# ALLAN GRAY OFFSHORE EXCHANGE

— SEPTEMBER 2020 —

ALLAN GRAY

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## THANK YOU FOR ATTENDING OUR **ALLAN GRAY OFFSHORE EXCHANGE**

After experiencing the worst five-week crash in history, we have since witnessed the emergence of a seemingly inexplicable disconnect between stellar stock market returns since the bottom, and deteriorating economic fundamentals. The combination of key markets around the world hitting new record highs, with bond yields on the other end of the spectrum being at record lows, presents a uniquely challenging environment for investors.

The global economic outlook remains murky and we all have many questions about what happens next and how to think about investing in this context. We hope that our Offshore exchange provided you with some answers to these questions and some new ideas on how to navigate this challenging environment on behalf of your clients.

To assist with the detail, we have asked each of the presenting managers to summarise their key messages, which we have collated in this booklet.

Please refer any specific questions to the relevant investment manager.

We look forward to hosting you at our next event.

Claudia Del Fante
Manager: Product Development, Allan Gray

CLAUDIA DEL FANTE

# A SUMMARY OF THE INSIGHTS SHARED AT THE ALLAN GRAY OFFSHORE EXCHANGE

Against the backdrop of highly volatile offshore markets and the search for low-risk returns, the Allan Gray Offshore exchange showcased the thinking and research from a range of offshore investment managers including Baillie Gifford, BlackRock, Coronation, Fundsmith, Ninety One, Orbis, Schroders and STANLIB. Here is a taste of what they had to say.

**What will it take to get the global economy going?**
Despite their best efforts to recover from lockdown and open for business, all major global economies, except for China, will end the first year of the new decade with negative GDP.

Kevin Lings, chief economist at STANBLIB, said: "Smart countries are focusing on areas they are good at; what they can easily turn on to get their economies going."

China engineered its recovery by focusing on industrial production. In the case of the US, their recovery is coming from consumerism. Americans are going shopping – and it is on the government's ticket. Indeed, largely thanks to state handouts, spending is revitalising the economy and household savings are up. The spree is being financed by the Federal Reserve (the Fed), which is printing money to buy government debt. It is free to do this because the dollar is relatively stable and inflationary pressures are subdued.

"Even though in all likelihood the US is creating problems for the future, they have a diverse and robust economy and the freedom to be irresponsible without immediate adverse consequences. The same does not apply to South Africa," cautions Sandy McGregor, portfolio manager at Allan Gray. "Our fiscal deficit exceeds our annual savings and the Reserve Bank can't simply print money and buy government bonds without having a big impact on the currency and inflation."

Smart countries are focusing on areas they are good at; what they can easily turn on to get their economies going.

And inflation is something McGregor worries about a lot. "Inflation can arrive suddenly, and we are ill-prepared for it," he notes.

So, what can be done in South Africa? What is the area that we are good at?

"Our state-owned enterprises are in a mess and our infrastructure is lacking. Public-private infrastructure projects may be the special ingredient to turn our economy around," said Lings.

Perhaps a more sensible solution for us than printing money.

**What does printing money do to the value of a currency?**
According to Nicholas Purser, who leads the team of currency analysts at Orbis, Allan Gray's offshore investment partner, money printing, also known as quantitative easing (QE), can lead to weaker currencies. "In the wake of the global financial crisis the Fed used QE aggressively and weakened the dollar for some time. One concern is that the Fed is again innovating its methods of easing monetary policy; and again, this easier policy is a risk for the dollar," he says.

He explains that there are lots of factors that drive currency movements. Orbis takes a valuation-driven approach, looking at how the currency has performed, adjusted for inflation. They also consider how the economy is behaving, examining factors such as export performance. If a currency appears substantially overvalued, they will sell it and replace it with something that is a better store of value.

**What should unsettled investors do in this environment?**
John Stopford, head of Multi-Asset Income at Ninety One, says that amidst the pandemic-related market volatility and the easing of monetary policy, risk-averse investors concerned about the impact of inflation are looking for an alternative to cash.

"We are in a yield-starved world and this is not going to change for the foreseeable future," he notes. "Get used to cash paying nothing in nominal terms. Cash is likely to continue to be a wasted asset, leaving you standing still."

Investors need to identify where they can achieve income and where it is illusionary. Income must be underpinned by strong balance sheets.

And global bonds aren't any better. Neil Padoa, portfolio manager and head of Global Developed Markets at Coronation, says that bond prices are high, and coupons are low, but "despite this, people are investing in global bonds, with 65% of them earning 0-1% in return".

According to Stopford, the solution lies in income. "Investors need to identify where they can achieve income and where it is illusionary. Income must be underpinned by strong balance sheets." He adds that investors shouldn't focus on buying asset classes, but rather look for individual securities and actively manage risk over time.

Padoa says that investors need to take on some risk as a trade-off for achieving some return. For risk-averse investors, he suggests holding around 40% of one's portfolio in risk assets, including diversified equities, real assets such as property, and convertible bonds. "You need a measure of risk to get a measure of return," he notes.

**Different strokes for different folks**
For medium- to long-term investors, Greville Ward from Fundsmith advocates a buy and hold strategy. "Buying and holding is a rewarding strategy during hyper volatility but works just as well in other environments. It has proven successful in fair winds and in foul," he says, adding that doing nothing is often the hardest thing for an investor.

Ward explains that buying and holding only works if the stocks that an investor buys and holds are very high quality. Fundsmith looks to invest in companies that make a cash return above their cost of capital throughout the business cycle without the requirement for leverage. Fundsmith has only found 73 such companies in the public markets and the Fundsmith Equity Fund is currently invested in 29 of those companies.

Liam Nunn, a fund manager at Schroders, has a different view. As a deep value, contrarian house Schroders is very picky about the price they will pay for an asset. He explains that there have been lots of examples over time when things have looked like a one-way bet, and then they have gone the other way. "We are all prisoners of time. We extrapolate trends of now into the future. But trying to predict the future is very hard," he notes, adding that what you see is often different to what is going on beneath the surface.

"The market is bifurcated from a valuation perspective. Dispersion in prices between the most expensive and the cheapest shows the market is not behaving rationally."

This is certainly true if one looks at the valuations of some of the US internet shares, which Orbis, as a contrarian, value-oriented manager, is largely avoiding. With a broad global research capability, Orbis compares and contrasts these popular and expensive shares with their peers elsewhere, and has found more compelling opportunities within selected Chinese internet stocks. As at 31 August 2020, the largest holding in the Orbis Global Equity Fund was Chinese technology company NetEase, which Orbis first bought back in 2008.

"As a provider of online games, education and entertainment, NetEase is almost custom-made for a quarantined world and has been the largest contributor to the Orbis Global Equity Fund's relative performance for the year to 31 August 2020 period," said Stanley Lu, a member of the Orbis Emerging Markets Investment team.

"NetEase is focused on creating premium, user-centric content – that is its core focus," adds Charles Zhaoxuan Yang, NetEase's chief financial officer, in a conversation with Lu.

Yang explained that NetEase's core online game business, which accounts for nearly 80% of revenues, is highly cash generative even after significant research and development spending to retain its competitive advantage. NetEase produces some of the highest quality mobile games in China, and the company is now expanding globally with some initial success, which should also extend its long-term growth potential.

NetEase is a founder-led business, and Yang attributes the company's success to the focus and determination of William Ding, who spends a lot of his time at product level. "The product is his passion," says Yang.

NetEase strives to make lives better through tech and innovation. Besides the core business, management is also excited about its new ventures including education business Youdao and NetEase Cloud Music.

When it comes to assessing opportunity, Baillie Gifford takes an unusual approach, focusing on "probability-adjusted payoffs". Tim Garratt, partner at Baillie Gifford explains: "Rather than looking at operating models we adopt a mindset of thinking of future possibilities; we consider all the 'what if' scenarios." And they think in decades, not quarters.

Bearing this in mind, it is probably no surprise that they are enticed by investments such as Tesla. They first took a nibble back in 2012 and have used times of volatility to build their position. They are not surprised that financial sector peers have been a bit more sceptical: "Tesla doesn't fit the spreadsheets of investment banks, whose models for cars are built for hardware not software." It is hard to grasp disruption, but this is where Baillie Gifford is seeing the opportunity.

But trying to find the next best thing is not for everybody, which is perhaps where passives come in. And with 70

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times more stock market indices than quoted stocks, those who want to dip their toe into the index investing pool are spoilt for choice.

"Choice offers diversity to investors and gives them more granularity," says Ahmed Zaman, director and index strategist within the EII Investment and Product Strategy team at BlackRock, noting that with options in both equities and fixed income, index investing is growing in popularity within wealth management portfolios.

Zaman points out that there is room for both active and passive in one's portfolio: "Gone are the days of active versus passive; investors need to blend the two."

**Good, independent advice is key**

Optimal allocation will depend on an individual's objectives and risk profile, which is where independent financial advisers come in. IFAs also play a crucial role in helping clients stick to their plans and not let their emotions get the better of them.

Simon Russell, founder and director of Behavioural Finance Australia, explains that emotion often trumps reason when it comes to making investment decisions.

"You can tell your clients about their investment mistakes by presenting the facts, but the evidence shows that this typically doesn't do much to alter behaviour," says Russell. "A range of approaches that target subconscious decision biases can have a better, long-term impact on their investment decisions and outcomes."

Sound advice as we try to make sense of this volatile, pandemic-unsettled environment.

SIMON RUSSELL

# BEHAVIOURAL FINANCE – LESS LIKE BOXING, MORE LIKE JUDO

This session provided a window into how advisers can use behavioural finance – the experimental evidence about the psychology of financial decision-making. It used the results of a survey of advisers who participated in the Allan Gray conference to demonstrate how people's decisions can be influenced by how information is framed. Research shows that these biases typically apply more strongly to clients than to advisers, but as was demonstrated by the survey, they can impact advisers too.

The main points from the session were:

1. Given they are often driven by subconscious mental processes, clients' decision-making biases can be very difficult to overcome. Rather than fighting against them (like boxing), advisers should try to align their advice, client engagement and value propositions with them (akin to using the "gentle art" of judo). This should lead to better outcomes for clients and make things easier for advisers too.

2. That clients dislike losses is not irrational, but it can lead to substantial negative consequences if it gets in the way of clients achieving their goals – such as by missing out on the long-term benefits of growth. This creates an opportunity for advisers to add a large amount of value.

3. Advisers can use behavioural finance techniques, in both large and small ways, to positively influence the way their clients respond to losses. One example is by changing the order in which returns are shown in a table of returns. Survey results suggest this is likely to change 1/12 client decisions (and about 1/25 adviser decisions).

Advisers can use behavioural finance techniques, in both large and small ways, to positively influence the way their clients respond to losses.

4. Another example is how returns are presented to clients in charts. The survey results demonstrated that in some contexts this can halve the number of dissatisfied clients (from 14% to 7%).

5. The same principles can be applied to client conversations, investment reports, records of advice, websites, emails, investment policy statements, etc. It involves advisers putting the long term first in client communications, making sure charts provide a clear story that accounts for loss-aversion, and broadening the frame of reference (ultimately, to the impact of losses on client outcomes).

6. A challenge is convincing clients to pay for behavioural coaching. Given the uncertainty faced by clients about the value of this advice, their perceptions are likely to be heavily influenced by biases, such as anchors. The survey results showed advisers' perceptions could be influenced by anchors too: Only 18% of advisers thought that clients would be willing to pay more than R5 000 for this advice, whereas this rose to 65% for advisers who had previously been presented a high anchor. (Theoretically, rationally, the anchor should be irrelevant).

Research suggests that advisers can use behavioural finance to create greater willingness to pay for behavioural coaching services...

7. Research suggests that advisers can use behavioural finance to create greater willingness to pay for behavioural coaching services if advisers a) quantify the value of the service, b) use this quantification to create a high anchor, c) also articulate the value in tangible, personally relevant terms, and d) discover and address the anchors that clients might otherwise use to assess the value of advice. These are the skills of the judo-adviser!

For more information on how advisers can use behavioural finance research, advisers can visit www.behaviouralfinanceaustralia.com.au, where they can access specialist behavioural finance-related resources including articles, podcasts, videos, eLearning modules and books.

AHMED ZAMAN

# THE RISE OF INDEXING

Growth in indexing is bringing greater choice for investors, but with so many indices available, selecting the right index has become crucial.

Indexing has grown considerably across equities and fixed income over the last decade, not only in terms of assets, but also in terms of the number of products available – so investors now have more choice than ever when implementing asset allocation decisions.

Index investing has been shown to increase portfolio efficiency through shortening due diligence processes, increasing control over managing risk, and curbing costs. This means investors can access market beta more efficiently and dedicate more of their time and risk budget on selecting true alpha sources – in other words, there is room for both active and index strategies in portfolios. Despite this growth, exchange-traded fund (ETF) penetration still remains at early stages across asset classes – and has plenty of room to grow. Alpha-seeking strategies still account for roughly twice as much assets under management (AUM) in equities and four times as much in fixed income (sources: World Federation of Exchange Database, BIS, HFR, iShares GBI).

Growth in indexing is bringing greater choice for investors, but with so many indices available, selecting the right index has become crucial. Indices have their own characteristics and nuances in construction, coverage, and risk drivers, which can have a significant impact on performance and can expose investors to unintended risk – so every investment decision really is an active decision.

Taking the example of European indices over a 10-year return period, we notice significant levels of dispersion in returns driven by a number of factors (for example, sector constraints and/or the investable universe). Differences can also be found in index construction methodologies across providers – EM country classifications, for example, are not consistent across index providers, leading to regional exposures that can vary from one EM index to another.

With the index landscape expanding at a rapid pace, it is crucial for investors to develop expertise across the investment journey, including a thorough due diligence process for index selection as you navigate the index landscape.

NEIL PADOA

# THE OFFSHORE CASH CONUNDRUM: FINDING A BETTER ALTERNATIVE

Key takeaways:

- As much as a quarter of the US$60 trillion of global fixed income assets is trading at negative yields, while another two-thirds offer less than 1% yield.
- Equities at historical highs do not necessarily reflect the underlying economic fundamentals.
- Investors looking for absolute returns should consider a risk-conscious portfolio that is diversified across assets that offer an alternative to offshore cash.
- The Coronation Global Capital Plus Fund has an 11-year track record of delivering on this investor need.

Investors who are seeking alternatives to investing in offshore cash are faced with a conundrum: cash and bonds are providing little in the way of returns and equities are already at historic highs. So where can you invest to preserve your capital and get some growth in these unprecedented times?

With global economies experiencing the strangest recession in history in 2020, financial markets are navigating uncertain and volatile conditions. Government debt is at its highest level in a century and the highest ever in peacetime.

Historically, conservative investment portfolios have a core holding in government bonds, which, together, amounts to US$60 trillion globally. But, with interest rates at historic lows and the most extensive stimulus programmes in progress ever, 25% of these fixed interest assets are trading at negative yields and a further two-thirds offer yields of less than 1%.

Meanwhile, the equity market has run ahead of fundamentals, with the S&P 500 Index far outpacing the growth in corporate profits. The demand-supply shock set in motion by the pandemic has resulted in a deflationary output gap in the short term. However, the fiscal and monetary policy stimulus packages may introduce inflation further down the line.

Against this backdrop, investors seeking to preserve capital while also achieving reasonable returns in a conservative portfolio will have to accept a degree of risk. The Coronation Global Capital Plus Fund does just that. It gives investors access to a portfolio that includes 24% exposure to equities but manages downside risk by diversifying risks across asset classes and within asset classes.

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Real assets complement the equity holding in the Fund. These include real estate and infrastructure investments that are resilient and stable, trading at reasonable valuations. These assets also have built-in inflation protection. We are currently finding attractive investment opportunities in German real estate and French infrastructure projects.

The Fund also invests in equity-like fixed income convertible bonds, which offer opportunities for equity-like returns but with less risk. These assets pay out a regular coupon and offer equity upside because you have the option to convert the bond into equity.

The majority of the portfolio (some 60%) is then invested in assets that further provide diversifying return prospects such as inflation-linked bonds, gold and other precious metals, absolute return instruments and hedging structures.

The inflation-linked bonds (bought at attractive valuations) protect investors from rising inflation, which otherwise erodes the value of the capital invested over time. As mentioned before, inflation expectations have collapsed in response to the wide output gap in the US economy. However, we believe it is unlikely that inflation will remain below the 1.5% currently priced into the market in the US for the next 10 years and it is this asymmetry between market expectations and our assessment of valuations that we look to exploit.

Gold is considered the ultimate in safe-haven investments, and thus there is exposure to the precious metal in the Fund. However, we expect platinum to offer growth potential as it is likely to be subject to an ongoing supply deficit, which will underpin the precious metal's valuation. Copper, although volatile in the near term, is also expected to undergo a multi-decade rally in response to the growing demand for renewable energy and electric vehicles, of which the base metal is a core component.

Absolute return investments suit the objectives of the Fund because they provide downside capital protection through all market conditions. We are investors in merger and arbitrage transactions, during which the valuations of assets are not based on the fundamentals of the underlying companies but the specifics of the deal underway. Also, the buyout price offers a predefined outcome that we can measure and value through careful analysis.

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In the Coronation Global Capital Plus Fund, we also use hedging to protect the entire portfolio against volatility. We were early in introducing hedging into the portfolio at reasonable prices. This decision paid off when levels of volatility in the market, as measured by the Volatility Index (VIX), increased.

Finally, 36% of the portfolio is invested in highly liquid, safe assets that can be drawn down quickly and reinvested elsewhere if we see better opportunities. Given the low rate environment, we have to fight for every basis point in this portion of the portfolio.

Together these diversified asset classes and underlying securities should deliver more than cash over time. The Fund's objective is to deliver 1.5% in excess of US cash over rolling two-year periods. This is not a guarantee, and investors should expect some fluctuations in the value of their holdings, given the exposure to assets in the portfolio that are riskier than cash. However, these are far more likely to deliver capital growth that exceeds inflation over time – and outpaces cash.

*For full details on the P class of the fund, download its end-August factsheet on Allan Gray's website.*

GREVILLE WARD

# BUY AND HOLD. IS IT A GOOD STRATEGY DURING MARKET HYPER VOLATILITY?

Fundsmith's view is that "buy and hold" should be a good investment strategy for a long-term investor whatever the market conditions – but only if the underlying holdings are very high quality.

Fundsmith has a three-stage investment process:
1. Find good companies
2. Don't overpay
3. Do nothing.

We believe that the first of these is the most important and the third is the hardest.

Fundsmith seeks to invest in:

- High-quality businesses that can sustain a high return on operating capital employed
- Businesses whose advantages are difficult to replicate
- Businesses which do not require significant leverage to generate returns
- Businesses with a high degree of certainty of growth from reinvestment of their cash flows at high rates of return
- Businesses that are resilient to change, particularly technological innovation
- Businesses whose valuation is considered by Fundsmith to be attractive

Fundsmith has only found 73 companies that meet its criteria for high quality in the public markets so far (many great companies are private), and is currently invested in 29 of these great businesses.

The average return on capital employed (ROCE) for the companies in the Fundsmith Equity Fund for the last eight years has been between 26% and 31%. In 2019 the average ROCE for the S&P 500 Index was 17% and for the FTSE 100 index was 17%. So Fundsmith believes that we own better companies than the market.

The three main sectors that Fundsmith invests in are: consumer staples, medical devices and installed bases of software. 67% of the fund investments are in the USA but this is not because of a top-down macro view; it is because the largest companies in the world in the sectors that we invest in happen to be located in the USA.

Having identified these above average businesses, Fundsmith attempts to buy them at the right price (often after a share price decline for some reason). Then we do the hardest thing of all in active fund management, which is nothing. We allow these great businesses to grow and compound a little every day.

In 2020 so far, Fundsmith has sold one holding (Clorox) and purchased two new holdings (Starbucks and Nike).

To the end of August 2020, the Fundsmith Equity Fund has returned +13.1% vs the MSCI World Index in British pounds, which is +4.7% over the same period.

Annualised to the end of August 2020, since inception in November 2010, the Fundsmith Equity Fund has returned +18.4% vs the MSCI World Index in British pounds, which has returned +11.6% over the same period.

So Fundsmith believes that buying and holding great companies is a good investment strategy through any market cycle for a long-term investor.

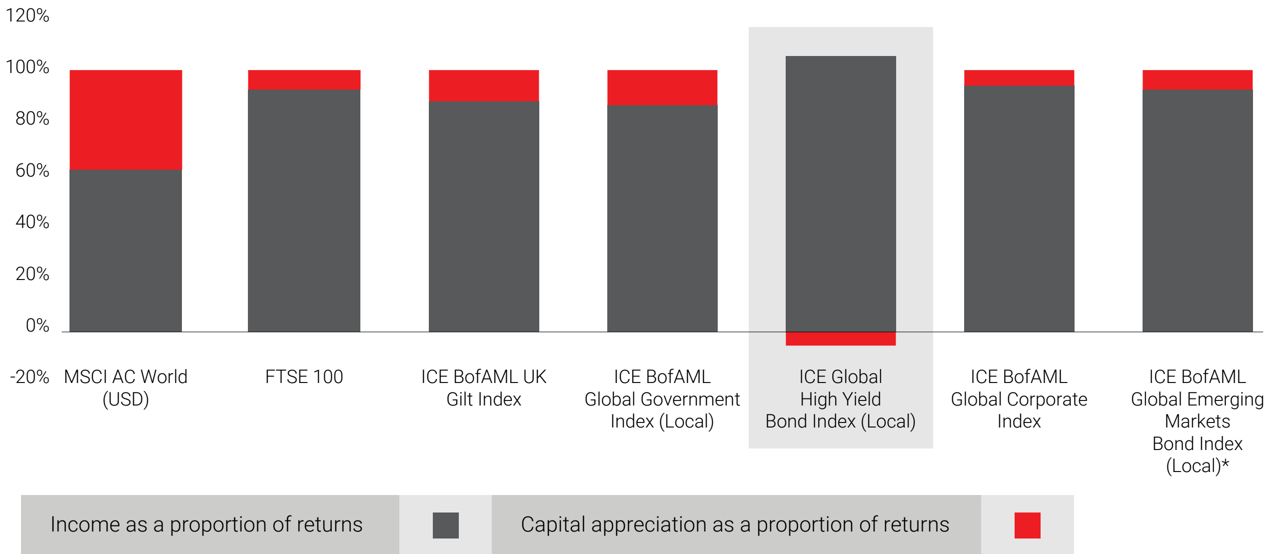
JOHN STOPFORD

# THE DOMINANT DRIVER OF RETURNS

Income is the dominant driver of most asset class returns over the long run. For some asset classes, such as high yield corporate bonds, the income received can even exceed the total return due to a portion of capital being lost to defaults. Even for equities, reinvested dividends are typically responsible for more than half of cumulative total returns over time. We'd argue that this understates the importance of income to stock market investors. What's more, buy backs provide an additional route by which cash is returned to shareholders

Given the importance of income, the decline in yields on most asset classes since the global financial crisis (GFC), and the further fall during the COVID crisis, appears to bode ill for future return potential. Central banks have doubled down on using ever-looser monetary policy to stimulate economic activity. Official interest rates have been cut to very low or negative levels in most developed countries and balance sheets have been used to buy bonds, pushing government yields close to zero or even below in many cases.

**Graph 1: Income beats capital appreciation as source of returns over the long run**




Past performance is not a reliable indicator of future results, losses may be made.

Source: Ninety One, Bloomberg as at 31 December 2019. Data since 30 November 1998. *Since inception: 31 December 2005. The yield of the underlying securities is not guaranteed, there is no assurance of its stability and sustainability and it does not represent the yield of the Fund. A positive yield does not imply a positive return.

### The definition of madness

One definition of madness is repeating the same action but expecting a different result. That hasn't stopped policymakers from believing that looser policy will eventually generate higher growth and inflation. For this strategy to work, they now believe that low interest rates and quantitative easing will probably be needed for the foreseeable future. The US Federal Open Market Committee, for example, is not expecting to increase interest rates at all over their entire three-year forecast horizon.

### Best yield premia in years

The good news, however, is there are still attractive yield premia to be earned across a range of asset markets and securities. The yield advantage over government bonds offered by corporate bonds and emerging market debt is above the median level that has prevailed over the last 20 or so years. In addition, the earnings income premium offered by global equities is also above the average seen since the GFC, and well above the levels that prevailed for the two decades prior to that.

Even in government bond markets, there are opportunities to earn relatively attractive yields in state and provincial bonds, and, selectively, in longer-dated maturities given upward-sloping yield curves.

These yield premia exist for a reason, however, with plenty of businesses and borrowers in financial distress. We have already seen a slew of dividend cuts, especially in sectors which were already under pressure, and are now beginning to see company failures and defaults.

### What's the answer?

The answer, then, we believe, is to be selective in what to own and what to avoid. History shows that the highest-yielding assets are often compromised and can deliver disappointing returns with significant risks. The yields they offer are essentially illusory, because their underlying assets struggle to generate sufficient cash to cover their income payments. Better returns for less risk can generally be found in moderately high-yielding securities where the yields are properly underpinned by resilient excess cash flows. At the security level there are many such opportunities to be found, you just need to look for them.

### Look for the oases, not mirages

In essence, investors need to distinguish between investment oases and investment mirages. In the equity market, the former are more likely to be found in companies with a mix of above-average dividends, supported by excess cash flows, but with lower leverage and higher profitability than their peers, providing dividend resilience, priced at valuations which suggest there is potential for capital upside or at least stability. This is in contrast to a typical dividend strategy which focuses primarily on the absolute level of yield and how consistent it has been.

The latter approach can prove to be a mirage and leave investors exposed to companies who have simply leveraged up their businesses to maintain high dividends.

In the current market, for example, within the healthcare and staples sectors there are a number of stocks offering above average yields, but with earnings growth which is organic and relatively stable. This provides a backstop to their dividends, with valuations that have decreased significantly in recent times.

By contrast, we can find few similar opportunities amongst higher-yielding equities in the utility, telecommunications and European banking sectors, where many companies are subject to regulatory restrictions on dividend payments, or which have built up high levels of debt to prop up dividend payments despite low and volatile earnings reducing their resilience over the long run.

The same approach of looking for sustainable cash flow generation to underpin yields applies equally in fixed income markets. Currently, we see decent value in a number of bonds issued by developed market investment grade-rated borrowers, supported by strong balance sheets and resilient income, as well as some equivalent emerging market issuers. Yield premia for the latter typically remain well in excess of developed issuers of comparable credit quality. They entered the COVID-19 crisis in good health and management have prior experience of managing market volatility and leverage through economic difficulties. Many BB-rated high yield bonds, in contrast, have limited room for capital gains from any further fall in yields, due to embedded call features, but remain exposed to losses in the event of higher yields, downgrades or defaults.

So, for us, the key to thriving in this income desert is to build a diversified portfolio selecting attractively priced individual bonds and equities offering decent yields, but whose income payments are well covered by sustainable cash flows – the oases, not the mirages.

LIAM NUNN

# BACK TO THE FUTURE FOR VALUE?

The iconic 1980s time travel adventure movie "Back to the Future" franchise paints a comical picture of what its writers believed life would look like in 2015: flying hover cars, robot servants, advertising holograms. With the benefit of hindsight, we can laugh at just how wrong they got it.

**Humans and stock markets are not good at predicting the future**

But the film tells us something quite interesting about how we as humans – and investors – approach thinking about the future in general. We take what's fashionable at the time and extrapolate its popularity out linearly over time. But the future rarely develops as smoothly as our forecasting brains would have us believe.

The stock market isn't much better at predicting the future than Hollywood. Time and again it believes it knows exactly what the long-term future holds, only to be tripped up by the inherent messiness of reality.

For a number of years, global equity markets have become increasingly concentrated, led by a narrow cohort of winners that just seem to keep on winning. But this has resulted in an extremely bifurcated market from a fundamental valuation perspective. The difference between the most well-loved parts of the market on the one hand and the most-hated on the other, is as wide as it's ever been in modern stock market history. We like to call this the very-stretched-elastic-band and it reflects that the market is taking a very binary view of the future at both ends of the valuation spectrum.

**We don't think it's different this time round**

But we don't have to look very far back to find another point in history at which this was the case. At the turn of the millennium, investors will remember that value as a factor was trailing growth materially; the elastic band was as stretched as it's ever been. Fast forward 12 months and by January 2001 the tables had turned: value had regained its historical advantage. The elastic band landed up snapping back far faster and far more aggressively than most people had thought possible.

Is it really so different this time around? We don't think so.

The stock market isn't much better at predicting the future than Hollywood. Time and again it believes it knows exactly what the long-term future holds, only to be tripped up by the inherent messiness of reality.

We think there are reasons to doubt that the quality of the businesses leading the market today is substantially different this time around.

The main issue with the tech bubble wasn't that the market fell in love with a bunch of empty concept stocks; it was that the market massively over-estimated the intrinsic value of businesses despite their quality and growth prospects. After all, it was the biggest weights in the index (names like Microsoft, Intel, Oracle, IBM, Cisco) that were driving the market higher – not the spiffy IPOs without a viable business model. We think there are reasons to doubt that the quality of the businesses leading the market today is substantially different this time around.

**The elastic band is being pulled from both ends**

But even if you disagree with that argument and you strongly believe that Google or Amazon or Facebook are exceptional businesses that can actually justify the multiples the market is applying, this wouldn't be sufficient to rationalise or explain away the broader market behaviour we are witnessing.

Because even if you remove the biggest and most expensive stocks in the universe, valuation dispersion is currently either beyond or very close to historical extremes. This is not just a function of the market getting extremely over-excited about the high growth areas of the universe. It is also a function of the statistically cheapest segments of the market falling to extremely attractive levels. The elastic band is very much being pulled from both ends – which wasn't necessarily true 18 months ago.

**We are optimistic about the future**

And as a result, we think there are genuinely incredible bargains to be found in the cheapest segments of the market. Some of the world's most well capitalised banks are trading on the same multiples they troughed at in the teeth of the financial crisis, diversified mining and energy businesses can be picked up at discounts to tangible net assets, world leading auto suppliers are trading on valuations that imply their earnings power has just permanently collapsed and there are Japanese businesses trading below the value of the cash on their balance sheets.

When we look at the absolute valuations we are being offered in the cheaper areas of the market today, we can't help but feel very optimistic about the scale of the absolute upside from our portfolio. Looking back at the lessons of the past, we think the future for value looks much, much brighter from here.

# IMPORTANT INFORMATION FOR INVESTORS



## Allan Gray

**Information and content**

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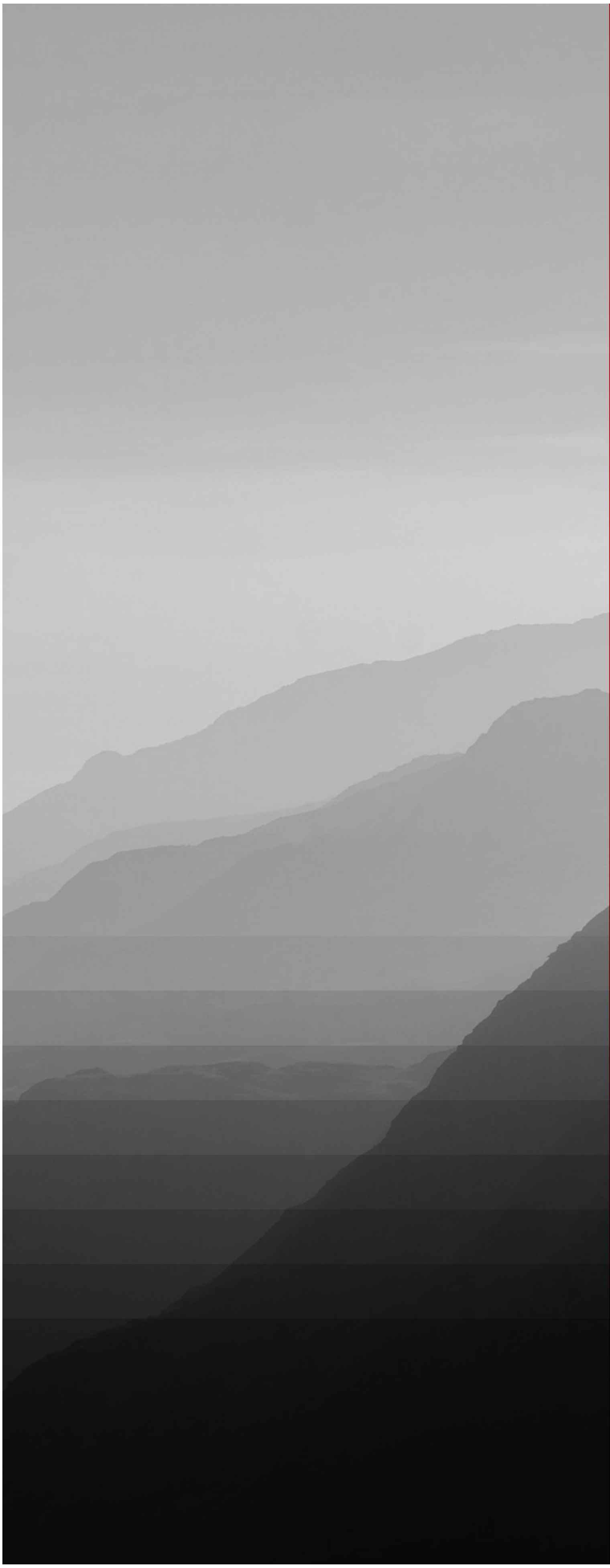


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