Best direction for your investments in 2016

It may come as a surprise that, when viewed from a foreigner's perspective, the JSE All-share index has not increased in US dollar terms since October 2007. In rand terms, the prices of local equities more than doubled over this period.

It's also worth noting that since 2011 our local market has underperformed the world's developed markets, as measured by the MSCI World Index, by 119% as the rand depreciated from R6.61 to R14.20 per dollar. Given the rand weakness and superior performance by developed market equities, our clients regularly ask us whether they should take more money offshore.

At our client roadshow in early 2011, we advised clients to shift their portfolios towards developed market shares given the over-valued rand at the time and relatively attractive valuations of these markets. This was met with some reluctance given that South African shares had outperformed developed markets by more than 500% over the previous decade.

The superior economic growth prospects of emerging markets relative to the developed world were also emphasised, while many investors remembered the painful consequences of moving money offshore at the worst possible time after the rand collapsed in 2001. Recent experiences and performances influence investor sentiment, but our investment philosophy takes us back to valuation/price as the primary consideration for investment decisions, while taking account of the prevailing trends and perspectives in the market.

In line with what we have advocated since 2011, our asset allocation portfolios have invested the maximum weight in offshore markets that prudential legislation allows. In our equity selection, we have tilted our portfolios towards 'rand-hedge' companies that derive the majority of their earnings offshore and away from so-called SA Inc companies whose fortunes depend on the domestic economy. This has benefited portfolio performance, but we continuously reassess our positioning.

The table below shows the past five years' share performance and current valuation of five well-run rand hedge companies versus five well-run SA Inc companies listed on the JSE.

SA Inc.	5-yr return p.a. including dividends	1-yr forward P/E		Rand hedge	5-yr return p.a. including dividends	1-yr forward P/E
Imperial	14%	9.1		Mediclinic	40%	21.4
Nedbank	17%	8.8		British American Tobacco	32%	17.6
Liberty Holdings	19%	8.5		SAB Miller	33%	25.7
Foschini Group	16%	12.0		Richemont	30%	17.8
Vodacom	25%	15.6		Mondi plc	46%	14.8
JSE All Share Index	16%					

The SA Inc basket has underperformed over the past five years and is now trading on lower valuations in comparison to the rand hedge basket. On a price-to-future-expected-earnings-ratio, the valuation premium on rand hedge companies is even higher if a stronger rand in line with its purchasing power parity (PPP) is assumed. The SA Inc basket is therefore expected to outperform should we move into a stronger rand environment.

It is notoriously difficult to predict shorter-term movements in the rand. In the longer term, PPP has been a good measure of the fair value of the currency and on this estimate the rand is very over-sold. However, the rand can for long periods move in the opposite direction as suggested by PPP and we ask ourselves how the perspective must change before the rand makes a U-turn towards its fair value.

SA has relied on portfolio inflows to finance its current account deficit, which makes the rand vulnerable when investor sentiment turns negative towards SA or emerging markets in general. Emerging markets have until recent years shown superior growth prospects, but the slowdown in China and resulting collapse in commodity prices have negatively impacted economic growth rates in certain prominent emerging markets, especially the commodity exporters.
Strong economic recovery in the US and expected rate tightening by the Fed has further contributed to capital outflows from emerging markets and a strong dollar. So while emerging market assets and currencies look cheap, the reversal of capital flows will require emerging markets to return to superior economic growth rates and require real interest rates to rise relative to developed markets to reverse capital flows.
However, an oversupplied commodity market may lead to lower-for-longer commodity prices while the Fed is yet to embark on its interest rate hike cycle. This leads us to conclude that it is too early to fundamentally change our portfolio positioning yet and retain our overweight offshore assets and rand hedge shares.

We are always mindful of not trying to be ‘too clever’ with regards to the timing of a fundamental change in our portfolio positioning. However, despite value arguments from a currency perspective in particular, the logical arguments still stack up against the imminent reversal of our call to invest offshore. We may well change this stance when we revisit this view in the near future.

Written by: Renier de Bruyn
Source:Fin24