

Finding opportunity in the volatility

The first quarter proved to be a difficult one with the Allan Gray Equity, Balanced and Stable Funds all delivering negative returns. The most significant detractors were the international investments (via the Orbis funds) and local equities. World markets fell 1% in dollars, the rand strengthened by 4% over the period and the FTSE/JSE All Share Index declined 6%. In our Balanced and Stable Funds, the positive contribution from fixed interest was insufficient to offset the equity declines.

The Equity and Balanced Funds' returns were marginally better than their respective benchmarks but this provides little solace for investors whose debit orders reflect the only positive inflow into their accounts.

Market fluctuations are an expected and necessary part of investing. The important thing is to stick to your long-term investment plan. This is easier said than done. It is useful to remember that when the market falls you still own the same assets; you are just paying less for them. Human psychology is odd: when cornflakes go on special we tend to take advantage and stock up, but when the stock market falls we become stressed.

Volatility

Some investors were lulled into a false sense of security by the orderly uptrend of world markets from January 2016 to January 2018, a period over which the MSCI World Index rose 50%. The strong markets over the past two (in fact 10) years have made us increasingly nervous; we far prefer volatile and falling markets over calm and strongly rising ones.

Don't get me wrong, we don't want our clients to lose money over any period, but the good thing about volatility and down markets is that they create opportunities for outsize returns. When markets fall value investors are able to buy companies that have been sold down to below their fair value – a very exciting prospect.

South African equities

We are constantly searching for assets that will give our investors good real returns. The cyclical South Africa-oriented businesses we bought in 2015 and 2016 performed pleasingly in 2017 and we were substantial net sellers of domestic equity in late 2017 and January 2018 as many domestically orientated companies reached

and exceeded our estimate of their fair value. This was particularly true of the banks we bought during the very volatile Nenegate period, when South Africa's future looked very grim and investors priced shares accordingly. At the time, investors over-reacted on the downside by becoming excessively cautious. We are concerned that after the great news of Cyril Ramaphosa replacing Jacob Zuma and the positive changes at Eskom and government generally, investors are over-reacting by becoming too positive on South African assets.

Value is subjective and inherently uncertain as it involves the future. Different investors use very different sets of assumptions to value assets. At the moment we think investors are using assumptions that may be overly positive and therefore they are overvaluing certain assets. If the future is not as rosy as these investors expect, the returns from the assets they value highly now will be disappointing. It is far better to invest in assets where expectations are very low, that way, when things turn out to be "not that bad" investors are surprised on the upside. We look for assets where expectations are low and our normal estimates exceed those priced in by the market.

Offshore opportunities

There have been a number of global events over the past three months that have created a more volatile environment:

- President Donald Trump's stance on trade tariffs was received negatively as the market worries about a reduction in trading and economic activity associated with a global trade war.
- Interest rate expectations have increased in the US, and the US 10-year bond yields have sold off from 2.4% at the beginning of 2018 to 2.8% currently. Typically as bond yields rise, investors reassess the return expectations from stocks, which causes markets to fall.
- New sanctions imposed on Russia by the US and EU have caused global business concerns.

Similarly to South Africa, the volatility in international markets presents Orbis, our offshore partner, with opportunities to buy shares for less than they are worth. In addition, the recent strength of the rand, which is the most significant contributor to the recent drawdown, has given us the opportunity to increase the offshore exposure across our Funds.

Commentary contributed by Andrew Lapping, chief investment officer, Allan Gray

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