GRAY ISSUE

17 January 2017
Issue no. 185

Keep calm and carry on investing

Adapted from the Chief Investment Officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2016.

The past 12 months seem to have passed particularly swiftly, maybe because fundamentally very little changed. Interestingly, the light in which investors view this unchanged reality is very different: the colour has changed from red to cool white.

A year ago investors were desperately seeking ways to take money offshore with the rand trading at R15.60/US$. The rand is now trading at R 13.60/US$ and this quest has gone quiet. This is counterintuitive: surely a dollar at R13.60 is a better investment than a dollar at R15.50 if the fundamentals are the same? The deficit on the current account is similar to a year ago, the fiscal position unchanged and, if anything, the probability of President Jacob Zuma leaving office early has lessened despite ever-more damning evidence of corruption and mismanagement in the ruling party. People have just chosen to worry about these issues a bit less. Maybe the level of concern is normal now and was too extreme in December 2015/January 2016.

A similar picture can be drawn in the commodity markets, where, against all expectations, prices for some industrial commodities have doubled or tripled over the last year. In fact, the risks to Chinese demand, which is basically the only thing that matters in the commodity world, have increased, with debt levels rising and the number of vacant Chinese apartments only growing.

The importance of a rational approach

The examples above indicate why it is so important to keep a level head and take a long-term approach when investing. A clear view of an asset's value allows the calm investor to make rational decisions, while others are panicking or getting over excited about current events.

A good illustration of this approach is our investment in Standard Bank, which my predecessor Ian Liddle discussed in the 2015 Annual Report. Ian noted that Standard Bank's share price had fallen from US$17 to US$6.40, a level that looked irrationally low and made for an exciting investment opportunity. Today the Standard Bank share price is US$11.20, 75% higher 12 months later (excluding the US$0.48 per share the company paid in dividends during 2016). Has Standard Bank's intrinsic value increased 75% in a year? No, it is probably unchanged over the period. This is why we were aggressive buyers at US$6.40 and are now reducing the position size given the much lower margin of safety to fair value.

Looking back on 2016

South African asset class returns were fairly muted in 2016, except for bonds – the All Bond Index returned 15.4%. These more moderate returns are what investors should expect after the spectacular returns of the past 20 years, driven by substantial earnings growth and a general rerating of South African assets. Unfortunately rerating can't continue indefinitely (well it can, to a degree, but these situations are commonly termed 'bubbles') so this tailwind had to stop sometime. Despite the past two years of moderate returns, our bottom-up research indicates that returns for South African markets will likely be modest over the medium term. Fortunately our Funds do not own the market but rather a specific group of assets that we think are undervalued.

Both the Allan Gray Equity and Balanced Funds managed to outperform their respective benchmarks in 2016. Unfortunately the Balanced and Stable Funds did not manage to grow our clients' investments in real terms, slightly underperforming inflation of 6.6%. What makes me positive for the future, particularly for our equity investments, is the 2016 relative outperformance came despite 7 of our top 10 equity holdings actually falling in price over the year. Our view of the intrinsic value of these underperforming investments is unchanged, or in some cases is slightly higher. This underperformance sows the seeds for future outperformance, as the differential between the share price and intrinsic value has increased. That said, our Funds did benefit from the move in the banking shares from a position of substantial undervaluation to one approaching fair value, something that won't be repeated in 2017.

The Orbis Funds had a great year, outperforming their various benchmarks and the team is excited about the opportunities they are finding to add further value.

Thank you for trusting us with your hard-earned savings. We will endeavour to protect and grow these investments as we have done historically. We cannot control the vagaries of the market, but we can control our decisions, and we will continue to make these decisions in a rational manner by following the same investment philosophy and process we have for the past 42 years.

Commentary by Andrew Lapping, chief investment officer, Allan Gray