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Why we remain cautious on prospective real local equity market returns

At the core of our investment philosophy we analyse the fundamentals of a business to determine its intrinsic or underlying value. We then compare this to the value the market assigns to this business, namely the share price. We will consider including the share in our portfolios if it is trading at a lower price than we believe it is worth and with a sufficient margin of safety.

A focus on earnings

There are many aspects to consider when calculating intrinsic value, including an assessment of the share's price to earnings (PE) ratio. When we assess whether a share is 'cheap' or 'expensive', we pay particular attention to the 'E' in this equation. If only investing was as simple as buying low PE shares!

Instead of using a company's current earnings when valuing that company, we estimate a 'normalised' level of earnings. The notion we subscribe to is that of assessing the sustainable level of profitability for a company throughout economic cycles and with regard to its competitive positioning.

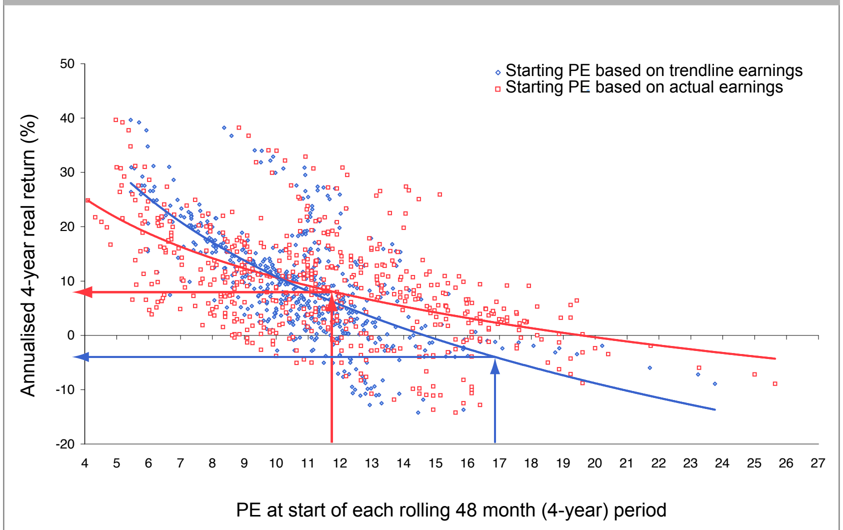
For the market as a whole, we use the FTSE/JSE All Share Index (ALSI)'s 'trendline' earnings as a useful proxy for normalised earnings. The 'trendline' earnings indicate the direction of earnings over the long term, as opposed to the long-term average earnings.

Actual versus trendline earnings

The chart provides an instructive framework for establishing reasonable expectations of future real returns from the market based on the ALSI's historic returns. Using monthly return data from 1 January 1960 we calculated the PE ratio on the ALSI's actual earnings, as well as the PE on its trendline earnings, at the beginning of each month. We then calculated the ALSI's subsequent rolling 48-month (four-year) real return. The chart shows a scatter plot of the starting PEs based on the actual and trendline earnings, together with the subsequent annualised returns from each of these points. The curved red and blue lines are 'fitted log trendlines'.

What is a logarithmic (log) trendline?
A log trendline is a best-fit curved line indicating the direction or trend of a variable's movement.

Historic returns at various market PEs



Unsurprisingly, in general the higher the PE ratio at the start of the investment period, the lower the subsequent real returns. Conversely, the lower the PE ratio, the higher the subsequent real returns.

At the end of July 2009 the ALSI's PE on actual earnings was just under 12 times: based on history, an investor can reasonably expect an annualised real return of 8% over the next four years. This is indicated by the red vertical arrow where it connects the fitted red curved trendline; the red horizontal arrow indicates the expected annualised real return based on historic returns and historic PEs using actual earnings.

History suggests greater caution

In contrast to this, consider the return expectations when using the PE on trendline earnings, which is currently approximately 17 times: from this starting point an investor can reasonably expect an annualised real return of -4% over the next four years. This is indicated by the blue vertical arrow where it connects the fitted blue curved trendline; the blue horizontal arrow then indicates the expected annualised real return based on historic returns and historic PEs using trendline earnings. In fact, since 1960 real returns from this level of trendline PE and higher have never been positive, as all the blue markers to the right of 17 are below the 0% annualised real return line.

Unless the high level of earnings is compensated for by a much lower PE, it will be difficult to reasonably expect a high real return from the overall local equity market from this point forward.

Commentary by Lindy du Plessis, Allan Gray Limited