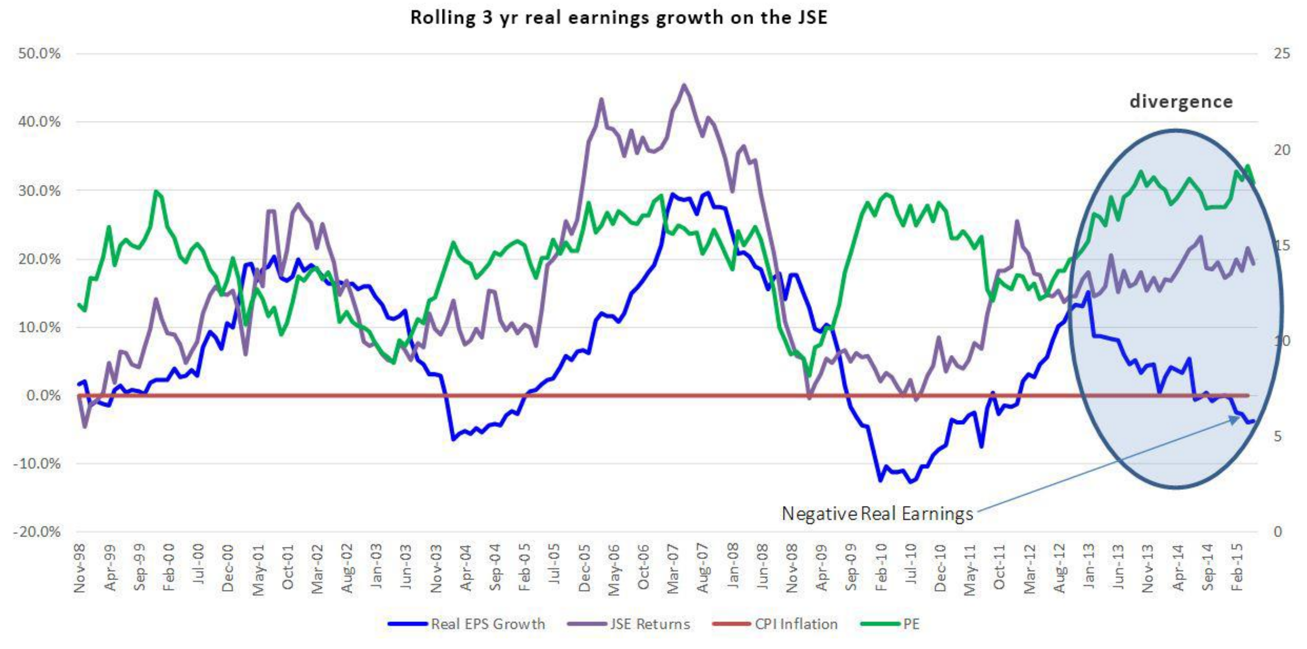
"Don't Blink": Has the tide turned on SA Equities?

This has been a central debate in the investment community for the better part of 3 years now, and reflects in most funds managed for SA investors being underweight South African equities. Despite this fairly uniform negative view the market has in fact continued to perform well – with the result that fund managers, by and large, have left a substantial component of returns on the table.

Our job is to try and understand the decision making behaviour of fund managers so that we can help guide clients. In this instance, it gets increasingly difficult to distinguish between fund managers being risk averse, and just plain wrong. What could they have missed in the market which resulted in this opportunity cost for investors? To try and understand this dynamic we look at a few areas of the market which may help shed some light.

For most investors, deciding where to invest their savings starts at home. This has been a wonderfully convenient starting place since the early 2000's, where, barring a few blips (the GFC[1] was a blip in the end – a large drawdown which was recovered in a matter of months), the JSE has made investing seem easy. To give a sense of this period – if you were an individual living in the US or Germany, over a period of 15 years your return from equities would have been close to 5%p.a (before any fees). Locally, investors have earned closer to 14%p.a[2]. Even adjusting for the levels of inflation, the difference is stark. But does this mean that just because SA equities have performed exceptionally well, that they are doomed to a negative future? This logic would have been extremely costly in the past. To understand this question we've looked at the earnings generated over time by shares listed on the JSE. After all, earnings from companies, and the dividends they pay, are what generate investor returns over time.

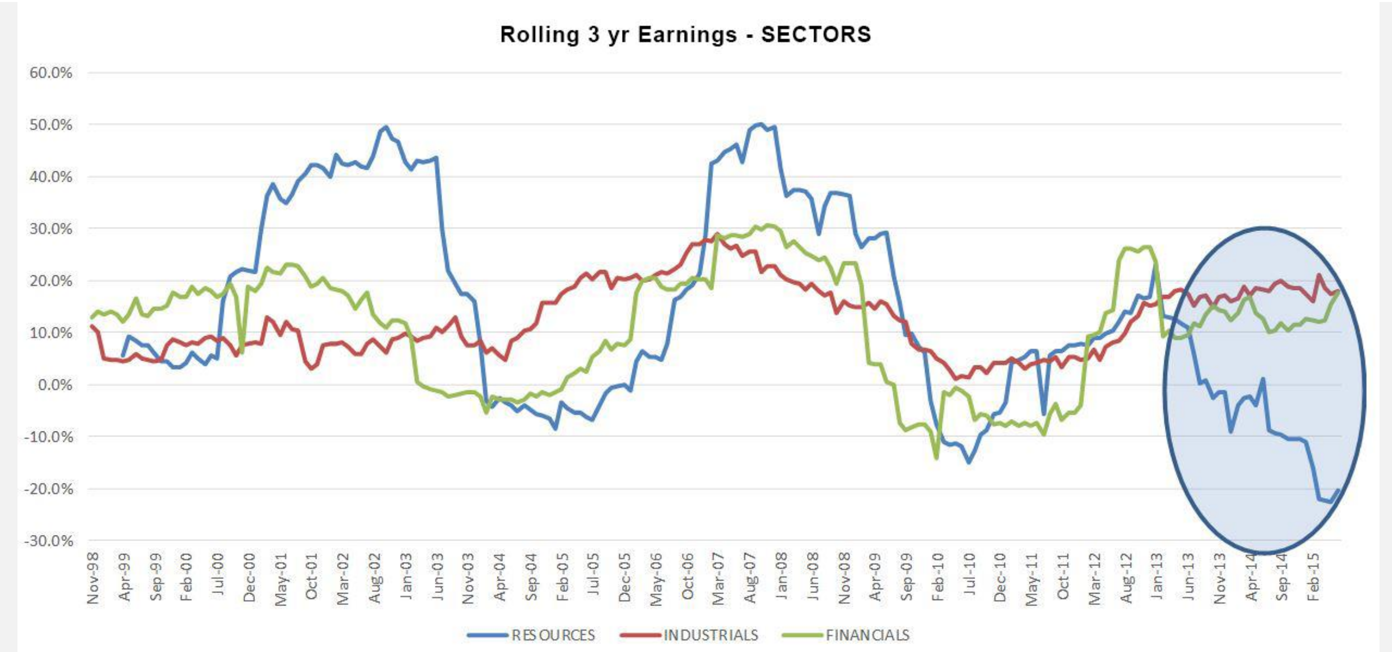
Looking at the chart below (Chart 1) you will notice that earnings are extremely cyclical, with substantial periods of high earnings, followed by weaker periods. The early and mid-2000's were examples of high levels of corporate earnings driving high levels of JSE returns. In the current market, we've seen high levels of JSE investment returns for almost 4 years now[3] *but on declining levels of corporate earnings*. In fact, real earnings generation from the JSE is now growing below the rate of inflation, at less than 2% nominal growth. As context, the long term average earnings growth for the JSE is around 12.5% p.a.



[1] Global Financial Crisis - 2008
[2] Note these numbers are in US Dollars so that we can gauge the differential fairly.
[3] We've measured this over a 3 year horizon – a period typically relevant to equities investing

It would be easy to conclude that SA companies, at an operational level, are not performing well. Looking at Chart 1 it seems obvious that investment returns should follow earnings performance, apart from the current anomaly period we are currently trying to figure out. In this period (2012 onwards), real earnings (ie net earnings growth after inflation) have been in a declining trend, but decent investment returns have remained. The market has done something similar twice over the past 20 or so years: in both 2003/2004 and 2010/2011 real earnings were declining, *but investment returns and the market rating had been low.* We now have the worst prospective combination: declining earnings with high market ratings. How can this be?

To help us, we've broken down JSE earnings further, into the constituent sectors. See Chart 2 for this breakdown:



Here we find divergence of a different nature: Resource shares are the culprit for low earnings on the JSE! To be fair this is no great surprise, resource shares have been beaten down for a long time now, and it's a rare occasion where a South African fund manager will have any meaningful exposure. And, in line with our experience in time, resource share returns have been poor in line with their declining earnings. So what are we left with? Industrial and Financial shares. Looking at the earnings lines for these sectors you can start to see why equity returns, barring resources, have been good. These sectors have delivered consistent real earnings growth for some time. Their returns have been through a combination of solid earnings growth, and an increased rating paid for these earnings. Industrials in particular have delivered substantial earnings growth above their long term average. This is companies like SAB, Remgro, Naspers, Steinhoff, retailers (Mr Price, Foschini, Truworths) and healthcare (Mediclinic, Life, and Netcare).

To answer our conundrum then, we need to decide which of the following scenarios is more likely: whether or not

- a) financials and industrials shares will continue to deliver good earnings, and thereby prop up the equity returns for investors, allowing the market to 'grow' into its high current rating[4], (this is our 'don't blink' scenario) or

- b) the earnings levels of these shares remain but the market starts to discount the rating they are prepared to pay (this could happen as a consequence of general global derisking – eg Greece and co) , - the 'reality check' scenario, or

[4] Next years expected JSE earnings are priced in, at around 15.5% growth, which is high

- c) resources shares make a comeback, and compensate for the cyclical high earnings where financials and industrials are today. (The 'long shot')

- Option d) though is the one which most fund managers have gone for: declining or weaker earnings across the board coupled with a lower rating placed on these earnings, and no real recovery in resources earnings over the medium term. Hence the bearish positioning in equities.

It seems a bit harsh to point out that option (a) was the right answer for the past few years, with the bearish nature of active managers coming through in option (d) (and the consequent opportunity cost mentioned above). This is a trait we see often, and over long periods: active fund managers, particularly South African ones, tend to be risk averse more often than not, and this can cost clients potential returns.

On the face of it, the real support of returns on the JSE has been exceptional earnings growth from industrial shares, in a tough operating environment (low GDP, weak currency, etc). It looks increasingly unlikely that this will continue at its current high level – the SA economy is not showing sufficient signs of growth to justify another 3yrs+ of abnormal high returns.

As for resources, their fate is to a large extent determined by the global economy. This is also a precarious place to be, and until global growth 'normalises'[5] we shouldn't expect too much.

So where have we ended up? It seems all we've done is justify the current position of most SA managers with respect to equities. And perhaps this is correct for the first time in a while. It does seem that now is the time for active fund managers to earn their keep through their risk averse nature.

[5] A loose terms perhaps, but resource earnings in SA are driven by demand predominantly outside our borders

Asset Class Review

It was a weaker quarter for asset classes as some of the realities of both domestic and global markets started to feature more prominently in asset prices.

In SA we saw a reasonable move upwards in the benchmark All Bond yield which was mirrored in the property market – both in line with an uptick on inflation. The impact of this weaker outlook was felt in returns, with property down over 7% for the quarter. This has been an asset class which has benefited to a great extent from low and declining interest rates – the question for us now is whether or not rates in general will move in an upward direction from this point out? Property stocks do carry a reasonable amount of debt to help fund their growth, and their prospects are also closely linked to economic activity (their tenants) and inflation (the value of their leases). It seems as though these factors may be moving against property.

Equities have also been weaker – the 12 month return on the JSE is below cash for the first time in 3 years. The contributors here were:

- Resources - a continuation of the negative momentum in resources generally (questions around global demand, political risk, oversupply)

- Midcaps – fairly widespread sell off, the sector as a whole was down 7%. Worst amongst these was Illovo which is now in real value territory, trading on a PE multiple of 8.2 and a dividend yield of 6.2%. It's no surprise this stock is held by the value players.

Stocks which showed positive gains were Mondi (there is general support for Mondi as it moves away from being a pure paper business); retailers Woolies and Pick ‘n Pay; and a large positive move from investment holding companies Brait (up 48% post its decision to buy Virgin Active gyms for $1bn, and PSG was also up 24% post its results which showed good growth out of its Konsult business.

Offshore, global equities were weaker (down 0.3% in $). As the rand/dollar was flat, the same level of return was experienced by SA investors. Emerging markets however showed reasonable growth, up over 2% for the quarter and 12% for the year to 30 June. Emerging market valuations remain substantially below developed markets (PE of 19.2 vs 14.2 for emerging). This difference does reflect the relative risk of the markets, but is it overstated? The one significant movement has been in China (25% of MSCI Emerging Index) where consumers have taken on debt to be able to buy shares and participate in the equity bull market. This has started to unwind rather quickly, and China is off almost 30% in US$ in June/July. Their government has reacted to try and reduce the drawdown, by lowering interest rates and reducing trading requirements, but it has had limited effect. We would expect a substantial part of China’s gains to be reversed during this time.

Greece though has been the focus of global markets during 2015. From our perspective we’ve been trying to gauge the potential impact of a Greece fallout/bailout, and it's not obvious. Greece contributes less than 2% of Europe’s GDP, so in itself is not a catastrophe for Europe in terms of impact on growth. But it does set a precedent for other EU members where membership is reversible, and the central bank won’t necessarily stop members from failing. The underlying dynamic has come through here: combining different countries of differing economic strength and productivity inevitably leads to fallout.

The impact for South African investors has been net positive though – this sounds odd but in fact the EU is our largest trading partner, and with the Euro bearing the brunt of weak growth, Greece, etc. the local currency strengthened against the Euro which helps our imports. The biggest concern coming out of Greece is not the returns in Greece, but how it affects the mindset of investors globally where their risk appetite reduces.

Gold is the one asset class we would expect to perform in uncertain times – however it continues on its negative trend and is now trading below $1200/oz, from a high of almost $1900/oz in 2011. The oil price also reflects lower global growth prospects, with Brent Crude trading below $60/barrel again after it had recovered to $68.

In terms of general investment positioning the same rules apply: wary of interest rate sensitive investments, capital growth is best achieved through a properly diversified equity portfolio, and it's better to spend your risk budget offshore than to use it for SA asset classes. We retain a defensive outlook, now more than ever.

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	0.2%	6.0%	5.2%	19.1%	18.1%	17.2%	11.5%	15.7%
FTSE/JSE SA Listed Property	ZAR	-7.3%	5.4%	25.5%	18.2%	20.2%	20.1%	13.3%	17.1%
SA All Bond Index (ALBI)	ZAR	-1.8%	1.1%	7.7%	6.5%	9.0%	8.2%	7.1%	7.0%
SA Cash Index (SteFI)	ZAR	1.6%	3.1%	6.3%	5.7%	5.8%	7.3%	0.2%	0.6%
Balanced Benchmark [2]	ZAR	-0.4%	5.0%	8.1%	17.2%	16.6%	15.0%	6.3%	6.3%
SA Inflation (1 month lag)	ZAR	2.6%	3.1%	4.6%	5.6%	5.4%	6.1%	1.3%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	-0.3%	1.5%	-0.4%	12.0%	10.8%	4.2%	13.5%	16.1%
Emerging Markets Equity (FTSE EM)	USD	2.0%	4.0%	-1.8%	5.1%	4.3%	9.1%	17.9%	23.6%
Global Bonds (Barclays Global Bond Index)	USD	-1.2%	-3.1%	-7.1%	-0.8%	2.1%	3.5%	4.8%	5.7%
Global Cash	USD	0.0%	0.1%	0.1%	0.2%	0.2%	1.7%	0.0%	0.6%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.2%	6.0%	5.2%	19.1%	18.1%	17.2%	11.5%	15.7%
Global Equity (MSCI World)	ZAR	-0.1%	6.5%	13.6%	27.7%	21.4%	10.6%	11.7%	13.0%
Emerging Markets Equity (FTSE EM)	ZAR	2.2%	9.1%	12.0%	19.9%	14.4%	15.8%	11.4%	15.4%
SA All Bond Index (ALBI)	ZAR	-1.8%	1.1%	7.7%	6.5%	9.0%	8.2%	7.1%	7.0%
Global Bonds (Barclays Global Bond Index)	ZAR	-1.0%	1.7%	6.0%	13.1%	11.9%	9.9%	12.1%	14.4%
COMMODITIES									
Gold (US Dollars)	USD	-0.8%	-2.1%	-10.9%	-9.4%	-1.0%	10.4%	18.5%	19.2%
Gold (Rands)	ZAR	-0.6%	2.7%	1.6%	3.4%	8.5%	17.2%	19.2%	21.3%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	0.2%	4.9%	14.1%	14.1%	9.6%	6.2%	14.4%	16.1%
Rand / GBP Pound	ZAR	6.1%	5.8%	4.9%	14.2%	10.7%	4.8%	12.0%	14.6%
Rand / Euro	ZAR	3.9%	-3.4%	-7.2%	9.2%	7.6%	5.3%	11.8%	13.6%