

There is Always The Next Big Thing

Every December, financial journalists sharpen their pencils and write about the biggest themes that will drive market returns over the next year. Indeed, thinking about and rationalising investment markets through a set of themes is a powerful way to convey some very succinct messages. For instance, the theme that the internet would change the world was one that found favour with a large number of investors leading up to the turn of the millennia. Globalisation and the idea of an interconnected economy is another theme that has been relatively popular in financial market discourse for decades.

Not only do themes provide us with investment narratives that we can believe and understand, being able to identify and take advantage of them can lead to positive investment outcomes. For that reason, being able to recognise even one of the factors that may lead to the next big thing is a prized skill in the world of investment management. So, when investment managers or the media present us with what seem to be compelling investment themes, we are often inclined to believe them. After all, every now and again, some of those themes actually do end up driving markets, but not necessarily in the way you may think.

For example, let's say for instance that in 1999 you believed that the internet would change the world we live in, you would have been right. But, had you chosen to buy a range of newly listed US companies that would benefit from that theme, you would have lost a lot of money in the Dot Com Crash. Recognising and accepting the investment theme as being correct wasn't enough, you would have also needed to know when to access it.

Indeed, more often than not, investors buy compelling investment themes at the wrong times, but it isn't always easy to see that when you're caught up in the market hype. To that end, let's use hindsight to our advantage and look at three themes of old, how they played out, and why the line between great investment themes and overpriced assets isn't always that easy to see. Although each theme is quite different, they have some important commonalities that may help us navigate another theme that has a powerful grip on financial markets today.

Theme #1: The (Still) Sleeping Dragon - China

The Positives: Over the past few years, we have written quite extensively about China, its economy and the investment opportunity that the world's second-largest economy represents. Indeed, China and the country's path to global supremacy has been one of the most common investment themes of the past decade.

First and foremost, Chinese equities have only really been available to purchase by foreign investors since 2012, when the Stock Connect programs were launched. These programs, sanctioned by the Chinese government, connected mainland Chinese exchanges with Hong Kong for the first time.

Over the ensuing decade, more and more 'good news' polished up the Chinese investment case – robust GDP growth, a nascent technology sector that would bring Chinese consumers online and strong regulatory support from the Chinese government, to name a few. In 2020, the COVID-19 Pandemic further accelerated a lot of these trends and the price of many Chinese shares rose meaningfully as a result. In the investment management world, China could do no wrong with many investors calling for specific Chinese allocations in addition to their emerging market exposure.

The Negatives: However, since 2021, a crackdown on the technology sector by the Chinese government has led many to question how investor friendly the state is. In addition, the country's complex real estate sector and its trade issues with the US mean that transitioning the economy is going to be trickier than once thought. And lastly, the robust economic growth that underpinned the entire investment case is slowing.

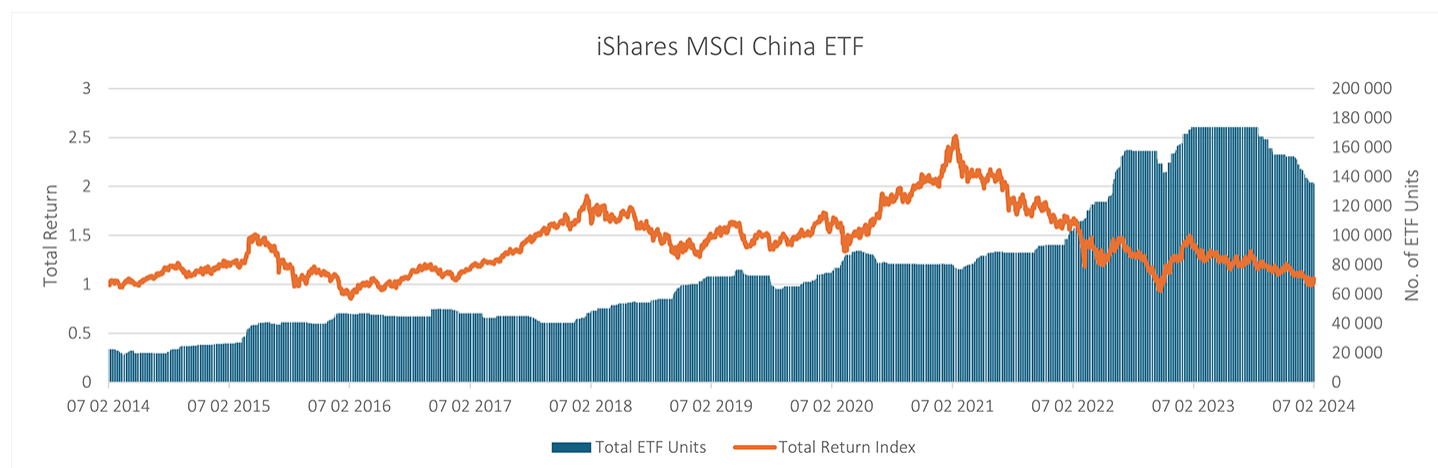
The CSI 300, which is an equity index that tracks 300 companies listed on the Shanghai and Shenzhen stock exchanges, reached an all time high on the 18th of February 2021. Today, its down 40% from that peak. In the investment management world, investors have now started calling for China to be excluded from their emerging market exposure and we have seen a number of "Emerging Markets ex-China" funds being launched.

Aside from the positives and negatives of the investment case, let's take a look at when many investors actually started to access the Chinese investment theme. Ultimately, when we start to consider investor behaviour an interesting trend emerges, regardless of the theme we are looking at. We show this below in Figure 1.

The orange line on the graph tracks the performance of the iShares MSCI China ETF over the last decade which serves as a proxy for the China investment theme. This is then compared to the number of units that have been created for that ETF over the same period of time. Essentially, as more capital flows into the ETF, more units are created so the Total ETF Units serves as a proxy for investment flows into the ETF.

What is interesting to see is that a meaningful uptick in flows into this ETF only really started to take place after the MSCI China Index peaked in late 2021. While it is important to note that this only relates to one ETF, it does illustrate an important point – investors really started to access this theme after the assets associated with it had experienced a significant increase in price. Ultimately, the theme and resultant growth that many investors were actually buying had already been priced into the market. This is a trend that is common across another two themes of old that we will also take a look at.

Figure 1 - ETF Performance vs Unit Creation Until February 2024 – iShares MSCI China ETF



Source: Thomson Reuters

Theme #2: ESG Investing

The Positives: Environment, Social and Governance (ESG) Investing is a form of investing that incorporates non-financial factors into the investment decision-making process. ESG Investing first came about when the UN Principles of Responsible Investment were developed in 2006, and became very popular in 2020 and 2021 off the back of strong performance from many ESG funds.

Ultimately, ESG investing considers the impact that a company or entity's operations may have on the planet, its employees and society more generally in addition to the company's financial performance. As society has become more aware of climate change, how companies are governed and how companies treat their employees, ESG investing has gained popularity.

ESG investing is based on the premise that, a combination of risk mitigation, long-term value creation and alignment with long-term market trends means that companies that adopt appropriate ESG practices are likely to benefit more than companies that do not.

The Negatives: However, since 2021, a number of factors have changed the ESG investment theme. For instance, most ESG metrics are still evolving and accurately gauging whether or not companies are ESG compliant is more difficult than previously thought.

In part, this has been driven by the fact that ESG scoring methodologies have tended to focus on how established a company's internal processes tend to be and not necessarily on the impact that the company's operations have on its external environment. For example, a company like Pepsi generally scores highly when it comes to disclosing its board composition, health and safety policies

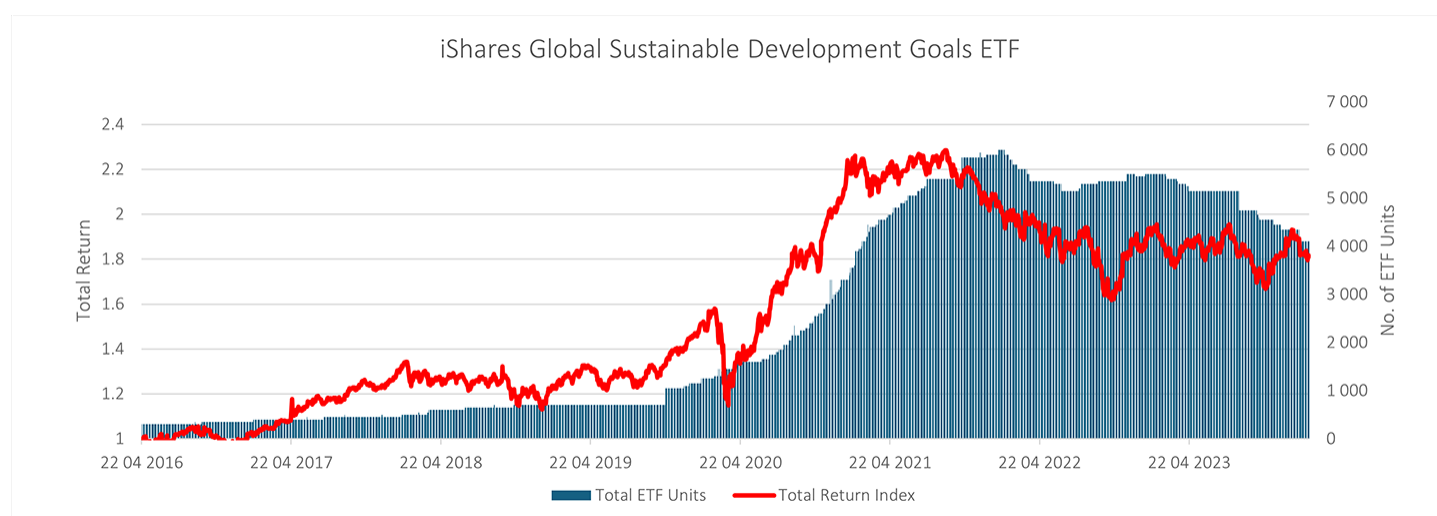
and climate targets, for that reason it may score highly according to some scoring metrics. However, when the impact of Pepsi's operations on the broader environment are considered it may not necessarily score as highly according to other metrics. Ultimately this leads to inconsistencies relating to how ESG investing is interpreted.

In addition, a number of companies have been engaged in a practice known as greenwashing, for promoting their ESG credentials falsely which has cast a negative light on the practice more broadly. For example, recently the German asset manager DWS came under investigation from regulators for engaging in greenwashing by promoting some of its funds as 'green funds' when they actually weren't. More specifically, from August 2018 to late 2021, the company marketed itself as a leader in ESG investing but actually failed to follow its own ESG investment processes that it said it followed in its communication to clients.

Taking all of this into account, it is interesting to again assess how investor capital flowed into the ESG Investing theme after the assets associated with that theme experienced a strong run in performance, similar to the China case. In Figure 2 below we look at this.

The red line shows the performance of the iShares Global Sustainable Development Goals ETF from 2016 until February 2024 and the number of units created for that ETF is also shown. In a very similar way to the iShares China ETF, flows into this ETF only really started to occur after a period of strong performance. Ultimately, this again illustrates an important point – many investors bought into this theme after it had been priced into markets.

Figure 2 - ETF Performance vs Unit Creation Until February 2024 – iShares Global Sustainable Development Goals ETF



Source: Thomson Reuters

Like the China and ESG Investing themes, one last theme of old has experienced a similar journey to these two.

Theme #3: Cryptocurrency

The Positives: Simply put, a cryptocurrency is a digital global currency created outside of the well regulated confines of the global monetary system. It exists only in the online world, and not in the physical world. This puts it out of reach of central banks, regulators and other watchdogs, making it the first independent, global currency.

For the better part of a decade, the price of cryptocurrencies like Bitcoin boomed. Largely as a result of a number of factors, including the scope and power of blockchain technology and the fact that they could act as an alternative means of banking in the future. We do not view Bitcoin as an asset, but rather as an alternative currency that in part promotes cross broader transactions more efficiently than traditional currencies do.

With that being said, a large part of the reason for the rise in the prices of cryptocurrencies like Bitcoin has been as a result of traders looking to profit from short term price movements and not necessarily as a result of a strong underlying investment case. Generally speaking, this can be considered a form of momentum investing which argues that assets that have experienced strong price increases will continue to experience more price increases as investors drive up prices.

The Negatives: However, since 2021, cryptocurrencies have experienced a difficult time. Primarily because of a reversal in macroeconomic circumstances worldwide, a regulatory crackdown which exposed unscrupulous businesses like FTX and technical limitations associated with various cryptocurrencies. Ultimately, the momentum trade on cryptocurrencies like Bitcoin reversed strongly.

Obtaining flows data on cryptocurrencies like Bitcoin is difficult, mainly because the first Bitcoin ETFs were only launched this year by Blackrock. A similar pattern shown in figures one and two has meant that many investors bought Bitcoin and similar cryptocurrencies after they experienced a very strong run in prices. In summary, many investors accessed the theme after it had already been priced into markets.

All three of the themes that we have discussed are still playing out to this day. Ultimately, we don't know how they will develop going forward, but if history has taught us anything, the price that they are bought at is often the differentiator between investment success and disappointment.

So what of the next theme?

Echoes of the Past – Theme #4 – Artificial Intelligence

We have explicitly positioned each of the investment themes by showing both the positives and the negatives associated with them and, where we can, illustrating how many investors accessed these themes after their growth had been priced into markets, and were left disappointed.

Over the past year, another investment theme has stolen a lot of the limelight from China, ESG Investing and Cryptocurrency. Indeed, it would be difficult to find an investment outlook that doesn't speak about Artificial Intelligence (AI) as being the next big thing. However, what is interesting about AI is that we seem to be at a point where the theme itself is still in its nascency.

The Positives: On the 30th of November 2022, OpenAI, a research organisation launched ChatGPT publicly, an AI powered chatbot. Although talk of AI and how it may impact the world we live in has been around for decades, ChatGPT acted as one of the first tangible pieces of technology that evidenced the power and potential power of AI.

From new scientific discoveries to increasing supply chain efficiencies, over the course of 2023, markets got very excited about the potential growth in company earnings that AI could unlock. In that process, seven companies were identified in part because of the role that they are playing in driving AI forward – today they are known as the Magnificent 7 (Apple, Microsoft, Alphabet, Amazon, Meta, Nvidia, and Tesla) and over the course of 2023, their market capitalisation in total increased by \$5 trillion.

The Negatives: As of today, the story has not yet been fully written and there may not actually be a negative story. However, it is important to note that while all seven companies are seen as market leaders in the AI space, most aren't actually generating profits from AI yet. Many investors have bought future earnings growth and in the process bid up the price of these seven companies substantially.

Ultimately, if yesterday's themes have taught us anything, we should at the very least be asking ourselves whether or not many investors are again buying a compelling investment theme after the positives have been reflected in the price.

MARKET REPORT

31 January 2024

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
SA Equity	ZAR	7.2%	-3.0%	-3.3%	9.7%	9.8%	7.8%	17.1%	14.3%
SA Listed Property	ZAR	24.4%	3.9%	15.2%	16.9%	-1.2%	3.6%	27.1%	21.3%
SA Bonds	ZAR	6.6%	0.5%	6.5%	6.8%	7.1%	7.1%	8.4%	8.0%
SA Cash	ZAR	2.1%	0.7%	8.2%	5.8%	6.0%	6.5%	0.5%	0.4%
Balanced Benchmark	ZAR	8.5%	-0.8%	4.5%	10.1%	10.0%	8.7%	11.7%	9.6%
SA Inflation (1 month lag)	ZAR	0.8%	0.0%	5.1%	6.1%	5.0%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity	USD	16.1%	1.2%	16.9%	8.0%	11.3%	9.0%	18.0%	14.9%
Emerging Markets Equity	USD	6.6%	-4.7%	-3.5%	-7.9%	0.8%	2.5%	19.0%	17.1%
Global Property	USD	16.2%	-5.0%	-3.5%	0.1%	-0.1%	3.1%	20.6%	16.7%
Global Bonds	USD	7.0%	-0.3%	4.0%	-2.9%	0.7%	2.0%	5.5%	4.3%
Global Cash	USD	1.4%	0.5%	5.2%	2.4%	2.0%	1.4%	0.6%	0.5%
MAJOR INDICES BASED TO RANDS									
SA Equity	ZAR	7.2%	-3.0%	-3.3%	9.7%	9.8%	7.8%	17.1%	14.3%
Global Equity	ZAR	15.2%	2.9%	24.8%	15.9%	19.1%	14.7%	16.2%	15.5%
Emerging Markets Equity	ZAR	5.8%	-3.0%	2.9%	-1.1%	7.8%	7.9%	14.1%	13.5%
Global Property	ZAR	15.3%	-4.3%	3.0%	7.4%	6.9%	8.5%	18.8%	17.1%
SA Bonds	ZAR	6.6%	0.5%	6.5%	6.8%	7.1%	7.1%	8.4%	8.0%
Global Bonds	ZAR	6.2%	1.4%	11.0%	4.2%	7.7%	7.3%	14.7%	14.9%
COMMODITIES									
Gold (US Dollars)	USD	2.8%	-1.2%	6.7%	3.3%	9.2%	5.1%	14.4%	13.6%
Gold (Rands)	ZAR	2.0%	-0.5%	13.9%	10.8%	16.8%	10.6%	17.9%	17.0%
CURRENCIES									
Rand / Dollar	ZAR	0.1%	-2.1%	-7.1%	-7.2%	-7.0%	-5.2%	14.4%	14.8%
Rand / GBP Pound	ZAR	-4.5%	-1.9%	-10.5%	-4.5%	-6.3%	-2.6%	12.6%	14.2%
Rand / Euro	ZAR	-2.5%	-0.3%	-6.9%	-3.2%	-5.8%	-3.0%	11.7%	13.0%

KEY

Asset Class	Represented By:
SA Bonds	Satrix Bond Index Tracker
SA Cash	STeFi
SA Equities	Satrix ALSI Index Tracker
SA Listed Property	Satrix Property Index Tracker
Emerging Markets	Vanguard Emerging Markets Stock Index Tracker
Global Cash	ICE BofA US Dollar 3-Month Deposit Bid Rate Average
Global Bonds	Vanguard Global Bond Index Tracker
Global Equities	Vanguard Global Stock Index Tracker
Global Property	iShares Developed Real Estate Index Tracker

REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

January 2024

Spot Rates		31-Jan-24	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	18.6	18.3	17.4	13.3	11.2	7.1
Rand/GBP	Rand	23.7	23.3	21.4	17.4	18.4	12.9
Rand/EUR	Rand	20.2	20.2	18.9	15.2	15.1	8.8
RATES							
Libor 6m \$	US\$	5.6	5.6	5.1	2.8	0.3	1.2
Repo Rate	Rand	8.25	8.25	7.25	6.75	5.50	8.00
Prime	Rand	11.75	11.75	10.75	10.25	8.50	12.00
All Bond Index Yield	Rand	10.3	10.3	11.6	9.4	9.0	9.7
COMMODITIES							
Gold (\$/oz)	US\$	2,048.4	2,065.5	1,928.2	1,322.6	1,242.7	401.3
Platinum	US\$	924.0	1,006.0	1,004.0	821.0	1,382.0	837.0
Oil (Brent Crude) \$	US\$	81.9	77.7	85.1	62.3	107.1	29.7
INFLATION							
SA Inflation	%	5.1	5.5	6.9	4.0	5.9	9.4

data provided by FE Analytics

Fundhouse is a leading investment adviser specialising in fund research, ratings and portfolio construction services. We help clients manage investments on behalf of the end investor. Our experienced team understands the complexities of the fund management world. We apply this knowledge alongside a client first mindset to improve the outcome for the end investor.

Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.

Email: adviser@fundhouse.co.za | Web: www.fundhouse.co.za

FUNDHOUSE
investment clarity