GRAY ISSUE

Did we get lucky?

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The Allan Gray domestic equity strategy delivered returns of 17.2% for the 12 months ending September 2016, after having subtracted all fees and costs. The FTSE/JSE All Share Index (ALSI) only delivered returns of 6.6% (before taking fees into account). While we are pleased with our performance, we would be the first to admit that an outperformance of this magnitude is unsustainable. Since 2000, our equity strategy has outperformed the market by 4.2% after fees. The performance of our Balanced and Stable Funds' equity carve-outs are in a similar ballpark.

Our market is very concentrated and the recent out-performance has been quite narrowly based. To end-September 2016, 8 of the top 10 stocks on the JSE contributed positively to our relative returns. That means we owned the 'right' shares, and avoided the 'wrong' ones. This is an unusually high success rate for the period, so much so that it must have included a fair amount of good luck. The best stock-pickers in the world (with all humility, we expect of ourselves to be in this group) achieve a success rate in the mid-to-high 50%'s over a long period of time.

Underperformance is part of the cycle

Unfortunately it is inevitable that in the future we will endure unlucky streaks where much fewer things go our way. That is the nature of investing. We can however use skill to tilt the odds of getting lucky slightly in our favour. To illustrate, a symmetric probability event like an evenly weighted coin toss can be profitably exploited over time if the payoff is asymmetric (e.g. heads you win R2, tails you lose R1). The same is true for an asymmetric probability event like the spinning of a roulette wheel with 12 red and 24 black pockets but an equal payoff (e.g. black you win R1, red you lose R1).

Betting on 'heads' or on 'black' and subsequently losing R1 does not invalidate the decision to enter into the wager in the first place; it is just bad luck. Over many coin tosses or roulette spins the true probabilities and/or payoffs will ultimately manifest.

The odds of getting lucky can be skewed by avoiding shares that reflect a disproportionate amount of good news in their prices. There is a lot of truth to the epigram that good things happen to cheap stocks. For example, the past year included a few important events that contributed significantly to our returns relative to the ALSI. Examples include:

- The rise in global terrorism: deadly attacks in Paris, Nice, Brussels, Istanbul to name a few dented the public morale, rattled the luxury goods market and contributed to Richemont being the top contributor to our relative returns for the 12 months to September.
- MTN's fine: completely unexpected, took management by surprise and contributed to the fall in the share price which made MTN our second biggest contributor to our relative returns for the 12 months.
- AB-InBev's acquisition of SABMiller: while in our assessment a transaction was probable, trying to predict merger and acquisition activity is near impossible.
- Brexit: by the time Brexit came about, we had reduced our clients' SABMiller holdings by two-thirds and were substantially underweight the stock. The concomitant fall in the share price stood us in good stead on a relative basis.
- Gold shares: in isolation accounted for a quarter of our outperformance. The gold price went up because of a confluence of global macroeconomic factors. We have no sustainable advantage predicting these factors, and won't get it right every year.

We didn't foresee any of these events

In each case, we owned or didn't own the relevant shares from our assessment of the bottom-up fundamentals. In all of these cases a lucky event was the trigger for a reassessment of value of a major stock by the market. We were lucky for so many of these reassessments to happen in one year, and we were lucky that we got such a high portion of the fundamental calls right on these stocks but, on average, over the long term, our philosophy of bottom-up, valuation-based, long-term, stock analysis seems to pay off.

We spend a lot of time dissecting the history of our funds and the market, mainly to learn from our mistakes. It is very difficult – and often humbling – to distinguish skill from luck when attributing past investment success. The skill of course lies in identifying implied probabilities and range of outcomes and having the fortitude to act on these. We certainly won't always get it right. But we will continually strive to ensure that our clients are lucky more often than not. The harder we practice hopefully the luckier we get*.

** Widely attributed to Gary Player.*
Commentary by Simon Raubenheimer, portfolio manager, Allan Gray