Sanlam Investments

SIM Global Market review

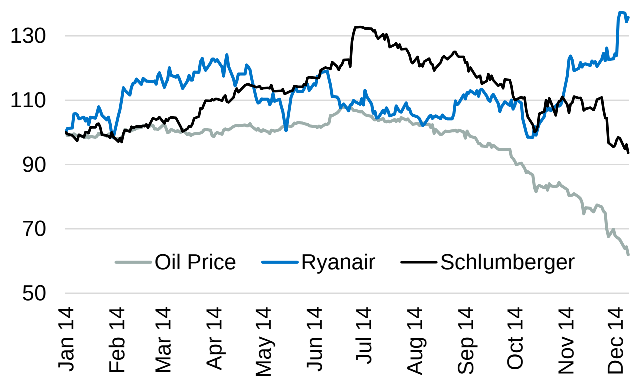
Issue 12 | December 2014

2014, a difficult year

A report by Goldman Sachs (“Mutual Fundamentals”, 8 Dec 2014) shows that 85% of large cap funds have underperformed the S&P500 this year (the highest % since 1997), testimony to the large number of unexpected outcomes during the year.

Graph 1 shows the bipolar outcome had you been invested in Ryanair or Schlumberger. (It is interesting how the falling oil price was largely ignored by the market until it realised the oil price could go below $80).

Graph 1: Oil price, Ryan air share price, Schlumberger share price (in USD)



Source: Bloomberg (priced in USD)

Bank shares also gave widely divergent returns this year. Table 1 shows the local currency and USD returns from 1 January till 10 December 2014:

Table 1: Share price movements 1 Jan to 10 Dec 14

	local currency	US$
US Bank Index		9.6%
Finance Index Indonesia	34.0%	32%
Bank Index (Thailand)	33.0%	33%
BSE Bank Index (India)	62.0%	61%
Sberbank (UK)	-31.0%	-58%
Greek Bank Index	-42.0%	-48%

Notes: The amazing 30%+ return of the three Asian indices despite widely diverging fundamentals (Thailand had a military coup and is facing a rapidly deteriorating economy whilst India and Indonesia have had positive election outcomes with in India’s case leading to 2015 GDP growth forecasts being upgraded)

Had you invested only in Asian banks with a smattering of US Banks you would have generated excellent returns (*Why, Oh, why was I invested in Sberbank? – we’ll come back to that later).* The table and graph above demonstrate the role country and industry selection played in 2014. India or airlines: your investors are smiling; but Russia and oil companies means gnashing of teeth.

Value investing: Overrated?

I can show many examples where value investing based on past track record and valuation didn’t work. But over time, value investing does generate index beating returns because mostly the bad case scenarios are “priced in”.

2014 was a year where index investing would have worked well, but don’t forget: whether you like it or not, investing via an index fund you are making assumptions on the future of oil, commodities, China, European politics, technology, etc. If oil goes back to even $90 in 2015, index funds will lose out as the weightings of oil related stocks will be significantly lower post the 2014 price decline. Similarly, if Russia or China doubles next year you would also lose out.

In that regard I have to remind you of the MSCI World Index's poor performance for the 10 years from 2000 to 2010 (and I've added the performance of our Sanlam Global Financial Fund to show how poor the index did do):

Table 2: Sanlam Global Financial vs MSCI World

Index moves: Jan 2000 to Dec 2010 Compounded return in USD	
MSCI World Index USD TR	-13.9%
SIM Global Financial Fund	10.1%

Source: Morningstar, SIM Global
(Fund performance is calculated gross of fees)

The reason why value investing works over time is that you invest when disappointment is priced in. George Soros and Howard Marks have two wonderful quotes that illustrate this:

George Soros: *"The worse a situation becomes the less it takes to turn it around, and the bigger the upside"*

Howard Marks (Chairman of Oaktree Capital Management): *When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price."*

Warren Buffett "bets" on certainty. He likes to invest in companies that operate in industries where demand is fairly constant and the suppliers are rational. Hence investors invest in a predictable earnings stream. If at the same time the company is managed by ethical and competent management and they allocate capital rationally you've got a winner – especially if you invest when the market has sold the share down during a bout of emotionality.

But then, his large investment in Tesco implies that he missed the fact that technology (which gave customers the ability to compare and compete on prices) combined with an economic downturn turned the retail market into a cut throat destructive cauldron.

But his track record remains unbelievably impressive. He has demonstrated that investing in certainty does generate the best returns over the longer term.

I alluded in our previous Market Review that we had done considerable work on "investing in quality" in the bank sector vs "value". And the research so far shows that quality outperforms value (value gives good returns, to my amazement quality gives better returns – but more about that hopefully in 2015).

What did we do in 2014?

Besides our "day jobs" of researching companies with the view of finding attractive investments for our funds, we spent considerable time thinking about SIM Global, learning from mistakes made in the past and how to position our funds. To generate above benchmark returns one has to take risk, and most of our thinking has been around the implicit risks one takes and the size of those risks.

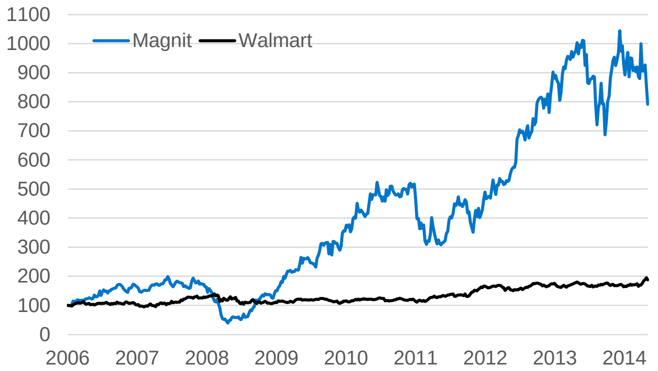
Emerging markets, because of their structural underlying higher growth rates can generate higher returns, but the lack of liquidity in those markets and the effect political changes have on the country's growth rate also make them more volatile.

For this reason we decided that the **Sanlam Global Best Ideas** will limit its emerging market exposure to 15%. It is prepared to differ considerably from its benchmark (MSCI World Index) but will find those opportunities largely in developed markets.

In the **Sanlam Global Financial Fund** our target is to outperform by a wider margin. This can only be done by taking more risk. We reduce the risk (of being different from the benchmark) through extensive industry knowledge and 25 years of financial sector research and investment experience, and the track record of the fund shows that over time the risks we took did generate the required returns.

Graph 2: Magnit vs Walmart

USD based to 100



Source: Bloomberg

But the focus is always on the company's innate ability to keep re-investing its returns at a similar rate.
Graph 2 shows how Magnit (Russian retailer) has been able to do this. The recent price underperformance has been due de-rating and rouble weakness, but the net asset value per share has continued to grow. It is a wonderful business run by extremely competitive management.

Similarly Sberbank. Up to 30 September 2014 Sberbank had outperformed Wells Fargo (best bank in USA) substantially (measured from 1 Jan 2003 in US$).

Table 3: Sberbank vs Wells Fargo

	NAV + Dividends (USD)		Share Price (USD)	
	Sberbank	Wells Fargo	Sberbank	Wells Fargo
2002	100	100	100	100
2003	112.6	125.1	127	126
2004	138.7	149.0	248	133
2005	215.1	174.5	683	134
2006	299.3	208.7	1,740	152
2007	590.7	226.2	2,052	129
2008	700.5	287.7	471	126
2009	566.3	349.0	1,343	115
2010	748.5	358.7	1,763	132
2011	1,006.5	390.3	1,385	118
2012	1,212.2	441.2	1,534	146
2013	1,360.6	480.1	1,580	194
2014	904.6	534.0	621	234

Source: All figures in USD, Company Financials, SIM Global Research

The summary in Table 4 shows how Sberbanks' net asset value per share has grown at a much higher rate than that of Wells Fargo. The combination of a falling oil price and Putin's new found belligerence/expansionism caused a 65% rouble collapse since 1 July 2014 (as can be seen in Table 3).

Table 4: Sberbank & Wells Fargo fundamental comparison

	14 year compound NAV/share growth
Wells Fargo	16%
Sberbank in Rouble	28%
Sberbank in US$	22%

Source: SIM Global Research

For 2015 one has to make a call on:

- How bad will the Russian recession will be?
- How long will it continue?
- What is the probability of oil rebounding back to 70?
- Will this pull the rouble back up with it?
- Will Putin continue with his policy of destabilising his neighbours?
- Has Magnit's/Sberbank's ability to generate 20%+ ROE been impaired, or will it resume post the crisis?

Table 5: Sberbank & Wells Fargo fundamental comparison

	P/NAV FDec 2015	Avg $ ROE past 14 years
Wells Fargo	1.95	21%
Sberbank	0.74	11%

A lot depends on the rouble. The price to net asset value is just too cheap for the way this company has delivered historically (Table 5).

SIM Global Equity Income Fund

The objective is to generate a low risk dividend stream for investors plus a satisfactory rate of capital appreciation. Normally companies with a high and consistent dividend pay-out are disciplined and rational in terms of capital allocation. The fund has generated an annualised return over the past two years of 10.7% and the past 12 months' 5.6% is good in terms of the defensive nature of the fund.

In a global low interest rate environment quality high yielding stocks will continue to be highly rated, so 2015 should be a good year.

Sanlam Global Best Ideas Fund

Douw and the team have spent a lot of time transforming the fund in a very tough environment, mostly successfully, but the impairments of the legacy Chinese shares did affect performance negatively. The fund's exposure to emerging markets has been reduced to 15% in order to reduce volatility. It has become a mainly developed market stock-picking fund and the team's goal is through stock picking to outperform the index with a strong philosophy and process.

Sanlam Global Financial Fund

As said, the team has built up considerable knowledge of and experience in financial shares backed up by an awesome proprietary data base developed over the years.

Unfortunately, the database doesn't warn us about macro events that lie ahead or a falling oil price, but it does give us excellent insight into the historic track records of the management teams and whether the valuations are attractive in various circumstances.

Whereas our Equity Income fund wouldn't invest in Sberbank no matter how high its dividend yield, the Global Financial fund does take that risk when the valuation is attractive enough (based on management visits and research). But it would be one of many decisions we take throughout the year. In other words, we know if we follow the process and stick to the philosophy the risks taken do lead to a wide margin of outperformance over time and the fact that our investment in India & Indonesia was 4 times the size of the investment in Russia proves the point.

2015

When supply cartels break…

Think back to your first years of employment and what it would have meant had your boss called you in and said your salary is being halved. This is what has happened to oil producing countries like Nigeria, Russia, Venezuela, Norway, etc. But the income taken away from the oil producers is being given to countries like India and Indonesia.

So you've got to make decisions;

- How far do prices have to fall to restore the supply/demand equation?
- More important, how much capital will be destroyed in the process?
- Which are the players that will fall over (both in oil production, retail etc.)?

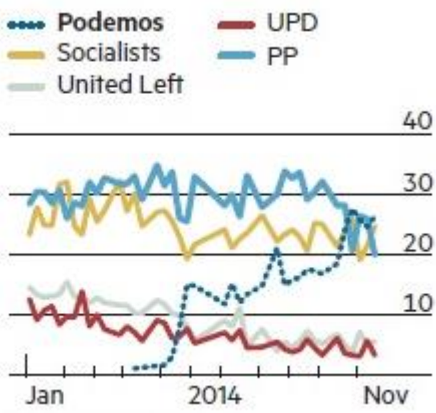
But don't forget the risk of European political instability. And quite a few of 2014's problems remain unresolved:

- Will China's slowing growth rate cause further deflationary pressures which will identify further cracks in their foundations?
- Will Abe's third arrow work and overcome Japan's demographic and deflationary pressures?
- Will Europe's left wing become a destabilising force?

Left wing (anti EU bailout) parties are showing rapid gains in popularity (refer Graph 3) with devastating effects on markets (Greece).

Graph 3: Spanish political party polling

Share of respondents (%)



** Poll of poll weekly averages*
Source: Financial Times Research

So 2015 will be about identifying the winners. But the market is intelligent. Winners seldom fall to really attractive valuations.

2015 will be about really knowing your companies and tilting the portfolio to where prices have declined the most.

The age old philosophy that has worked over time will continue to generate good results for the next 5-10 years:

"Identify well managed companies that generate good returns on their capital and remain invested in them"

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