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Investment update: Taking advantage of disparities in the market

One of the key preconditions for successful active management is the level of disparity in the markets. Duncan Artus discusses this below, and in our latest video update, offering a review of 2020 and an explanation of how the portfolios are positioned to maximise opportunity in 2021 and beyond.

As I write this in mid-January, the FTSE/JSE All Share Index (ALSI) is making new all-time highs in rand terms, while the World, Nasdaq and Emerging Market indices are making new highs in US dollars. This may seem almost inconceivable when thinking back to the dark days of March and April 2020 and shows how quickly sentiment can change.

The South African equity market, as represented by the ALSI, returned 7% in 2020, outperforming both cash at 5.4% and inflation of 3.2%. The FTSE/JSE Capped Shareholder Weighted All Share Index (SWIX), which many funds use as a more representative equity benchmark, returned 0.6%. Resource shares outperformed their financial and industrial counterparts. The best-performing local asset class was bonds, with the FTSE/JSE All Bond Index ending the year at 8.7%, with longer maturity bonds underperforming the short- and medium-term portion of the yield curve. The worst-performing asset class was listed property, with a loss of 34.5%. Internationally, the MSCI World Index returned 21.7%, and the FTSE World Government Bond Index 15.6% in rands, respectively. The rand weakened by 4.6% against the US dollar.

The calendar year return numbers highlighted above clearly hide significant intra-year moves. The ALSI fell from 59 105 in early January 2020, to 37 177 on 19 March, having peaked at 61 776 in 2018. This translated to a 48% decline in US dollars given rand weakness. The rand would eventually peak at R19.35/US$ in April. What really unsettled investors was the speed of the market decline. Investors were discounting a deep financial crisis on top of a humanitarian one.

Performance

Absolute and relative performance of Allan Gray unit trusts remained muted for 2020, reflecting a local equity market that had traded sideways since 2014 and, even then, returns were dominated by a few large shares. The Allan Gray Balanced Fund returned 3.6%, underperforming its benchmark's return of 5.7%. The Allan Gray Stable Fund returned 3.4%, underperforming its benchmark of cash plus 2%, which returned 5.5%. South African equities detracted from performance, while fixed interest, foreign assets and commodities contributed. We did not believe South African equities were expensive before the pandemic and added to positions in the decline, as we did with local government bonds, where we were able to lock in what we believe represent attractive returns.

Within equites, detractors included Sasol and financials, such as Old Mutual and Nedbank, that were aggressively sold off during the pandemic collapse. Glencore, our large resource position, while being a positive contributor, underperformed BHP and Anglo American as iron ore continued to trade at very high levels. Positive contributors included Naspers and British American Tobacco, as well as Sibanye-Stillwater and MultiChoice. Reviewing the list of top detractors and assessing where our estimate of intrinsic value has permanently declined, is a useful way of assessing the potential value in the portfolio. Other than Sasol and hospitality shares such as Sun International, I feel comfortable that the intrinsic value for the rest of the list has not declined significantly, although given the effects of the pandemic, it will take longer to realise this value in certain cases.

The performance of our feeder funds and the offshore portion of our local funds depends on the performance of our offshore partner, Orbis, and the levels of the rand. The Orbis Global Equity Fund performed strongly in the fourth quarter of 2020, returning 15.6% in dollars for the year, lagging the FTSE World Index by 0.7%. The Orbis SICAV Global Balanced Fund returned 8.9%, versus a 60/40 benchmark that returned 14.2%. Performance improved in the second half of the year as investors started buying depressed cyclical shares, which complimented winners such as NetEase, XPO Logistics and Taiwan Semiconductor. Within the Global Balanced Fund, we prefer hedged equities and gold to global sovereign bonds. Orbis continues to believe its portfolio is attractive relative to the index.

Positioning

Central banks and governments, particularly in the developed world, have responded to the economic fallout of the pandemic with a combined fiscal and monetary policy response of almost unprecedented proportions outside of wartime. In the short term this has propped up economies, but over the longer term the bill will come due – potentially in the form of higher inflation and interest rates. This money often finds its way into asset prices, and this time perhaps also into the prices of goods and services. This is what the market refers to as the "reflation trade", which is characterised by a weaker dollar, higher commodity prices and higher long-term government bond yields. Reinforcing the trend is the commitment by central banks, to let inflation overshoot targets before raising rates. This, while understandable given the current environment, will be a difficult balancing act, in my view.

Whatever one's view, the reflation trade has benefited emerging markets, and indeed South Africa, through increased portfolio investment flows and higher commodity prices. There is also the possibility that foreign investors start to buy our government debt given the attractive real yields that they offer. The yield curve in South Africa remains steep, and we are holding more bonds than we

have in the past. This comes with greater risk given SA's poor fiscal position and long-term fundamentals, but we believe the risks are adequately priced in and must be compared to the alternative risk of holding too much cash with short-term rates at very low levels.

This shift in market thinking has also had a positive effect on value shares internationally, which contributed to Orbis' performance in the fourth quarter. While this is pleasing, we recognise that there is still catching up to be done when looking at the medium-term returns.

This brings me to one of the key preconditions for successful active management: the level of disparity in markets. To produce returns better than the index, you need a distribution of valuations, and the greater the disparity, the greater the opportunity for outperformance. Unfortunately, the journey can be painful in the short term, as we have witnessed recently, as the market has been driven by a small number of large mega cap shares. Local examples include Naspers, Richemont, BHP and Anglo American, as well as the precious metal shares. Our three largest shares are Naspers, British American Tobacco and Glencore, which all trade at attractive valuations. However, many other shares remain well off their highs. We continue to find exciting opportunities in many domestic shares in the financial and industrial sectors, which should benefit from the second-round effects of higher commodity prices. More importantly, their valuations are just too low and sentiment towards them is poor. Great prices are not made in good times. In five years, when investors look at the prices they were able to pay for selected local companies in 2020, I think they will seem like bargains.

Internationally, the US market, large tech shares and "disruptor companies" substantially outperformed. While having select exposure to the above, Orbis is finding many opportunities outside the US and across sectors outside of technology. I continue to believe that the offshore portion of the portfolios represents the biggest opportunity for outperformance.

Balancing risk and return

It appears the pandemic is going to be with us for a while. Although we do think about it in terms of managing risk in the portfolios, I am doubtful that we can add value by trying to predict the future, as even the experts seem to disagree on the most appropriate response. Our base case is that the rollout of the vaccination will be complicated, and there is going to be bad news along the way. I hope this proves to be pessimistic.

The investment team is applying the same philosophy and process we have for the last 46 years in managing your hard-earned savings. I encourage you to focus on your long-term financial plans and goals, rather than worrying about the daily news cycle. On behalf of the investment team, I thank you for the trust you have placed in us.

Adapted from the chief investment officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2020.

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

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