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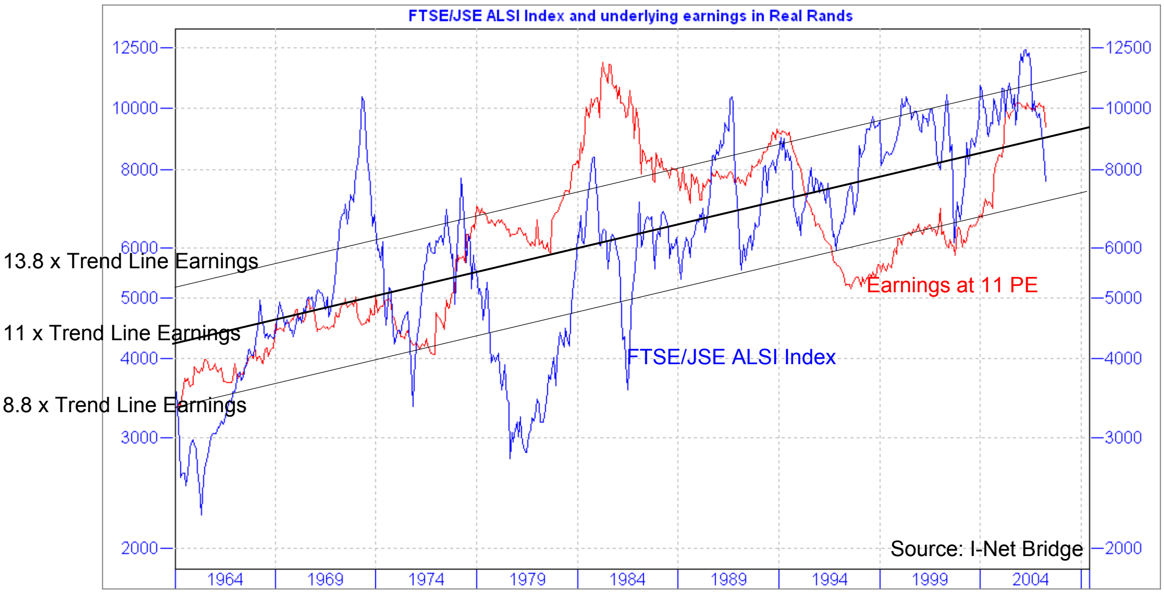
A Longer Term Perspective of the South African Equity Market

Year to date, the FTSE/JSE ALSI index is down 20% and it has lost 36% of its value since its peak in May 2002. After declines like these, investors are understandably nervous about their existing and prospective share investments. In our experience though it is exactly at these times of extreme volatility that the best investment opportunities present themselves. History is often a helpful guide to identifying these opportunities.

The graph below depicts the FTSE/JSE ALSI index since 1960 and the earnings underlying this index valued at a PE multiple of 11, this index's long-term average. Both the index and earnings are expressed in real Rands.



A look at the FTSE/JSE ALSI Index earnings clearly shows the cyclical nature of this series. It is exactly this cyclicality in company earnings that make equity investing so difficult. A number of different variables tend to impact on company earnings at any point in time such as the business cycle, commodity prices, the exchange rate of the Rand, monetary and fiscal policy etc. However over the longer term the dominant economic forces tend to endure. As the stockmarket tends to look through the shorter term cycles, a look at the stockmarket's behaviour around its longer term trend line earnings largely improves the conclusions we can draw about its valuation and expected future returns.

We have fitted a trend line through the earnings series using the least squares fit method. Upper and lower boundaries were fitted around this trend line. With the earnings series being valued at an 11 PE, the trend line, upper and lower boundaries depict market valuations at 11, 13.8 and 8.8 times trend line earnings respectively. I would like to highlight two observations:

- The value of the market has largely fluctuated between the upper and lower boundaries i.e. between 8.8 and 13.8 times trend line earnings. The exceptions were the bull market tops in 1969 and 1987 and the bear market lows of the early 60's and the mid 70's.
- During this period the market has bounced off the 8.8 times trend line earnings line on a number of occasions but it has only traded at a lower level on 5 occasions. An investment in the market at each point in time where the market has dropped below the lower boundary, would have generated three year real returns, inclusive of dividends, as follows: 1960: 9.0%; 1971: 18.4%; 1975: 4.0%; 1982: 9.9% and 1998: 22.9%, even though short-term returns were negative. If we consider that over the long-term the SA share market has generated an average real return of 6.8%, with one exception, these investments would have yielded above average three-year returns.

Historically buying the market at less than 11 times trend line earnings have yielded above average long-term returns. Buying the market at the lower boundary (8.8 times trend line earnings) has yielded exceptional returns. With the FTSE/JSE ALSI Index currently trading at 9.0 times earnings, current market valuations are approaching the lower boundary. History argues strongly for a maximum equity exposure at this point in time. This is borne out by the fact that we currently find numerous shares that we believe will be very rewarding investments over the next 5 years.

Forecasting the turning points in markets is a very difficult exercise, and the likelihood that one gets it wrong is very high. The fear of capital loss is normally at its highest exactly at that point in time when equities represent their most attractive buying opportunities. It is our view that the FTSE/JSE ALSI currently offers one of these opportunities.

Commentary by Arjen Lugtenburg, Director