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Q2 | 2015

# contents

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# introduction



To those who were fortunate to take a mid-year break, welcome back and we trust that you are ready for the second half of what has been an exciting and yet volatile first half of 2015!

The FTSE/JSE All Share Index (ALSI) once again reached a new record high on 24 April, touching 55188 points. In April alone we saw the ALSI edge higher by 4.7% for the month. This was, however, short-lived as markets around the world declined in June on the back a possible ‘Grexit’, ultimately resulting in Mr Market taking back all of the performance he gave during the month of April.

In this edition of Cognitio Ricco, in his article “The return to Value”, set out to investigate the performance of value and growth investing styles given the current extreme market valuations with the aim to contrast the fortunes of growth and value investors when price earnings multiples are contracting based on past cycles.

Enjoy the read!

The SIM Unconstrained Capital Team

The FTSE/JSE All Share Index (ALSI) once again reached a new record high on 24 April, touching 55188 points. In April alone we saw the ALSI edge higher by 4.7% for the month. This was, however, short-lived as markets around the world declined on the back of Greece's prime-minister Alexis Tsipras calling for a national referendum (July 5) to determine whether or not Greece would accept the Troika's (IMF, ECB and European Central Commission) demands for yet another bailout.

Prior to printing our newsletter (July 6) a 'No vote' result was obtained from the referendum. This is clearly unchartered territory for the Eurozone and we will most probably continue to see volatility ahead. One thing is certain, whether substantial debts are written off, or whether a new, devalued Drachma is reintroduced or even if Greece takes a 'holiday' from the Eurozone, economic instability will not end anytime soon. Tspiras clearly wants a deal with the Troika, but his biggest resistance would probably come from his Southern European counterparts, such as Spain, Portugal and Italy, who would perhaps feel they have not been fairly treated.

It was ultimately the Greek woes, along with growth concerns in China that have resulted in our market (ALSI) ending down over 6% from its April peak and flat for the quarter.

The best performing sectors during the quarter were Support Services (+11.7%), General Financials (+11.5%) and Mobile Telecoms (+11%). The worst performing sectors were Gold Miners (-16.8%) and Industrial Metals (-13.7%).

Also noteworthy was the rejection of Eskom's application for an additional 12.6% electricity tariff hike by the National Energy Regulator of SA (Nersa). This would definitely provide some relief towards an encroaching interest rate hike and although not fully avoiding it, it could potentially reduce the extent of an imminent increase.

**Portfolio**

All our equity portfolios outperformed their benchmarks during the quarter. During the second quarter we saw some of the construction stocks in the portfolio recover somewhat with shares like Stefanutti and Group Five providing returns of 24% and 13% respectively and adding to the overall attribution of the funds.

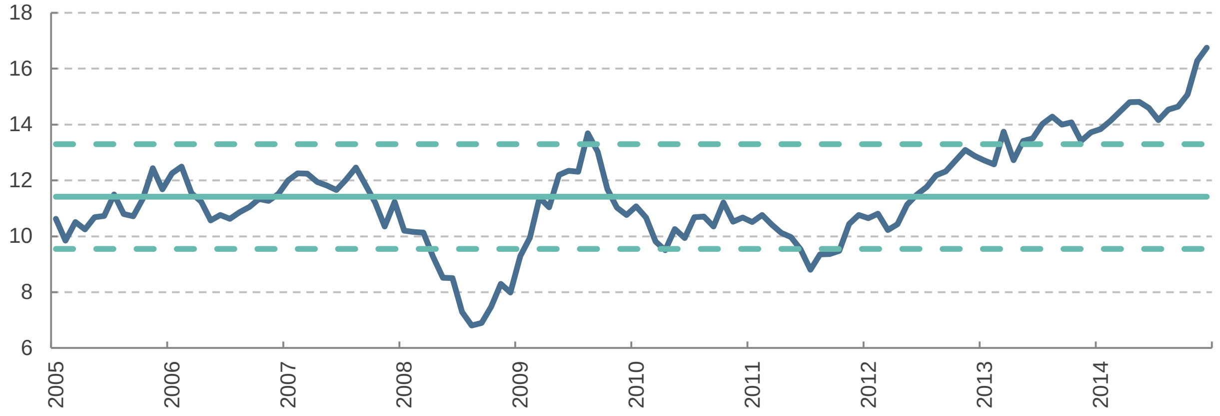
Other stocks that contributed to overall relative outperformance were Hudaco, Investec and newcomer Choppies. Our investments in Sun International, Allied Electronics and Foschini detracted value during the quarter.

The portfolio continues to be overweight in financials, with a relatively neutral exposure to resources compared to the market and a strong underweight in industrials. We currently have no exposure to expensive industrial shares, such as Naspers, Richemont, SABMiller and Aspen, as we see better opportunities elsewhere.

**Outlook**

On a 17x Price to Earnings ratio the South African market is not cheap, relative to both its own history and other global equity markets.

FTSE/JSE All Share Index Historical PE Ratio




We still believe that there are a handful of stocks which are contributing to the overvaluation of the market, including Naspers, SABMiller, Aspen and British American Tobacco.

The resources sector has delivered very poor returns over the last decade and offers some interesting opportunities with both commodity and share prices approaching levels last seen in the 2009 Global Financial Crisis. We will remain vigilant in selectively allocating capital to these stocks, as a greater margin of safety is required when the distribution of likely outcomes is very uncertain.

We expect the interest rate cycle to normalise as the market (Forward Rate Agreements) is already pricing in an approximately 150 basis point increase in interest rates over the next two years. Looking back in time, PE multiples normally contract in an environment of higher interest rates. Since 1960, ALSI PE multiples have contracted on average 22% during periods of rising interest rates. [1]This will place pressure on equity market returns in an environment where corporate profit growth remains depressed. On the positive side, however, our approach of investing in companies which are cheaper than the market should perform better when interest rates are rising and PE multiples are contracting.[2]

In summary,

- The global economic backdrop remains unsupportive of commodity prices in the short term, which is placing pressure on mining profitability. We have a preference for platinum stocks and companies which will benefit from significant self-help initiatives, such as Anglo American. The short-term future, however, will remain challenging.
- Industrial earnings will be supported by continued weakness in the currency, and a benign consumer environment, but stocks are generally expensive. We have a significant underweight position to industrial stocks due to these very high valuations.
- Financial earnings will probably continue to grow in the teens, and current valuation levels do not appear to be excessive. We hold large positions in banks and Old Mutual.

[1] Sbg Securities, 11 June 2015
[2] Please refer to the article "the return to Value" in this edition of Cognitio

By Ricco Friedrich & Khuthadzo Masindi

One of the most common investment errors that hurts returns is forecasting the future by extrapolating the most recent past, without reference to the longer-term cycles or norms. This point is well made by David Dreman's quote, "Market history provides a continuous example of our adherence to the belief that deviations from the norm are, in fact, the new norm."

This is particularly true today of the current loss of faith in the value approach to investing in South Africa. Value investing has underperformed the market for almost five years. The most recent period of underperformance has coincided with a significant expansion of price to earnings (PE) multiples. Since 2012, the PE multiple of the FTSE/JSE All Share Index (ALSI) has expanded by well over 50% from little over 12x to 18x, fuelled by lower local and global interest rates, which cannot last indefinitely.

This makes it the 10th highest month-end PE since 1997. The only other periods with a PE higher than this were this year (end of February, March and April) and during the dot com bubble. Share and market ratings are mean reverting and periods of above-average or high PE ratios normally precede poor investment performance. This applies to the many overvalued industrial companies which have contributed to the higher PE multiples of the ALSI relative to its long-term average. We do not believe there is any fundamental reason for a permanent re-rating of these stocks or the market.

There is a strong relationship between interest rates and the market. Rising rates are bad and falling rates are good for the market. The forward curves are currently pricing in a 160 basis point increase in interest rates over the next 21 months (i.e. roughly six increases of 25 basis points each). From this point on, the prospects of a broad multiple expansion seem low. Without broad multiple expansion, stock selection will be key with a preference for active over passive investing.

*"Nothing could be more useful, than to be diffident when others exalt, and with a secret joy buy when others think it in their interest to sell." ~ Sir Richard Steele, c 1700*

We set out to investigate the performance of value and growth investing styles given the current extreme market valuations. Our approach to the value vs growth debate is not novel, as many similar studies have been carried out before, but we believe that current market valuations warrant the discussion. We aim to contrast the fortunes of growth and value investors when price earnings multiples are contracting based on past cycles.

We have used the MSCI Value Index SA and the MSCI Growth Index SA as a proxy for a portfolio constructed from stocks that meet the value criteria and the growth criteria respectively. Periods where the market PE is contracting are highlighted in the chart below. Over the past twenty years there have been five major cycles when value outperformed growth. In each of these periods, the outperformance coincided with contracting market PE multiples. In other words, the drawdown of value stocks is lower.[3] The opposite is also true. In all instances when the ALSI PE expanded, the MSCI Value Index underperformed its growth counterpart.[4]

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[3] CSS, 22 October 2007, The Substance of Style, The relative performance of value and growth strategies in South Africa
[4] This is consistent with several studies which conclude that growth stocks tend to outperform value stocks in times of stock market bubbles. Ibottson Associates Inc, 1928-2005.

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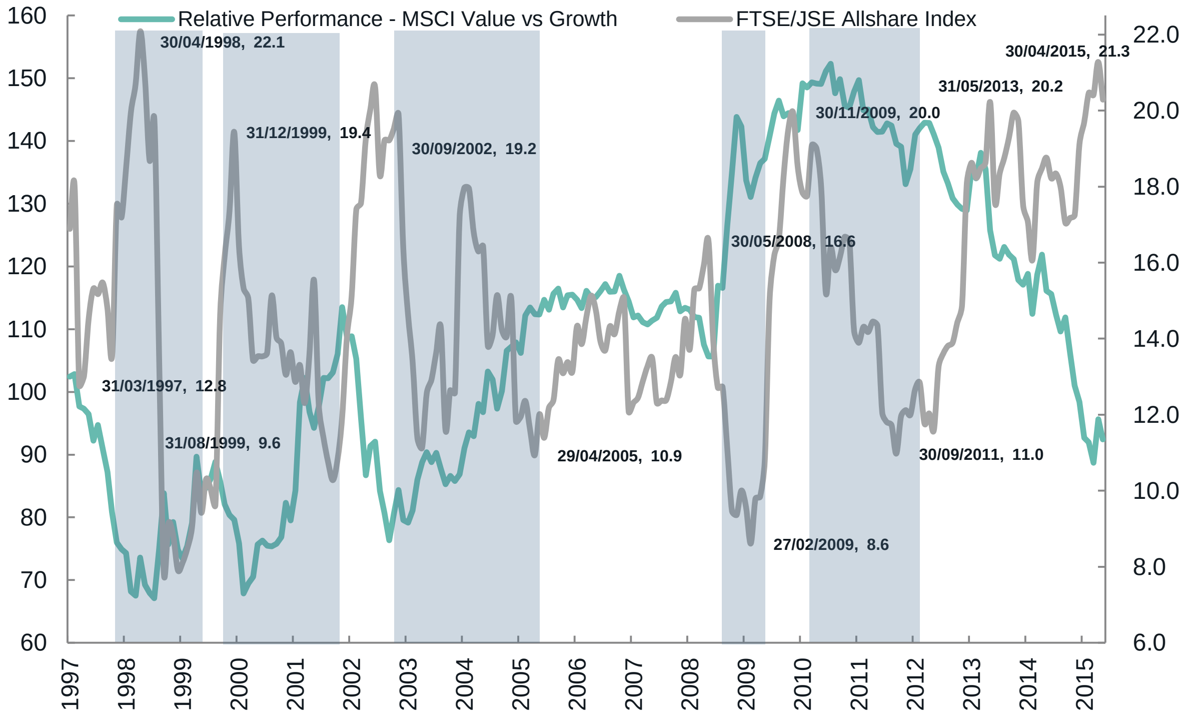
### ALSI PE multiple (grey) and MSCI Value vs MSCI Growth performance (green)




The table below highlights the magnitude of the relative difference in performance from the chart above between value and growth in South Africa when the ALSI PE is rising and falling.

| Contraction – Value Outperforms | | | | |
|---|---|---|---|---|
| Start | End | ALSI PE at Start | ALSI PE at End | Relative performance |
| Apr 1998 | Aug 1999 | 20 | 9 | 15% |
| Dec 1999 | Nov 2001 | 18 | 10 | 38% |
| Sep 2002 | Apr 2005 | 13 | 10 | 48% |
| May 2008 | Feb 2009 | 15 | 7 | 14% |
| Nov 2009 | Sep 2011 | 13 | 11 | -3% |
| **Average** | | **16** | **10** | **23%** |

| Expansion – Value Underperforms | | | | |
|---|---|---|---|---|
| Start | End | ALSI PE at Start | ALSI PE at End | Relative performance |
| Mar 1997 | Apr 1998 | 12 | 20 | -32% |
| Aug 1999 | Dec 1999 | 9 | 18 | -14% |
| Nov 2001 | Sep 2002 | 10 | 13 | -40% |
| Apr 2005 | May 2008 | 10 | 15 | -14% |
| Feb 2009 | Nov 2009 | 7 | 13 | 12% |
| Sep 2011 | Apr 2015 | 11 | 19 | -69% |
| **Average** | | **10** | **16** | **-26%** |

When PE multiples expanded, the MSCI Value Index underperformed the MSCI Growth Index by 26%. Since September 2011, the ALSI PE has expanded from 11x to around 18x. Over this period Value underperformed the MSCI Growth Index by a significant 69%. On average, when PE multiples fell, the MSCI Value Index outperformed the MSCI Growth Index by 23%. As night follows day, periods of lower PE multiples seem to follow periods of above-average PE multiples. As we have seen in the past, this will support the outperformance of Value vs Growth.

“Many shall be restored that are now fallen and many shall fall that are now in honour.” ~ Horace
Given the currently elevated valuation levels of the market, and the high probability that interest rates are on the rise, it is unlikely that PE multiples will rise from the current elevated levels. Mathematically, there are two factors which could cause PE multiples to fall.

Prices decline. There could be several factors that could contribute to falling prices. Overpriced growth expectations, higher interest rates or a shock, such as Greece exiting the Eurozone, would fall into the former group. Value investing tends to pick stocks with low expectations. Therefore when markets correct, it’s the overpriced stocks with high implied growth expectations that tend to fall the most.

Earnings growth improves faster than prices, resulting in PE multiples contracting. In an environment where growth is scarce, growth stocks tend to trade at substantial premiums to the rest of the market. As growth improves, the desire for investors to own these expensive growth stocks when the choices have broadened diminishes, which results in the subsequent underperformance of growth companies.

In either case an allocation to a value-based approach, such as ours, offers a “free option” on the likely mean reversion of the extremely elevated market valuations.

In conclusion, value investing is currently being judged by the pain that investors have experienced by performances that have lagged market returns (or in some extreme instances resulted in losses). The sharp emotions associated with these recent experiences, without consideration of long-term cycles, may negatively affect decision-makers with a long-term investment approach.

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