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TURMOIL REIGNS IN THE MARKETS. WHAT SHOULD I DO NEXT?

EXECUTIVE SUMMARY: With the events of the recent past in mind, Jonathan Brodie and Trevor Black, from our offshore partner Orbis, deliver some insights on making investment decisions. They note that successful long-term investment performance requires a partnership: your investment manager needs to have an effective approach to enable it to outperform markets, and you and/or your advisers need to ensure that you do not react inappropriately to short-term factors. Together this partnership can build long-term value.

Much has been written about the turmoil which has engulfed world financial markets for the past 18 months. Rather than a post-mortem, or an attempt at forecasting outcomes, we thought it might be helpful to address a more focused question: given the events of the recent past, how should a long-term investor react?

By describing what we at Orbis are doing, we hope to provide some guidance on how to answer this question.

Increased exposure to technology companies

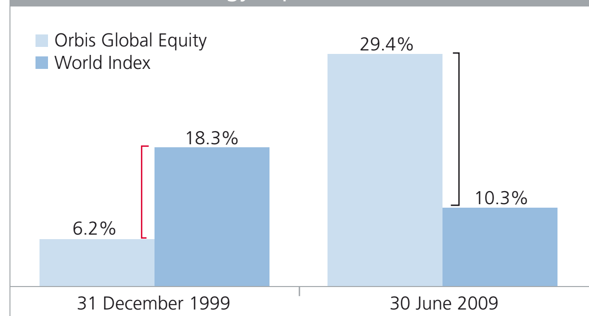
We currently have a significant exposure to technology companies. This is a marked shift from the end of 1999, the peak of the technology, media and telecommunications (TMT) bubble. At the time, we wrote in our annual report:

'Your Fund has very little invested in technology shares. This does not reflect scepticism regarding the wonderful potential of technological developments such as the internet.'

Back then we were concerned about the very high valuation and prices the market was paying for these businesses. Ten years later, we find that the information technology (IT) industry is more mature. Spending money on core IT is now central to all organisations. Company valuations are supported by real cash flows, while in the bubble they were largely speculative.

We find a number of technology companies attractive as a direct result of applying our existing philosophy to bottom-up stock picking. Each of our holdings appeals to us because of the specific business characteristics involved. The reason for the cluster in the technology area is a response – we think reasoned and consistent – to the opportunity set which the market now offers us.

GRAPH 1 Technology exposure - then and now



Source: Orbis research

In some cases, such as Microsoft and Samsung, we see solid businesses meeting our criteria for valuable franchises with attractive margins of safety. Google appeals to us as it has a strong competitive position, but the stock has been sold off indiscriminately. And then there are companies where an adverse market cycle has allowed us to buy long-term winners at a discount, particularly in the semi-conductor industry, which accounts for about 10% of our portfolio.

The point here is that while we have changed our weighting in technology stocks from what we held in 1999 in response to developments in those businesses, there has been no change in the rigour of our bottom-up analysis or in our investment philosophy. And because we have high conviction in our analysis and our philosophy, we are able to withstand short-term price movements and ultimately to behave logically at times when it has been extremely hard for global investors to do so.

This point is as relevant for investors in our funds as it is for ourselves – investors do not always stay invested for long enough to enjoy the benefits of our approach, and their investments do not always perform as well as the funds in which they have invested. This is because the returns experienced by the investor depend not only on the returns generated by the manager, but also on the time and timing of the investor's holding in the fund.

> "By chasing recent winners, investors make allocation decisions between funds by looking in the rear-view mirror ..."

How should you respond to recent turmoil in the markets?

There are three key determinants of the returns which investors experience over time: the performance of markets, the performance of the manager, and the behaviour of the investor in timing his or her exposure to their chosen investment managers.

1. Do not give up on equities

We at Orbis claim little expertise in predicting overall market returns. However, we do not agree with those who believe they should give up on the stock market entirely. It is true that the FTSE World Market Index declined over 50% from its 2007 peak to the trough earlier this year, and it is also the case that, since the inception of our funds in 1990, the Average Global Equity Fund has failed to outperform US dollar bank deposits – a fact which is particularly sobering.

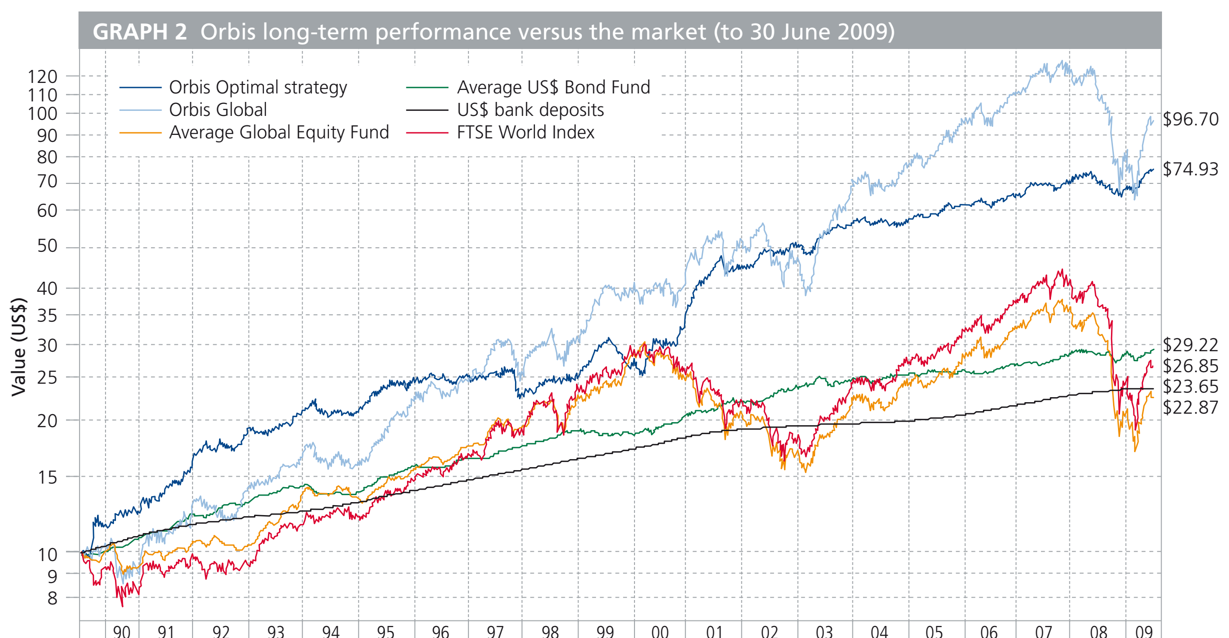
Nevertheless, we are of the opinion that the long-term outlook for global equities is more attractive than bonds or cash, particularly in the face of a potential rise in inflation in coming years. If stocks offer a dividend yield of 2.5%, real long-term earnings growth is about 1% (in line with long-term normalised performance), and assuming no significant change in valuation levels (markets currently trade at about the mid-point of their long-term ranges), then stocks generally offer sound, if not remarkable, long-term value.

2. Choose a manager very carefully...

Turning from the market in general to managers in particular, the unfortunate reality is that over the long term, the average money manager adds little value. As indicated in **Graph 2**, the average Global Equity Fund has underperformed the market index. At Orbis, we have been fortunate to outperform over the long term – although not every year. We remind investors that outperformance does not come in a straight line.

3. ...and do not switch around

A troubling observation is that, for all long-term periods, the

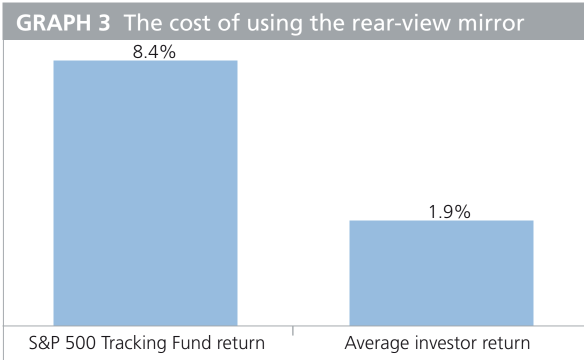


GRAPH 2 Orbis long-term performance versus the market (to 30 June 2009)

Source: FTSE World Index data source: FTSE International Limited.
Average Fund data source: ©2009 Morningstar Inc. All rights reserved.

average investor has continuously lagged the performance of the funds in which he or she was invested. By chasing recent winners, investors make allocation decisions between funds by looking in the rear-view mirror and are engaged in a systematic process of buying high and selling low. The ensuing performance gap can be wide, as shown in **Graph 3**, which highlights the impact of ill-timed shifts between funds.[1]

GRAPH 3 The cost of using the rear-view mirror



Source: Quantitative Analysis of Investor Behaviour, 2009, DALBAR Inc.

[1] Johan de Lange covered this subject is some detail in the previous issue of Quarterly Commentary in his piece 'How long is long-term? Setting reasonable goals'. (You can also read this piece on our website, www.allangray.co.za under the 'Latest news' tab.)

The investment performance partnership

One might conclude from the above discussion that we advocate not making any shifts in response to significant market changes. However, the real point is that we believe that responses to short-term price changes are generally ill-advised unless they are based on analysis and philosophy. Investors should understand the underlying philosophy and process which their managers use so that they are equipped to withstand short-term volatility and to avoid switching around inappropriately. It is this same emphasis on philosophy and process which led us to make what we believe is a sensible shift within the portfolio towards technology companies and to hold both our 1999 and current positions with conviction.

Long-term investment success requires a partnership. Investment management needs to have an effective approach to enable it to outperform markets and, critically, investors and their advisers need to ensure that they do not react inappropriately to market moves. Both the investment manager and the investor need to commit to a strategic philosophy and an established approach. Together, this partnership can build long-term value.