ALLAN GRAY

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In pursuit of undervalued assets

The South African equity market returned 12% in 2019, after being saved at the death by December's 3.3% return. However, this pales in comparison to the 28% return generated by the MSCI World Index last year. Equities were not the only asset performing well; the JSE All Bond Index returned 10% for the year. These returns compare to South African consumer price inflation of 3.6%. The inflation rate was lower in 2003 and 2010, but in both these cases this was a result of high base effects from a very weak rand in the prior year. Today's low inflation is thanks to stable, rather than volatile, price levels.

Allan Gray and Orbis funds: Performance review

Disappointingly, the Allan Gray funds didn't take full advantage of the strong equity markets. Looking at the Balanced Fund, which returned 6.7% for the year, the underperformance came in two areas. Firstly, the Fund's domestic shares returned only 5.7%, underperforming the FTSE/JSE All Share Index (ALSI) by 6.3% and secondly, the Orbis assets returned 8% compared to their 60/40 benchmark's 16% return. (The benchmark used is 60% of the FTSE World Index including income and 40% of the J.P. Morgan GBI Global Index). The local equity underperformance cost the Fund 3% in absolute performance, while the Orbis underperformance cost 2.4%.

Looking only at the equity holdings, the four largest absolute detractors were Sasol, KAP, Glencore and Sappi, which cost our funds 2.1%, 1%, 0.9% and 0.8% respectively. We also missed out by not owning Anglo American, AngloGold, Anglo Platinum and by only having a small holding in BHP; this cost us 3% in performance relative to the ALSI. As Jacques Plaut notes in his December Equity Fund factsheet commentary, 2019 was unusual in that the large companies did particularly well while the remainder disappointed. The four largest shares in the ALSI (Naspers, Richemont, Anglo American and BHP), which account for 40% of the market, returned on average 22%, while the remaining 154 stocks returned just 5.6%. We own Naspers but our caution on the super profits from iron ore meant we avoided Anglo American and BHP and preferred Glencore. Glencore underperformed BHP by 35% in 2019.

Avoiding losses is a key part of the Allan Gray philosophy so we feel the detractors acutely. We were keen Sasol sellers in the latter half of 2018 and the first half of 2019 when the share was above R400, but we only sold 38% of our holding before the news emerged of additional cost overruns and delays at their Lake Charles Project. These delays, together with lower chemical prices, caused the share to fall to R300 by year end from R425 in January 2019. The rand oil price rose 19% over the period. At R300 we see good value in Sasol and bought some shares below R270. Based on our estimates of normal earnings we also believe Sappi, Glencore and KAP present good investment opportunities and are excited about their prospects for the year ahead.

I noted above that most of the shares in the ALSI did poorly in 2019. Given the weak economy and sentiment towards South Africa, it will be no surprise that the worst performers were domestically orientated companies. The General Retailers Index fell 18% while the Financials Index was almost flat, returning 0.6%. We are beginning to see value emerge in many of these companies, which bodes well for future returns.

The Orbis funds have underperformed since their strong run up to early 2018. All of last year's 28% return from world markets was a result of rerating, rather than earnings growth. The price-to-earnings (PE) multiple on the MSCI World Index increased from 15.7 in January to 20.6 in December; this rerating is not sustainable. Markets driven by this type of momentum do not favour value managers like Orbis. That said, Orbis is happy with the shares they own and their prospects. Exactly like Allan Gray, they own shares that they think are trading at substantial discounts to their fair values and, most importantly, they are carefully avoiding companies that have become extremely overvalued.

Assessing available opportunities

Money market funds received strong inflows over the past few years as investors became disillusioned with weak and volatile equity returns. Over the past five years the ALSI returned 6.0% while the Allan Gray Money Market Fund returned 7.6%. Prospects for the next five years have very likely swung in favour of equities. Three-month interest rates are now 6.5%, which compares to the 7% dividend yield on Nedbank shares. Only once since 1988, in 2003, has Nedbank's dividend yield exceeded the rate available on three-month deposits. Yes, the outlook for banking earnings growth is poor and Nedbank will have a more volatile return series, but the balance of probabilities surely favours an investment in Nedbank over a money market deposit for the next five years.

Investor concern about South Africa's future is not limited to equities. Despite inflation of 3.6%, the 10-year bond yields 9.1% for a 5.5% real return. Investors clearly don't think the low inflation rate is sustainable and are pricing in a rate of about 6%. Whether inflation remains subdued or it spikes higher, inflation-linked bonds offer a great opportunity. Five years ago investors were willing to buy the 10-year inflation-linked bond at a return to maturity of around 1.60%; today the same asset is available with a real return to maturity of 3.72%. The risk/return profiles of nominal and inflation-linked bonds are very different, but we see value in both these asset classes and have been increasing our exposure accordingly.

Global asset valuations – both equity and fixed interest – look less appealing than those of South African assets. Despite this, we still have a 30% exposure to international assets through the Orbis funds, which we believe is essential for diversification. Naturally the future can take many paths, some of which are extreme, and despite local assets being cheap, a 70% exposure in our asset allocation funds is a large position. Furthermore, Orbis has taken care to seek out undervalued assets globally and therefore by buying Orbis funds we are not just buying large capitalisation American shares which dominate the international benchmarks.

What is driving the rand?

After treading water for the past four years we think at R14/US$ at end 2019 the rand is slightly overvalued. A few of the drivers behind the stable local currency include global investors investing in our fixed interest market, the recent surge in precious metal prices and the weak economy suppressing demand for imported goods.

The Allan Gray investment philosophy is unchanged

Our founder, Allan Gray, who sadly passed away in November, developed our distinctive investment philosophy when the firm was founded in 1973 and it remains in place today. We continue to seek out and invest in undervalued assets. There have been periods in the past when the philosophy has led to underperformance but, importantly, in each of those cases we stuck to our philosophy and our investments came through. We think we are in a similar position today. We have underperformed over the past 18 months, but we believe we own undervalued assets and are excited about their prospects and future returns.

Adapted from the chief investment officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2019.

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

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