REFOCUS

PORTFOLIO MANAGER MONTHLY - OCTOBER 2019

Piet Viljoen

This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

Should South African investors run for the hills?

Many financial commentators are warning of a financial tsunami for South African investors, given the prospects of a credit downgrade. The gist of what many commentators are saying, following the deterioration of the South African economy during Zuma's destructive tenure, is:

1. South Africa faces an imminent rating downgrade by Moody's to junk status;
2. That this is a result of a declining commodity cycle, government corruption and commensurate out-of-control spending, and general lawlessness;
3. Despite this, many economists insist on viewing the state of affairs through rose-tinted glasses;
4. The rand has collapsed over the past 10 years, but Regulation 28 has precluded SA investors from moving enough money offshore to "benefit" from rand weakness;

In short, we do not disagree with these views. Where we do differ, is on the investment implications thereof. The main reason for this is that, in our opinion, markets have already priced in much of the downside. After all, markets are a discounting mechanism – market prices are simply a summation of their participants' views. And South African market participants have rarely in history been as negative as they are now.

Moody's remains the last of the big three ratings agencies to have South Africa on an investment grade rating. Currently, our government bonds trade at yields of around 500 basis points (or 5%) over US Treasury yields in US dollar terms. This is higher than the yields Brazil pays on its government bonds. Notably though, Brazil is already rated junk by all the ratings agencies, including Moody's – indeed their rating is two notches below where SA's rating stands today. Looking at interest rates around the world, current SA bond yields imply that we should be rated four notches below investment grade. There is a lot of pessimism baked into this cake already.

Russell Lamberti – an economist whose work we respect – has run the numbers on what happens to markets after downgrades to junk status. He studied the following markets:

- Brazil Dec 2015
- Russia Feb 2015
- Croatia Feb 2013
- Hungary Dec 2011
- Uruguay Mar 2002
- Colombia Sep 1999
- Indonesia Dec 1997

After studying market reactions to these downgrades, his conclusions were:

- Much-anticipated downgrades tend to have a minimal negative effect with most of the pain having already taken place before the downgrade;
- After an initial downdraft, bonds, currencies and stocks tended to perform better after downgrades than before downgrades;
- Small-cap value stocks eventually performed especially well;
- Policy rates were lowered;
- Currencies were reasonably stable;

Turning to the rand, we would hesitate to describe its action as "collapsing", especially if one takes relative interest rates into account. The reality is, if one had started out with R100 five years ago when the Rand was at R10.90, deposited it into a local bank, withdrew it today and bought dollars at the prevailing exchange rate of R14.70, you would have more US dollars than if you had simply converted to US dollars outright in 2014 - and this is with US dollar having been the strongest currency in the world over that time frame. The same applies over ten years. Interest rates have more than compensated local savers for a weakening currency. So we would suggest that it is quite a stretch to say that the rand has collapsed. A collapse is what happened in Zimbabwe, Venezuela and Argentina. It wipes investors out completely. Over the past decade, taking into consideration the local interest rates you'd have earned over that time frame, investors in the rand have done better or about the same as investors in US dollars, euros, Japanese yen, Australian dollars and British pounds. Surprisingly, SA investors have also done as well as the associated equity markets in constant currency terms, with the exception of the US equity market – which has dramatically outperformed most other markets globally.

The point is, there are always good investments and poor investments – it's just not clear a priori which are which. If anything, no one would have guessed that SA investments would have generally held their own given what has transpired here over the past ten years.

To summarise, we agree with a lot of the pessimistic macro views out there, but we think the market is efficient, and has discounted most of these views already. And SA has the ballast of high interest rates and low equity prices to keep us stable, in prospective return terms - just as it has done, in general, over the past 10 years. Referring to selective measurements with the benefit of hindsight adds no value to any investment strategy.

Of course, if South Africa were to go the Zimababwe/Venezuala route, then all (local) bets are off. Investors with all their money in local investments will face ruin. On the other hand, given current valuation levels, if things were to improve even moderately, local assets will do extremely well.

We think an intelligent investment strategy should recognise that different outcomes are possible, and no one outcome can be guaranteed. A well-diversified portfolio should offer some downside protection if things go from bad to worse, and upside participation if things go from bad to even slightly better. A portfolio built on forecasting one outcome correctly can do very, very well, or very, very poorly. And we all know forecasting is a mug's game. For instance, how many of us thought that the Boks would be in the world cup final when we lost to New Zealand 57 – 0 two years ago?

Investors should also be careful not to completely write off funds governed by Regulation 28. An allocation of 30% offshore is probably inadequate, given the risk investors are facing, but the fact is that in the remaining 70% one can build in strong additional rand hedge protection through the local market. Overall, one can still build a well-balanced portfolio, despite the regulations. We do believe that in future increased prescribed assets are likely, which will make Regulation 28 funds even less attractive, but not unattractive enough to ditch them wholesale. Remember – we have lived through this once before – before 1994 we had 50% prescribed assets here in SA, and fund managers were forced to buy bonds from a totally bankrupt and equally corrupt government. Yet Regulation 28 funds still managed to do okay through that time. The market came up with innovative instruments that helped local investors withstand that particular government's worst regulations and policies. Who remembers ELFI bull and bear bonds? If you have no clue of what I'm talking about, ask an old-timer for a lesson on how financial innovation can help investors get around corrupt government policies. Bitcoin anyone?

To put all your eggs in one basket – be that basket local property, offshore cash, offshore equities, Mauritian properties or Japanese biotech - is, in our view, risky and irresponsible. We think a more nuanced view is likely to lead to better portfolio construction and investment outcomes.

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