GRAY ISSUE

Annual report from the outgoing chief investment officer

1 March 2016
Issue no. 177

Adapted from the Chief Investment Officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2015. These are Ian Liddle's final Annual Report comments as CIO, as he hands the baton over to Andrew Lapping, who succeeds him on 1 March 2016. Ian was appointed as Chairman of Allan Gray in May 2015.

Our purpose is to grow your savings. To do this we must invest wisely and retain your trust and confidence. We never take your trust for granted, and we work hard to earn it by communicating regularly, clearly and transparently with you and by providing excellent service.

I am pleased to report that we are achieving our purpose for the overwhelming majority of our clients. Thank you for your unwavering support. Having clients who look to the long-term allows us to make hard decisions which we believe to be in your best long-term interest, but which can sometimes turn out to be painful for uncomfortably long periods. I hope that the good performance of our unit trusts in difficult markets in 2015 has rewarded your loyalty and patience.

South Africa is suffering some trying times, and conditions may get worse before they get better. In our own small way we are trying to make a positive contribution as a company: firstly, by empowering you by growing your savings, but also by supporting the Allan Gray Orbis Foundation, which is creating opportunities for many young South Africans. The establishment of Allan & Gill Gray Foundation by our founder to hold and govern the controlling interest in our business and devote its dividend receipts to philanthropy will hopefully make an even bigger impact in the coming years.

The price today determines future returns

One of the exciting aspects of markets is that they move ahead of events. So while the public awareness of South Africa's many challenges is now burgeoning both at home and abroad, the share price of Standard Bank, for example, has already collapsed almost two-thirds from its peak above US$17 in October 2007 to its current level around US$6.40.

The most important determinant of future investment returns is the price you pay today. Consequently, we are now buying domestic South African businesses in your portfolios, not because we are positive on South Africa's near-term economic prospects, but because we find the share prices attractive enough to offer potential returns which compensate for the risks.

Our South African share portfolios currently contain an eclectic assortment of companies. They range from businesses with strong growth potential such as Blue Label Telecoms, RMI, Naspers and Aspen, to businesses which have fallen on hard times, such as Murray & Roberts and Aveng. They include exporters such as Sappi, Sasol, Kap and African Rainbow Minerals and domestic consumer-facing businesses such as Standard Bank and Sun International. Some are big multinationals such as British American Tobacco or Old Mutual, while others are small caps such as Comair, Adcorp and Super Group.

The common thread that weaves through this seemingly incongruous mix is that our own fact-based and un-emotive research into each of these businesses concludes that their current share prices are attractive relative to their true underlying values. Of course, our valuation of at least some of these shares will be proven wrong in time. That is why our investment process is designed to encourage independent thought and constant questioning of our assumptions from each member of our investment team. It is also why we hold a diversified portfolio, in which the winners can hopefully outnumber and outgun the losers.

Staying conservative

Our conservative stance was rewarded in 2015, and we are using some of our large cash and other liquid holdings to buy shares which have fallen significantly over the last year. But prices have not fallen enough to go 'all in'. While shares in emerging markets are down significantly off their highs, the same cannot yet be said of the bellwether US market. If corporate profitability were to revert down to its long-term average, and / or company valuations were to revert down to their normal levels, global share prices could fall significantly. The Allan Gray Balanced Fund had a net equity exposure of 60% at year-end, but one should remember this includes a 4% exposure to SABMiller, which will be sold for cash if the acquisition by AB Inbev proceeds.

Looking ahead

We can't see the future, but it wouldn't surprise me if 2016 proves to be a tough year. Hopefully our diversified portfolios of relatively under-valued shares and our considerable cash and other liquid holdings, will help us to weather the storm. I have the utmost confidence in Andrew Lapping, who will be succeeding me as CIO, and in our investment team, to steer us through the choppy waters.

Commentary by Ian Liddle, Chairman, Allan Gray, January 2016