10-year RSA Government bond closed the month at 8.69%, 15 basis points lower than the level on 31 March 2017. This happened amid significant market volatility, clearly illustrated by the wide trading range of 8.46% to 9.21% for this instrument. As yields declined across the full term structure, the JSE All Bond Index managed to render a positive return of 1.5% for the month. This was well above the cash return of 0.6%, making up some of the lost ground to nominal bonds caused by the cabinet reshuffle and negative credit ratings action during March.

Still no end to strong foreign demand for high yielding bonds

A host of factors contributed to the better monthly bond performance. Yields in the main developed bond markets, led by the US Treasury market, declined as investors reconsidered earlier more aggressive reflation views. In turn, this contributed to higher global risk appetite which boosted the reach for higher yield assets to the benefit of most emerging markets. In the case of South Africa, net purchases of rand-denominated RSA bonds by foreign investors totalled just over R16bn during April. This boosted net non-resident purchases to R35bn for the first four months of the year leaving almost two-fifths of local currency government bond issuance in foreign hands. To put this in perspective: the R35bn roughly equates to 13 weekly government bond auctions. A partial, yet strong recovery of the rand on international currency markets and the release of interest-rate positive local data also contributed to the relief bond rally.

Local economic data releases were also generally bond supportive

From a bond market perspective, the quicker than expected deceleration of both the consumer and producer price rates of inflation are probably the most noteworthy. The confirmation that the government met its budget targets for the fiscal year 2016/17 helped to ease concern about the fiscal outlook. However, it is important to note that the tax revenue collection effort received a large, unexpected and probably unsustainable last minute boost from dividend tax receipts. The monthly international trade data also continues to point to an improving current account position.

Poor run of inflation-linked bonds continue

In contrast to nominal bonds, the inflation-linked bond market, which until a few months ago benefitted from a relatively high rate of inflation, continues to lag in terms of performance. The recent deceleration in the rate of inflation and concern about significantly lower inflation in the short term, which works its way into the valuation calculations of these bonds via a three-month lagged inflation carry component, reduced demand and caused real yields to drift higher. Another, but more indirect driver is concern about government's commitment to continued fiscal consolidation. An inability to stick to the latest budget estimate could force government to fund a wider deficit by tapping into markets, thus leading to an increase in both nominal and inflation-linked bond issuance. If this leads to a demand/supply imbalance, yields would have to rise to attract potential investors. It is also worth noting that, unlike in the case of nominal bonds, foreign investor involvement in the inflation-linked bond market has always been very limited. Therefore, this market did not benefit from the recent spike in offshore bond demand.

Key macroeconomic themes

Economic growth

A mild, uneven global economic recovery remains our base case, with a relatively strong US economy still leading the way. The Trump presidential victory (together with a House and Senate Republican majority) boosted speculation that higher US fiscal spending will benefit the US growth trajectory. This remains to be seen and for now the risk is that markets may have to face disappointment with respect to both the timing and size of the much anticipated stimulus. We believe that the global recovery will be structurally lower than in previous cycles, mainly due to lower productivity growth, ongoing broad-based balance sheet repair (deleveraging) and shifting demographics (older populations tend to save more and spend less).

Most emerging market economies are caught between an improved, but still mixed outlook for the developed world, the implication of structurally lower Chinese economic growth on commodity demand and the US Federal Reserve's well telegraphed intent to normalise monetary policy. Therefore, commodity producers with external imbalances, such as SA, remain vulnerable.

Locally, the biggest impediment to higher local growth remains of a more structural nature. Encouragingly, engagement between government, business and labour has resulted in agreement on South Africa's national minimum wage. Continued engagement between this triumvirate – and practical follow through – remains essential to unbundling domestic growth potential. The cabinet reshuffle is likely to, firstly, slow the momentum of this process and secondly, negatively impact both consumer and particularly business sentiment.

Inflation

The strong rise in energy and other raw material prices in the last few months has started showing in headline inflation numbers in many economies. Although reflation is welcomed with open arms, since this is what policy makers had aimed to achieve, the feed-through to underlying inflation is still not entirely convincing. Final demand is simply not yet strong enough.

Locally, the expected drop in food inflation and the stronger rand in the last few months has forced down our 2017 annual average inflation forecast to 5.6%. Recent rand weakness in response to the cabinet reshuffle and S&P's sovereign credit ratings downgrade do not yet pose a threat as a weaker rand assumption has been accounted for in our consumer price inflation forecasts.

Balance of payments

Significant rand depreciation until a few months ago, an improved terms of trade position and a pick-up in global economic activity are lending relief to the balance of payments position. As a result, we expect a narrowing of the current account deficit from an annual average of 3.3% in 2016 to 3.0% in 2017, followed by marginal widening to 3.5% in 2018. The surprisingly small deficit for the fourth quarter of 2016 is not sustainable. Our terms of trade is expected to weaken from current levels, while the unfavourable income account deficit (primarily comprised of net dividend and interest payments to foreigners), remains a significant drag on a sustained and meaningful balance of payments correction. A stronger currency may also limit a significant further narrowing of the current account deficit over the medium term.

Key macroeconomic themes *continued*

Monetary policy

Having finally started the long awaited and well telegraphed monetary policy normalisation process, we agree with the Federal Reserve's intent to follow a slow and gradual process. With an unemployment rate seemingly stuck below 5%, slowly-rising wages and the more stable PCE core inflation rate now hovering at 1.8%, we believe that the Federal Reserve should continue with its interest rate normalisation process, but for obvious reasons at an appropriate pace. The recent pick-up in market chatter about the imminent shrinking of the Federal Reserve's large balance sheet (the largest since the Second World War following its response in the aftermath of the 2008 financial crisis) is premature to our minds.

The current trend of global monetary policy divergence is expected to continue over the next year or so. With more policy tightening in the US on the cards, the European Central Bank and Bank of Japan will retain their respective quantitative easing and negative interest rate policy programmes, with some tweaks. At the same time, some of the smaller advanced and commodity-driven economies may be forced to ease policy, mainly due to below-trend economic growth and a modest inflation backdrop. On the positive side, monetary policy divergence will act to soften the impact of higher US rates on global growth.

In the case of SA, we feel comfortable with the prospects of the South African Reserve Bank (SARB) being at the peak of the interest rate tightening cycle. A cautious approach is supported by the weak economic growth backdrop, low levels of credit extension growth and limited evidence of demand-led inflation. However, considering the size of the balance of payments deficit and the stickiness of inflation (in the upper end of the target range), we deem a neutral policy stance (thus no cuts) as the most appropriate course for monetary policy right now. Recent market turmoil should also add to the list of reasons for the central bank to remain cautious about reducing the repo rate.

Investment view and strategy

With the exception of the US, and more encouraging signs of some improvement in other G10 countries, the global growth recovery remains fragile. This sets the scene for a modest rise in inflation as well as monetary policy divergence. It also implies a steady tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should limit significant upside to global bond yields. On the negative side, the continued uncertainty about the global, and particularly the Chinese, growth outlook remains a risk – especially for emerging market commodity producers with a weak external position in both absolute and relative terms.

Locally, the downward trend to inflation is entrenched, supported mostly by significantly lower food price increases. While the South African Reserve Bank has adopted a neutral bias, it is unlikely that they would consider interest rate cuts soon. The external imbalance, albeit improving, is still too big to allow for a lower real repo rate. Unpredictable currency swings also continue to pose a risk to the more benign inflation outlook.

Although the newly-appointed Minister of Finance is doing his best to downplay risks to the previously carefully managed fiscal consolidation, it would take far more to convince us that all is indeed well. The combination of negative ratings momentum, uncertainty about the fiscal outlook and the continued aggressive accumulation of local currency bonds by foreign investors, remains a potential lethal mix for the local bond market. Of particular concern is the risk of a double ratings downgrade by rating agency Moody's. This will force international passive fund managers to reduce their large South African bond exposure. Considering this, we shall continue to approach the market with caution.

Investment view and strategy

Our broad interest rate investment strategy for a core bond fund benchmarked against the ALBI is as follows:

- Modified duration - Underweight (60% of maximum allowable range)
- Cash - Small overweight
- Nominal bonds (1-3 years) - Underweight
- Nominal bonds (3-7 years) - Overweight
- Nominal bonds (7-12 years) - Underweight
- Nominal bonds (12+ year) - Underweight
- Inflation-linked bonds - Zero holding

Key economic indicators and forecasts (annual averages)

	2013	2014	2015	2016	2017	2018
Global GDP	2.6%	2.8%	2.9%	2.5%	3.0%	2.8%
USA	1.9%	2.4%	2.4%	1.6%	2.1%	1.8%
Euro area	-0.4%	0.9%	1.5%	1.7%	2.1%	1.7%
Japan	1.6%	-0.1%	0.5%	1.0%	1.7%	0.7%
China	7.7%	7.4%	6.9%	6.7%	6.6%	6.2%
SA GDP	2.2%	1.5%	1.3%	0.5%	1.5%	2.0%
SA Headline CPI	5.8%	6.1%	4.6%	6.3%	5.6%	5.5%
SA Current Account (% of GDP)	-5.8%	-5.4%	-4.4%	-3.3%	-3.0%	-3.5%

Source: Old Mutual Investment Group

Produced by



Wikus Furstenberg
Portfolio Manager &
Head: Interest Rate Process

Product information and performance

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
MONEY MARKET											
Call Money Market	Average Call rate of four largest SA banks	Aims to provide maximum return on overnight cash investments.	Nazley Bardien	January 2000	Product Benchmark Outperformance	7.27% 6.90% 0.37%	6.40% 5.98% 0.42%	5.85% 5.41% 0.44%	5.80% 5.34% 0.46%	6.99% 6.51% 0.48%	7.08% 6.60% 0.48%
Core Money Market	STeFI 3-month Index	Targets high cash returns through a carefully balanced and actively managed mix of short-term interest-bearing investments. The weighted average duration for the Composite may not exceed 120 days.	Michael van Rensburg	July 2004	Product Benchmark Outperformance	8.44% 7.23% 1.21%	7.42% 6.47% 0.95%	6.74% 5.94% 0.80%	6.63% 5.89% 0.74%	7.83% 7.03% 0.80%	7.86% 7.13% 0.73%
180 day Enhanced Money Market	STeFI Composite Index	Targets high cash returns through a carefully balanced and actively managed mix of short- and medium-term interest-bearing investments with maturities ranging from 180 days to 2 years.	Michael van Rensburg	July 2004	Product Benchmark Outperformance	8.81% 7.59% 1.22%	7.70% 6.82% 0.88%	6.97% 6.22% 0.75%	6.85% 6.10% 0.75%	8.03% 7.18% 0.85%	8.08% 7.25% 0.83%
STeFI PLUS											
Yield Enhanced A STeFI+ Short Term	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of A-. Weighted average term to maturity less than 365 days.	Daphne Botha	October 2002	Product Benchmark Outperformance	8.86% 7.59% 1.27%	7.92% 6.82% 1.10%	7.74% 6.22% 1.52%	7.71% 6.17% 1.54%	8.65% 7.28% 1.37%	8.96% 7.79% 1.17%
Yield Enhanced A STeFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of A based on official ratings. Weighted average term to maturity less than five years.	Daphne Botha	January 2010	Product Benchmark Outperformance	10.21% 7.59% 2.62%	9.00% 6.82% 2.18%	8.62% 6.22% 2.40%	8.56% 6.17% 2.39%		8.63% 6.22% 2.41%
Yield Enhanced BBB STeFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB.	Daphne Botha	February 2010	Product Benchmark Outperformance	11.10% 7.59% 3.51%	10.80% 6.82% 3.98%	10.22% 6.22% 4.00%	10.20% 6.17% 4.03%		10.13% 6.21% 3.92%

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
STEFI PLUS CONT.											
Yield Enhanced BB SteFI+	StEFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BB.	Daphne Botha	January 2012	Product Benchmark Outperformance	9.54% 7.59% 1.95%	12.65% 6.82% 5.83%	11.39% 6.22% 5.17%			11.77% 6.19% 5.58%
Yield Enhanced Geared BB SteFI+	StEFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement, as well as equity risk. The Composite's weighted average rated credit quality must be a minimum of BB-.	Daphne Botha	January 2008	Product Benchmark Outperformance	10.23% 7.59% 2.64%	12.77% 6.82% 5.95%	11.18% 6.22% 4.96%	11.67% 6.17% 5.50%		11.86% 7.11% 4.75%
Power Debt***	StEFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB. Investments in this product are limited to listed and unlisted assets in the power sector and supporting industries.	Paul Semple	May 2014	Product Benchmark Outperformance	11.76% 7.59% 4.17%	11.46% 6.82% 4.64%				11.46% 6.82% 4.64%
INCOME											
Core Income	50% SteFI Call Deposit Index; 50% 3-7 Years All Bond Index	Aims to deliver excess return by investing in money market and bond assets with a focus on yield enhancement while limiting interest rate risk to a maximum average duration of two years.	Wikus Furstenberg	November 2002	Product Benchmark Outperformance	9.47% 9.57% -0.10%	7.83% 7.86% -0.03%	6.92% 6.46% 0.46%	7.14% 6.63% 0.51%	8.11% 7.45% 0.66%	8.59% 8.01% 0.58%
Flexible Income	110% SteFI Call Index	Aims to deliver excess return by investing in money market, bonds, preference shares and listed property and taking advantage of yield enhancement and capital growth opportunities. The composite is not limited by duration constraints.	Wikus Furstenberg	July 2006	Product Benchmark Outperformance	9.65% 7.68% 1.97%	7.55% 6.85% 0.70%	7.50% 6.28% 1.22%	7.91% 6.32% 1.59%	8.65% 7.20% 1.45%	8.96% 7.29% 1.67%
Yield Enhanced Income	20% All Bond Index; 80% SteFI Composite Index	Aims to deliver excess returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted assets. Interest rate risk is constrained.	Wikus Furstenberg	May 2012	Product Benchmark Outperformance	9.88% 8.22% 1.66%	8.80% 7.09% 1.71%	8.56% 6.49% 2.07%			8.56% 6.49% 2.07%

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
INTEREST RATE ASSET ALLOCATION											
Interest Rate Asset Allocation	ALBI (62.5%); JSE ILB IGOV Index (30%); STEFI Call Deposit Index (7.5%)	Aims to deliver excess return mainly through a combination of aggressive asset allocation within the various interest-bearing asset classes.	Wikus Furstenberg	July 2010	Product Benchmark Outperformance	8.61% 7.47% 1.14%	7.83% 7.16% 0.67%	8.49% 7.24% 1.25%			9.49% 8.46% 1.03%
INFLATION-LINKED BONDS											
Passive ILB Index	Barclays Capital/ Absa SAGILB	Aims to match the returns of the benchmark through passive interest rate and yield curve management.	Nazley Bardien	September 2005	Product Benchmark Outperformance	1.22% 1.14% 0.08%	5.70% 5.70% 0.00%	7.18% 7.25% -0.07%	8.81% 8.93% -0.12%	9.18% 9.28% -0.10%	9.37% 9.45% -0.08%
Core ILB	JSE ILB IGOV Index	Aims to deliver excess return through active interest rate risk management and limited yield enhancement.	Wikus Furstenberg	November 2005	Product Benchmark Outperformance	1.71% 1.28% 0.43%	5.82% 5.67% 0.15%	7.44% 7.23% 0.21%	9.31% 8.92% 0.39%	9.57% 9.27% 0.30%	9.54% 9.25% 0.29%
Yield Enhanced Long Duration ILB	Barclays SAGILB 15+ Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets.	Mei-Chi Liou	June 2011	Product Benchmark Outperformance	1.15% -0.97% 2.12%	7.36% 5.07% 2.29%	9.65% 7.47% 2.18%			10.48% 8.46% 2.02%
Power Inflation-linked***	RSA Inflation Linked Government Bond I2038 Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets in the power sector and supporting industries.	Mei-Chi Liou	January 2014	Product Benchmark Outperformance	3.04% -0.11% 3.15%	9.11% 6.13% 2.98%				8.70% 6.20% 2.50%
Infrastructure & Development ILB	Barclays BESA SAGILB 15+	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Mei-Chi Liou	Pending	Product Benchmark Outperformance	N/A					
NOMINAL BONDS											
Passive All Bond	All Bond Index	Aims to match the returns of the benchmark through passive interest rate and yield curve management.	Nazley Bardien	June 2000	Product Benchmark Outperformance	10.60% 10.58% 0.02%	7.87% 7.86% 0.01%	7.31% 7.31% 0.00%	8.34% 8.36% -0.02%	8.07% 8.05% 0.02%	10.83% 10.80% 0.03%
Core Bond	All Bond Index	Aims to deliver excess return through a combination of interest-bearing asset allocation, active duration management and yield enhancement.	Daphne Botha/ Wikus Furstenberg	January 2000	Product Benchmark Outperformance	11.34% 10.58% 0.76%	8.23% 7.86% 0.37%	8.02% 7.31% 0.71%	9.09% 8.36% 0.73%	8.80% 8.05% 0.75%	11.29% 10.68% 0.61%

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
NOMINAL BONDS cont.											
Long Duration Bond	All Bond Index 12+ Years	Aims to deliver excess return through active allocation between long-dated fixed rate and inflation-linked bonds, limited yield curve selection, duration management and yield enhancement.	Wikus Furstenberg	December 2006	Product Benchmark Outperformance	10.32% 10.60% -0.28%	7.33% 7.76% -0.43%	7.31% 7.54% -0.23%	8.34% 8.44% -0.10%	7.53% 7.19% 0.34%	7.74% 7.46% 0.28%
Yield Enhanced Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted assets.	Jason Lightfoot	December 2001	Product Benchmark Outperformance	12.04% 10.58% 1.46%	10.16% 7.86% 2.30%	9.72% 7.31% 2.41%	10.99% 8.36% 2.63%	10.46% 8.05% 2.41%	11.19% 9.27% 1.92%
Infrastructure & Development Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Jason Lightfoot	January 1995	Product Benchmark Outperformance	11.71% 10.58% 1.13%	9.87% 7.86% 2.01%	9.69% 7.31% 2.38%	11.01% 8.36% 2.65%	10.54% 8.05% 2.49%	12.61% 10.68% 1.93%
SOCIALLY RESPONSIBLE INVESTMENTS											
Infrastructure & Development Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Jason Lightfoot	January 1995	Product Benchmark Outperformance	11.71% 10.58% 1.13%	9.87% 7.86% 2.01%	9.69% 7.31% 2.38%	11.01% 8.36% 2.65%	10.54% 8.05% 2.49%	12.61% 10.68% 1.93%
Development Equity	Consumer Price Index (CPI) + 10%	Targeting high returns by investing in equity and related assets that are socially responsible or developmental.	James Howard	September 2006	Product Benchmark	1.75% 16.14% -14.39%	13.60% 15.49% -1.89%	11.96% 15.69% -3.73%	12.09% 15.51% -3.42%	12.68% 16.40% -3.72%	16.88% 16.31% 0.57%
Community Property	Consumer Price Index (CPI) + 4%	A portfolio specialising in the finance and development of retail shopping centres catering to the needs of under-served communities throughout South Africa.	Smital Rambhai	June 1996	Product Benchmark	24.31% 10.31% 14.18%	17.00% 9.48% 7.52%	14.42% 9.68% 4.74%	12.51% 9.50% 3.01%	13.12% 10.39% 2.73%	13.79% 9.92% 3.87%
Agri	Consumer Price Index (CPI) + 10%	A portfolio specialising in equity investments in agricultural land, agribusinesses and farming infrastructure.	Smital Rambhai (Product Manager)	March 2010	Product Benchmark	N/A					

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
SOCIALLY RESPONSIBLE INVESTMENTS cont.											
Development Balanced***	A composite weighting of the underlying funds' benchmarks.	A balanced portfolio providing investors with social impact from a targeted and development perspective and exposure to listed equities that track the JSE's SRI Index.	James Howard	November 2004	Product Benchmark Outperformance	9.07% 6.56% 2.51%	7.02% 4.86% 2.16%	10.34% 8.55% 1.79%	10.56% 9.04% 1.52%	9.36% 8.30% 1.06%	13.01% 12.06% 0.95%
Power Debt***	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB. Investments in this product are limited to listed and unlisted assets in the power sector and supporting industries.	Paul Semple	May 2014	Product Benchmark Outperformance	11.76% 7.59% 4.17%	11.46% 6.82% 4.64%				11.46% 6.82% 4.64%
Power Inflation-linked bond***	RSA Inflation Linked Government Bond I2038 Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets in the power sector and supporting industries.	Mei-Chi Liou	January 2014	Product Benchmark Outperformance	3.04% -0.11% 3.15%	9.11% 6.13% 2.98%				8.70% 6.20% 2.50%
Infrastructure & Development Inflation-linked bond	Barclays BESA SAGILB 15+	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Mei-Chi Liou	Pending	Product Benchmark Outperformance	N/A					

Currency: ZAR/Gross of fees

*Annualised

**Currently investors are Futuregrowth staff who may elect to invest through their retirement funds.

***Portfolio returns. Supplemental information.

FUTUREGROWTH

/ ASSET MANAGEMENT

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