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Q1 | 2015

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introduction

The first quarter of 2015 has been witness to a number of firsts which are a reminder to us of the distortions which exist in global financial markets. The lacklustre economic growth outlook in Europe has continued to drive global interest rates lower. Switzerland became the first government in history to sell benchmark 10-year debt at negative interest rates. Low interest rates continue to drive equity valuations to new highs and South Africa is no exception. The 1yr-Fwd PE ratio is now approaching 17x, significantly above the 10-yr average of 11.5x. Another interesting event is the Nasdaq's return to the 5000 level for the first time since its prior peak in March 2000. If you had followed the crowd and invested in technology stocks in 2000, fifteen years later your money would still not have kept up with inflation. This is the risk associated with overpaying for the promise of future growth which never materialises.

It's against this backdrop that it helps to try and understand what we are trying to do as investors. In simple terms, our objective is to invest in companies at below intrinsic value. That is to get R1 worth of value for 85c or less. These opportunities tend to arise at the time of maximum pessimism or neglect. As history illustrates above, to make extraordinary returns requires one to behave differently to the crowd.

Two sectors of the local economy that are currently going through an extremely challenging time are the resources and construction industries. In 2007, the valuation of companies in either of these two industries was at extremely elevated levels and an investment at this time would have translated into a permanent loss of capital. In much the same way today, the valuations of internet/ecommerce companies are looking very stretched (trading at over 50x 1yr Fwd PE[1]).

In our first article, "The Inefficient Market Hypothesis (IMH): profiteering from irrational market behaviour", Claude elaborates on why markets are in fact inefficient and how these inefficiencies have over the course of history provided regular investment opportunities to value managers.

We have often discussed the importance of the capital allocation decision which executives are responsible for. In the second article, "Not all capital allocation decisions were created equal", Joachim discusses the key factors that have an influence on those decisions: flexibility, sustainability and time horizon.

Our focus is on maximising the probability of outperforming the market without increasing the risk of a permanent loss of capital. This risk is highest when following the crowd and investing in so called "glamour stocks" at the time of maximum optimism. We believe our disciplined, long term and sometimes contrarian approach allows us to add value via stock selection.

Enjoy the read!

The SIM Unconstrained Capital Team

[1]Based on an index of the 10 largest ecommerce companies

The FTSE/JSE All Share Index (ALSI) delivered a positive return of 5.8% during the first quarter of 2015. The returns certainly did not come in a straight line and markets were quite volatile and mainly driven on news flow about Europe's Quantitative Easing and speculation around the timing of interest rate hikes in the US. Once again we saw our market hitting an all-time high on 24 February when the ALSI traded at 53,374 points.

The best performing sectors during the quarter were Household Goods (+28.0%),Technology (+25.9%) and Media (+23.3%). The worst performing sectors during the quarter were Platinum (-14.8%) and Energy (-9.2%).

In South Africa the Monetary Policy Committee (MPC) kept rates on hold during the quarter, but a more hawkish statement was issued at their last meeting. Eskom was downgraded to BB+ (from BBB-) by Standard & Poor and they kept Eskom's rating on negative outlook. We continued to see strong offshore inflows into our equity market with net inflows of close to R10bn during the quarter. The strong dollar resulted in the rand depreciating by 4.6% against the dollar, whilst appreciating against the euro by 7.5% during the quarter.

Comments by the Federal Open Market Committee (FOMC) on the US economy sparked speculation that a rate hike was imminent, although the timing of a hike was still uncertain. It could, however, be as early as June this year. The reverse was true for China as a slowing economy led the People's Bank of China (PBOC) to cut interest rates by 25 basis points to 2.5% (one year benchmark deposit rate). European Central Bank (ECB) President Mario Draghi announced a quantitative easing programme worth at least €1.1trn in January to counter the threat of a deflationary spiral. The ECB pledged to purchase €60bn per month through to September 2016, having started in March 2015.

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Portfolio

Although we believe that the market is now expensive at the aggregate level, there remains a distinct difference between the segment of the market that is particularly expensive and certain stocks that remain attractively valued. This allows us to gradually increase our holdings in the more attractive segment of the market where the margin of safety is the greatest. The global macro uncertainty, in particular the recent poor macro data coming out of China, has led to further weakness in commodity prices. Commodity stocks have come under further pressure. We have a small exposure to the platinum sector (in total approximately 5%) and continue to add gradually to Amplats and Implats. We added to our holdings in Anglo American over the quarter.

Although the weakness in resources detracted slightly from performance over the quarter, this was more than offset by strong performances from our largest portfolio holdings. Steinhoff rose 28% over the quarter, while Old Mutual rose by 16.1%. In addition, our two clothing retail holdings, Foschini and Truworths rose by 35.5% and 17.4% respectively. Our purchase of Standard Bank in the fourth quarter of 2014 proved to be a great addition to the portfolio. The share price rose by 17.1% in the first quarter of 2015. We own approximately 6% in the portfolio.

Outlook

On the local front, economic growth remains subdued. The South African Reserve Bank has revised their inflation projections upwards to 4.8% and 5.9% in 2015 and 2016 respectively, whilst its growth outlook for 2015 was left unchanged at 2.2% and its growth outlook for 2016 was lowered marginally to 2.3% (from 2.4%).

In the US, nonfarm payrolls continued to rise with the economy adding more than 550k jobs in January and February. This, together with stronger consumer spending, should bode well for the continued recovery in the US economy. In Europe, the impact of quantitative easing should also be positive for growth. We have already seen the ECB raise its GDP growth estimates to 1.5% for 2015 and 1.9% for 2016. Moving to the East we expect to see further policy easing in China as its growth continues to come under pressure.

We believe that the gradual recovery in global economies, together with a more normalised interest rate environment (we expect higher interest rates globally over time) will lead to more rational capital allocation. This will support our value approach to investments and our current portfolio positioning.

The Inefficient Market Hypothesis (IMH): profiteering from irrational market behaviour

So, we don't think we're about to win a Nobel prize for our brief analysis below on why we believe markets are inefficient, but then again, we won't bore you with too many detailed mathematical formulas to prove a point. Instead we'll employ a few simple real life examples.

Much has been written in the market about the Efficient Market Hypothesis (EMH) and there have been many critics of this hypothesis. Since there is sufficient evidence to refute the EMH globally, I will focus on specific facts in the SA market that refute EMH and support, the "Inefficient Market Hypothesis".

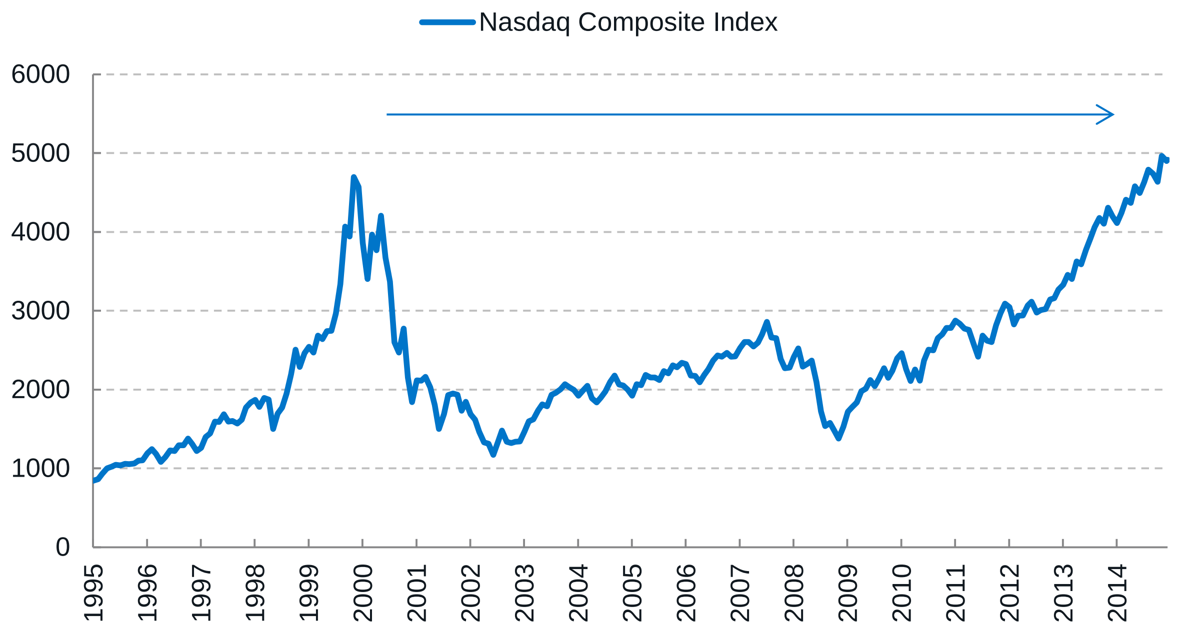
Let's first look at the definition of the EMH:

The Efficient Market Hypothesis (EMH) states that it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. According to the EMH, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks at inflated prices. As such, it should be impossible to outperform the overall market through expert stock selection or market timing, and the only way an investor can possibly obtain higher returns is by purchasing riskier investments.

The following are the main assumptions for a market to be efficient:

- A large number of investors analyze and value securities for profit.
- New information comes to the market independently from other news and in a random fashion.
- Stock prices adjust quickly to new information.
- Stock prices reflect all available information.

The primary evidence against EMH is the existence of bubbles. I won't go into any detailed analysis of past bubbles. The technology bubble (refer to the chart below), the commodities bubble leading up to 2008 and the more recent Global Financial Crisis (from late 2008 and counting…) are fresh enough in our memories.



Source: Factset (31 March 2015)

The Inefficient Market Hypothesis (IMH): profiteering from irrational market behaviour

From its peak in February 2000, it has taken almost 15 years for the Nasdaq Composite Index to reach the same level in nominal terms!

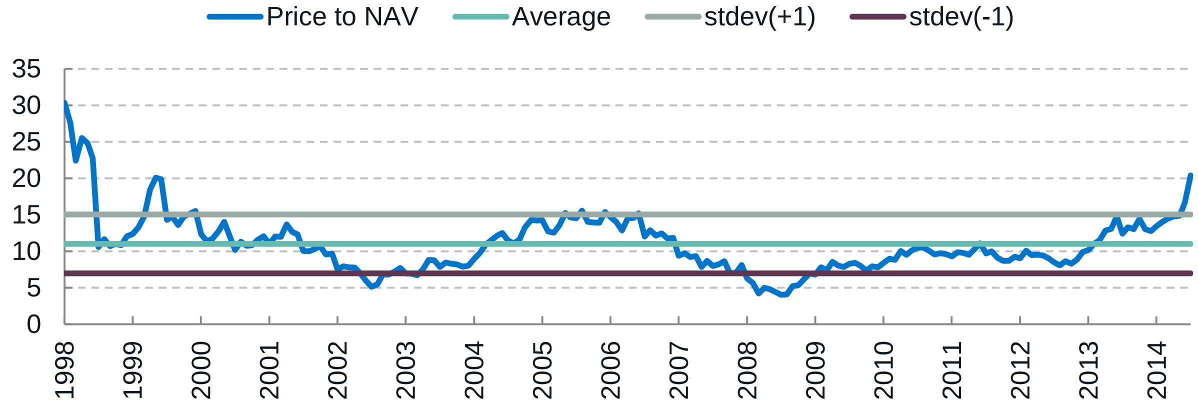
Even Eugene Fama, the "father of EMH" is perhaps recognising that markets may be less efficient over longer periods. The Nobel Prize in Economics was awarded to Eugene F. Fama, Lars Peter Hansen and Robert J. Shiller in 2013 "for their empirical analysis of asset prices". The official press release of the Royal Swedish Academy of Sciences was entitled: *Trendspotting in asset markets* and stated "there is no way to predict the price of stocks and bonds over the next few days or weeks. But it is quite possible to foresee the broad course of these prices over longer periods, such as the next three to five years".[1]

Stock prices may incorporate short-term information (facts) that will lead to a short-term adjustment to the share price to reflect either good or bad news, but this certainly does not mean that it reflects all relevant information and hence trade at fair value.

By definition, if a stock is trading at fair value at all times then it should increase (over time) in line with its "required return"[2] and its long-term growth expectations. If the market was efficient, then it would be well aware of its long-term growth prospects and the risk inherent in the stock (and hence the required return). You should not have a situation where a stock price falls by 50% or rises by 185% in the space of a few months (as Capitec has done over the past 13 months). Capitec is one example of a company that illustrates that the market is inefficient with a large number of irrational investors driven by fear and greed. In this case, fear was the cause of a massive mispricing in the market (at the peak of the ABIL debacle) and now greed is probably resulting in an overvaluation as we speak.

Let's take another local example. Why is it that Steinhoff was trading at a P/E ratio of 7.7 on 24 May 2013, yet at the end of Q1 2015 it was trading at a one-year forward P/E ratio of 17 – a mere 22 months later? An investment in Steinhoff over this period would've provided an investor with a handsome 92% annualised return. Why is it that the "efficient market" is now willing to pay so much more for Steinhoff's earnings? The simple answer: the market is inefficient! Incidentally, Steinhoff is the largest holding in our portfolio and has contributed handsomely to the portfolios returns.

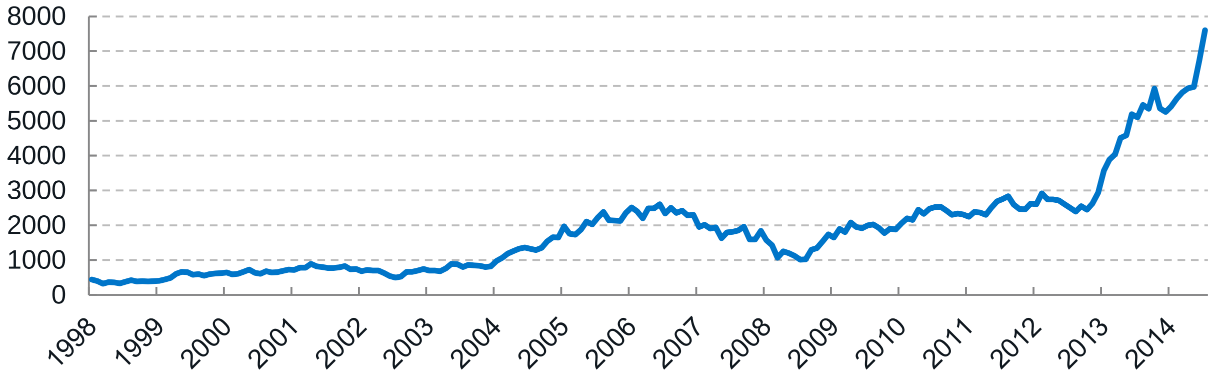
Steinhoff Price to Earnings ratio



Source: I-net (31 March 2015)

[1] Official press release on the 14th October 2013 for The Prize in Economic Sciences 2013
[2] Required return = Risk free rate + equity risk premium

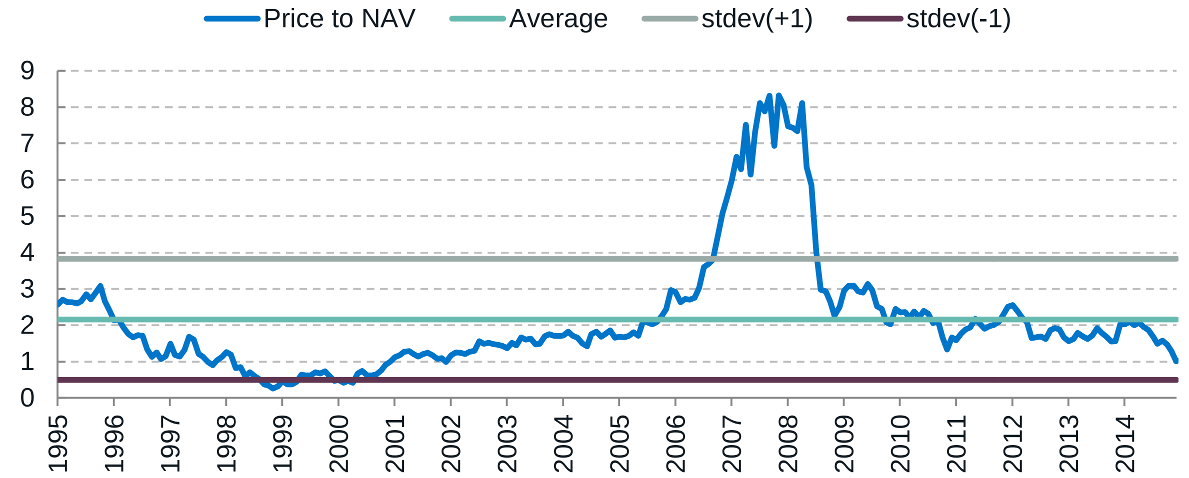
Steinhoff share price



Source: I-net (31 March 2015)

Let's turn to a few more companies that have, at times, been grossly overvalued by the market. We can take a closer look at the construction sector. Murray & Roberts (MUR) is a case in point. What rational investor would've paid 10400 cps on 31 August 2008 for MUR? A P/E ratio of 30 times for a construction company at the peak of the construction cycle? On a Price to NAV of 8 times (refer to the chart below), for a company that has barely covered its cost of capital historically, the share price was grossly overvalued for an extended period of time. The current share price is 87% down from its peak and is now trading on a Price to NAV of 0.9 times. Theoretically, a company that is able to generate a return on equity in line with its weighted average cost of capital of, for example, 14% and is able to grow at a rate of 7% in the long term, should trade at no more than its book value.[3] This is a far more realistic valuation. Once again, the market was driven by greed in the lead up to the infrastructure boom in SA in 2008 and is now driven by fear.

Murray & Roberts price to NAV



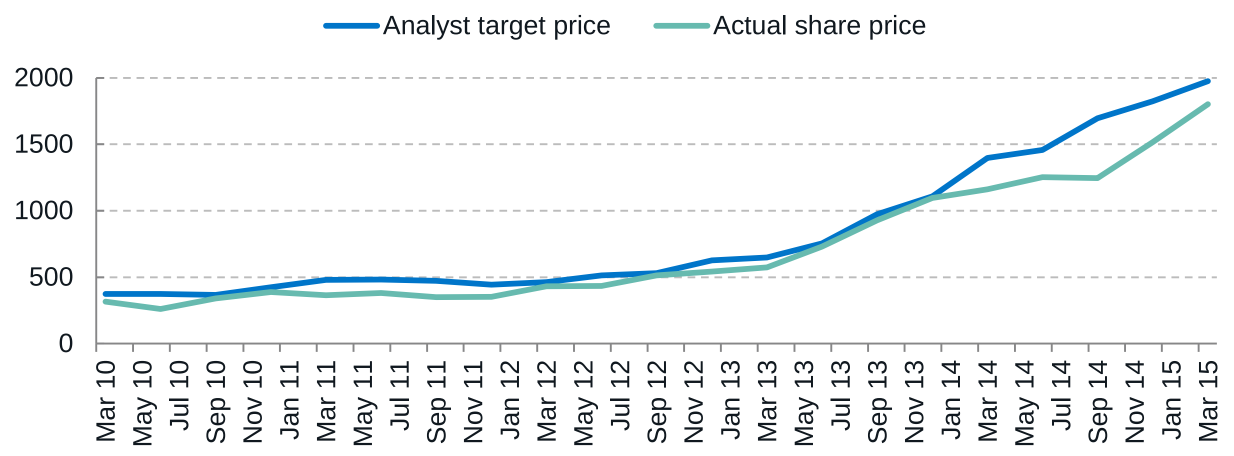
Source: Factset (31 March 2015)

[3] Price to Book = (ROE-g)/(k-g), where ROE = return on equity, g = long-term growth and k = required return (WACC).

The Inefficient Market Hypothesis (IMH): profiteering from irrational market behaviour

What about Naspers? It's up 60 % over the past 12 months. If the market was efficient then you would expect analysts' fair value of Naspers to be consistent (it should only increase in line with its required return and growth expectations over time). Yet, referring to the graph below, analysts' fair values have increased in line with the share price increase. This tells you that the market is inefficient and is finding it difficult to value as we see the "herd effect" of analysts moving their target prices to the actual price. This in itself should ring warning bells.

Naspers analysts' (consensus) target price vs actual share price



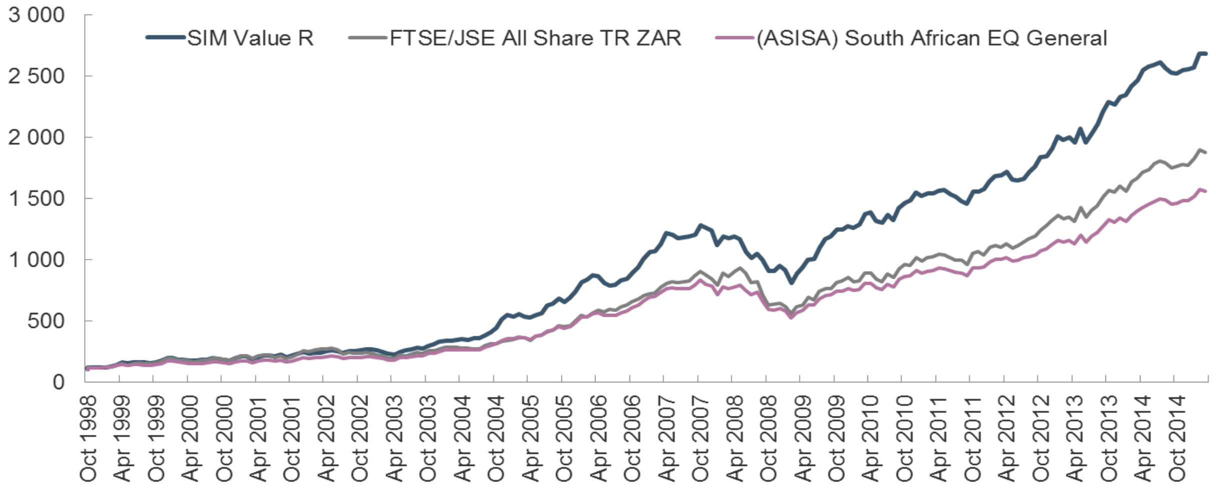
Source: Factset (31 March 2015)

In conclusion, it is undoubtedly difficult to beat the market. There will be periods where "rational investors" will outperform the market and periods where they will underperform the market. In the short term the market is a voting machine. It is driven by fear and greed with few rational investors and many irrational investors.

However, over time, the rational investor with sound investment principles is likely to capitalise on these inefficiencies and outperform. We have managed to achieve this *over time* (refer to the chart below) but outperformance does not come in a straight line. Beating the market is not about forecasting asset prices, cash flows and earnings; it is about exploiting irrational market behaviour and having the patience to exploit such behaviour over time.

The Inefficient Market Hypothesis (IMH): profiteering from irrational market behaviour

SIM Value Fund performance vs median SA general equity unit trust vs FTSE/JSE All Share Index



Source: Morningstar (31 March 2015)

An investment in the SIM Value Fund since inception would have provided the investor a gross return of 23.6% each year relative to an investment in the FTSE/ JSE All Share Index that would generated a return of 18.3%. This demonstrates the ability to exploit market inefficiencies over time.

Article: Claude van Cuyck

Not all capital allocation decisions were created equal

When it comes to investing, most individuals focus on generating the highest possible return on each available Rand. We are faced with many different options and to make the best possible choice one should weigh each outcome by its probability and rank them accordingly. In this newsletter we have often written about the capital allocation decision which executives are faced with and in this article we discuss the key factors that have an influence on those decisions: flexibility, sustainability and time horizon.

Flexibility improves the chances of success

We are faced with different choices on a daily basis and we would like to have the flexibility to choose whichever option looks most appealing. However CEO's do not have the same degree of flexibility. Take platinum companies as an example; they are very capital intensive, have a high fixed cost infrastructure and need to constantly replace depleting ounces with less favourable economics. Capital is allocated in large amounts at a time, with a payoff that spans many years and a significant amount of uncertainty around the future prices at which the metal will be sold. When times get tough as they have been for the past few years, flexibility is severely constrained (it's a very hard decision to close a mine) as companies focus on cash preservation. This compares to a business like AVI (which produces branded consumer products such as Bakers Biscuits, Five Roses and Freshpak) which is faced with an easier decision when allocating capital. Capital is allocated in smaller amounts to factories that can be strategically positioned in terms of proximity to markets or raw materials. The incremental cash flows and shorter payback allows for flexibility in capital allocation. The risks associated with wrong decisions are not as enduring and can be more easily corrected, i.e. factories can be closed or relocated. It is able to expand incrementally as capacity is filled and demand grows. Given the lower capital intensity, cash can be returned more frequently to shareholders.

How sustainable are the returns on each Rand invested?

When capital is allocated in the platinum industry it is usually done taking into account unit cost forecasts relative to industry peers. However as time passes and the industry invests, those initial relative cost projections change and may become less attractive than initially forecast. New capital needs to be allocated on a frequent basis to remain competitive, which reduces the sustainable returns relative to a branded business. It also reduces the cash flows available for alternative projects and for shareholders.

On the other hand, each Rand AVI invests in marketing, improving product quality or range and distribution contributes to strengthening the sustainability of its brands while at the same time widening its economic moat. The improvement in the company's positioning further strengthens its negotiating power with suppliers and its ability to price products at a premium. This reinforcing loop translates into higher cash flows that can be allocated to further strengthen the business. Not unlike a good education it can never be taken away from you – but you need to maintain and protect it.

Not all capital allocation decisions were created equal

Timing is everything

Many ounces in the platinum industry are currently mined from underground operations. These operations deepen over time and the shafts that are required to reach the ore bodies are getting more expensive. New shafts cost in excess of R10bn and will take some 10 years to reach full production. The uncertainty surrounding the likely price of the metal, future costs of extracting the ore and possible unfavourable ground conditions add to the complexity of these decisions. To make matters worse, the management team who made the original decision will be long gone before the mine actually comes into operation. The future management team will blame underperformance on prior decisions and be forced to devise a new strategy which they too will probably not see through. Due to the long-dated nature of mining projects and the relatively short term of service by company executives, it is critical to have a strong corporate culture running throughout the business to ensure adequate continuity and execution of long-term strategies; otherwise it could turn into a value destructive popularity contest.

Conversely, the life of a brand takes a form of its own and it is up to the management team to protect and grow the brand. Capital allocation decisions within a branded business tend to have a shorter payback and can be relatively quickly identified as good or bad decisions. In addition, the pricing power allows the passing on of cost pressures with relative ease and removes some of the unpredictability associated with longer-dated mining projects. In summary, increased predictability of project outcomes allows for easier ranking and decision-making in a branded food business as compared to a long dated mining project. This is illustrated in the example below:

The impact of flexibility, sustainability and timing over time (2005-2014)

	Plats	AVI
NOPLAT[1] increase 2005-2014	-71%	267%
Cumulative Capex - R'm	149 730	3 616
Cumulative FCF[2]	45 513	5 531
FCF % of NOPLAT (Cumulative)	40%	80%
Cumulative capital returned[3]	35 353	4 853
% of cumulative FCF	78%	88%
Market Value in 2005 R'm	135 500	5 000
Capital returned % of starting Market Value	26%	97%

The three biggest players in the platinum industry spent almost R150bn of capital over the period 2005-2014, yet volumes have gone backwards and they have little to show in terms of increased profits. Of the cumulative NOPLAT that was generated over this period only 40% was converted to Free Cash Flow (FCF), of which 78% was returned to shareholders.

[1]NOPLAT (Net Operating Profit Less Adjusted Taxes)
[2]FCF (Free Cash Flow)
[3]Cumulative capital returned over the period 2005-2014 in the form of dividends plus buy backs less share issues

Not all capital allocation decisions were created equal

AVI spent R3.6 billion over this period and almost quadrupled profits. 80% of the cumulative profits that were generated were converted to FCF and almost 90% of that was returned to shareholders. Nearly 100% of an investor's original investment 10 years ago was returned to shareholders in the form of dividends or buy-backs.

The abundance or lack of FCF available to shareholders due to flexibility, sustainability and time horizons can make significant differences to investor returns over time. The above factors cannot always be measured at the point of investment.

In the same way that executives allocate capital on behalf of shareholders, our job is to identify and rank the best possible investment opportunities based on the upside potential versus the downside risk and the probability of the respective outcomes. We are, however, fortunate not to be bound to a specific industry. This gives us the flexibility to allocate your capital to generate sustainable long-term outperformance.

Article: Joachim Kotze

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