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Outlook for 2004

At the start of each year, investors, economists, and market commentators haul out their crystal balls and try to predict what the next year will hold. The problem with crystal balls is that they are not normally very clear. Or, maybe it is that the owners of the accurate crystal balls do not want to share their future millions with the broader investment public. What further complicates this crystal ball gazing is that different crystal balls seem to make very different predictions.

What it means in reality is that it is incredibly difficult to accurately forecast economic variables, even in stable first world economies. Thus, an investment strategy based on economic forecasts alone is, in my mind, doomed to fail. This does not, however, mean that economic fundamentals are to be ignored in investment decisions. One should merely not put too much reliance on economic expectations when investing, particularly not over the short-term.

Investment success can be dramatically improved by focusing on the one variable in the investment equation that is certain: the price you pay for your investment. A good company acquired at an attractive price will be a rewarding investment in all but the worst scenarios. What an attractive price is, is normally not that easy to determine, but it usually pays to spend most of one's effort here.

Instead of trying my hand at the hazardous task of making forecasts for 2004 I would rather give my views on what I think about the pricing and fundamentals of the South African stockmarket and if an investment here is likely to be rewarding over the longer term.

After a strong run off its April 2003 lows the South African stockmarket still offers attractive value. South African shares are trading at just over 13 times earnings. Although this is at a premium to this market's long run average PE ratio of 11 times, I believe this slightly higher price is justified given our very sound economic fundamentals. These strong fundamentals can be seen in sound government finances, with the deficit to GDP the lowest in many years, sound monetary policy (if not too conservative), and low levels of borrowing in corporations and the public at large. The reductions we have seen in the levels of inflation and interest appear to be sustainable for some time to come.

An interesting feature of the South African stockmarket today is that value is fairly evenly distributed across the market, after years of huge variation. However, best value is still to be found among domestic industrial shares. This is best illustrated by looking at a domestically orientated company like Tiger Brands. Tiger Brands has a number of large, dominant businesses that produce strong and stable cash flows, year after year. This company has consistently grown its earnings faster than the market and is expected to continue to do so in future. It is priced at a PE ratio of 10.6 and a dividend yield of 3.5%. This discount to the market is not justified. Another feature of Tiger Brands, and many other domestic industrials, is that it has almost no financial gearing (debt). To illustrate how undervalued these shares are: Tiger Brands could theoretically incur borrowings and pay a special dividend equal to the current share price of approximately R80 per share, whereafter, by my calculation its operating earnings will still handsomely cover its interest charge and it will produce approximately 240 cents per share in after-tax earnings. It is exactly this undergeared nature of domestic companies that hold tremendous potential for value release and that make them potentially rewarding investments with low downside risk.

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