ALLANGRAY

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Understanding recent performance

2018 has been a difficult year for investors with most asset classes falling in price.

The prices of all assets are volatile; the only asset to seemingly lack volatility is cash, as it is the unit of account. Calculating the value of an asset is difficult and if you asked 10 people to independently calculate an asset's value you will get 10 very different answers. The market price of an asset is the point at which the number of buyers temporarily matches the number of sellers. But as people become more positive or negative, or change their valuation assumptions, the balance point between buyers and sellers moves sharply. The actual value of the underlying asset changes very little, especially over short periods of time.

Price versus value

It is important to remember just how slowly asset values change both when asset prices are rising and falling. Consider luxury goods company Richemont. Richemont is a very stable business with brands that have been around for decades and substantial net cash on the balance sheet. Despite the business being one where the underlying value is particularly stable, the market price in Swiss francs started the year at CHF88.90 per share, then rose to CHF99.00 and subsequently fell 35% to CHF64.00 as investors adjusted their valuation assumptions.

The Allan Gray Balanced Fund invests in many underlying assets both locally and internationally. The prices of all these assets are constantly changing but, given the diversified nature of the portfolio, these moves often offset one another. Unfortunately over the past 12 months the majority of the underlying assets have fallen in price. The Fund currently has 48% invested in local equities and the average South African share, as measured by the FTSE/JSE All Share Index, is down 12.5% over the period. A further 28.5% of the Fund is invested in the Orbis Funds, which are down 10.4%. Offsetting, to some extent, the 77% invested in these two asset classes, is the 23% invested in local cash and bonds, which returned 8%. As a result of the underlying asset class returns, the Balanced Fund returned a negative 6.2% for the year to 30 November.*

Should we have been more heavily invested in cash?

Many investors are asking why the Balanced Fund was not more heavily invested in cash given the outperformance of cash relative to equities over the past one, three and five-year periods. It is true that cash has been a superior investment of late – and this is not the first time it has happened; cash has outperformed frequently in the past. However, equities have outperformed over more periods and, when measured over long periods of time, by a substantial margin. Over the past 20 years, which approximates the average investor's time horizon, SA equities have returned 12.5% compared to 8.2% for cash. The level of under- or over-valuation of equities at a point in time gives an indication of how equities will perform relative to cash over the subsequent three, four or five years. At current valuations, and taking account of our analysts' valuations, we think that the equities we hold should outperform cash over the next four years and give investors solid real returns.

Given this valuation discrepancy, we are selling the Fund's cash holding to invest additional money into equities. Importantly, equities are a real asset compared to cash. Historically real assets have protected wealth far more effectively than cash during periods of fiscal distress. Investors must always consider the potential outcomes, rather than just a single point estimate.

Orbis performance

No asset class or asset manager can consistently outperform. While there are periods where cash outperforms equity, over the long term it has underperformed. Similarly, while it is inevitable that our offshore partner Orbis will periodically underperform, over the long term the Orbis Global Equity Fund has outperformed both the equity market and its peers.

Orbis has had a difficult year, with its Global Equity Fund underperforming the benchmark by 12.2% for the 12 months to November. This is not unusual for a contrarian manager, whose funds look very different to the benchmark, and therefore deliver different performance. The Orbis Global Equity Fund has underperformed by more than 10% on nine occasions over the past 28 years, including two periods when it underperformed by more than 18%. On each occasion the underperformance was recovered and the Fund went on to outperform. Orbis has applied the same philosophy successfully since 1990, across multiple generations of stockpickers, and we see no reason that this time would be different.

None of us like to see the price of our investments fall, but unfortunately this is a part of long-term wealth creation. Remember returns do not come in a straight line. The recent drawdown of the Allan Gray Balanced Fund is by no means the worst and there will be future periods when absolute returns are negative. During periods of negative returns, as an investor it is critical to remain focused on your long-term objectives; sit tight so that you don't lock in losses. Similarly, as your fund manager, it is critical for us to stick to our investment philosophy, invest with conviction and remain focused on delivering results over the long term.

*The weighted average of the three asset classes mentioned is -7.1%. The actual performance differs as the Fund also had positions in commodities and Africa ex-SA assets. The percentage of Fund invested in each asset class changed over the period – in particular in the early part of the year only 25% was invested in Orbis, and as equity prices fell we have increased the share exposure.

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

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