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Active management: Potential for a comeback in a divided inflationary world

For most of the 2000s, the developed world has been characterised by disinflation and falling interest rates. This is despite a large increase in leverage, to which significant fiscal spending has now been added. This has resulted in increases in the price of goods, including commodities. The increase in commodity prices is occurring as the environmental, social and governance (ESG) trend accelerates, raising the cost of capital for mining and other related industries. This increases the cost of transition. The world is potentially dividing between China and the United States, which creates its own ESG risks for investors.

If indeed we are at a secular turning point, as an investor you need to make sure your portfolio is well diversified and positioned to benefit – a potential opportunity for active management to make a comeback. Duncan Artus discusses this in the article below, which is based on his 15-minute presentation delivered at the recent virtual Allan Gray Investment Summit.

The world is probably going to be very different in 10 to 15 years; no one knows for sure what will happen. Investing is a probability business. At Allan Gray, we are bottom-up investors, but want to be on the right side of long-term trends and extremes, whether in valuations or economic variables.

There are several risks that investors face – perhaps the most topical at present is inflation. We have seen unprecedented money creation globally, which dwarfs the response to the global financial crisis (GFC); and we now have fiscal spending in tandem. This is likely to carry on for some time to keep the show on the road. This is leading to increased inflation, particularly in the developed world, along with higher commodity prices measured in nominal US dollars. This will be exacerbated by ESG policies – raising the cost of capital for resources and capital-intensive industries.

Risks arising

South Africa will be temporarily buffered by high commodity prices, but as each year passes, the risks are increasing as our unemployment rate is not sustainable. We are used to inflation in South Africa: We have inflation because we are expecting it.
But the world could also face stagflation (slow growth in combination with inflation) and financial repression (where governments try to keep interest rates low through yield curve control and legislation that forces you to buy government bonds or making it a regulatory requirement for financial companies).

The continued money creation enables an increasing size in the government relative to the economy and this has an adverse impact on productivity. In times when money is printed, people lose faith and there is growing inequality: Those who own assets get relatively wealthier. The greater inequality from money creation results in redistributive policies and policy that favours labour. If we read history, we can see that periods of inflation lead to social instability and further reinforce the trends.

Where does ESG come into it?

When people think about ESG, there has been a strong focus on the environmental aspect. But social and governance issues are starting to get more attention – as we have seen through events in China and the US with Nike and H&M, among other Western brands, raising issues about labour practices and human rights concerns in China and subsequently facing criticism and boycotts of their products in China. Within governance, it's not just boards of companies; the focus is also on politics, which may result in a more politically polarised world. You are either supportive of the West (US) or East (China). Why is this important for equity investors?

South Africa has a significant direct exposure to China. Our five biggest shares – Naspers, Prosus, Richemont, BHP and Anglo American – are exposed to China through being in China, or through the commodities sold. South Africa is indirectly exposed to China through the commodities we sell, which allows us to run a trade surplus. What happens in China therefore has a direct impact on the stocks in our portfolios, as recent events have illustrated.

What can we do about all of this?

An important point to make is that we should not assume what has worked since the GFC will continue to work in the future. If we look at the history of markets, we see themes that last for a number of years – until they don't – e.g., the Nifty Fifty (a group of high-quality franchises with strong balance sheets and ever-increasing valuations that became the darlings of many investors, until the US entered a bear market in the early 70s), the commodities boom, Japan, emerging markets, US technology shares, financials and now what we call "disruptors". So, what should an investor do?

We can tilt our portfolio positioning to consider the risks discussed above. However, when a risk is well known to the market it is very expensive to hedge. We are looking out for cheap and not obvious inflation hedges.

When it comes to current asset allocation, we prefer:

- Very little or no exposure to developed market sovereign bonds and compressed spreads in the high-yield market
- To be underweight technology stocks
- Exposure to producers of metals used in the energy transition, such as Glencore
- Exposure to precious metals and precious metal suppliers; this is a good potential hedge against inflation
- To use our bottom-up process to find ideas that don't rely on the big things discussed above – e.g., the opportunity presented through omnichannel retailers like Country Road, or low value retailers, who can capture some of the beneficiaries of additional government spending, e.g. Pepkor
- To look beyond the "big five" towards other opportunities, e.g. British American Tobacco, which has zero exposure to China, or AB InBev, which has great potential
- To look beyond the best ESG companies that everyone is buying, to the companies that are improving their ESG the most

In conclusion, we believe that independent thinking is going to be increasingly important, with detailed, bottom-up research key to identifying good-quality opportunities. In a world that could look very different than the recent past, active management has the potential for a comeback. One cannot be running a benchmark-cognisant portfolio and look the same as everyone else and hope to do well.

Commentary contributed by Duncan Artus, chief investment officer, Allan Gray