GrayIssue

Managing portfolios in times of uncertainty

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My inbox is filling up with commentary about the impact of Brexit. Some of the commentary is of debatable long-term value and with news of this nature it takes some time for markets to settle and reach equilibrium – especially when a large portion of the volume is dominated by high-frequency and algorithmic traders and hedge funds who are not long-term investors. As always we believe it is important to take a rational, long-term approach and to guard against acting emotionally in response to the short-term market movements.

When managing our clients' hard-earned savings our foremost focus is always on absolute risk - the risk of a permanent loss of capital - even if this introduces risk into our performance relative to our peers. We believe that it is possible to maximise long-term returns by managing risk while thinking hard about the true underlying long-term value of assets (i.e. taking a 'bottom-up approach') and being contrarian when appropriate.

I can think of a number of risks our portfolios are facing, of which Brexit is just one. Maybe the most worrying risk is that we are investing during the greatest monetary experiment in history with very little precedent to use as reference for possible outcomes.

By distorting interest rates, the most important aspect of price in the markets, there is likely to have been large misallocations of capital. As such, we remain cautious on assets that have benefited from unsustainable demand borrowed from the future, including government bonds, Chinese infrastructure, sales of luxury goods and leveraged acquisitions (whether of other companies or share buybacks).

Let's look at the Allan Gray Balanced Fund to demonstrate how we are currently positioned.

The Balanced Fund's positioning

The goal of the Allan Gray Balanced Fund is to create steady, long-term wealth for investors by balancing income generation, capital growth and risk of loss using a mixed selection of assets. The Fund's holdings of short duration cash, hedges and high-quality offshore equities have provided liquidity to take advantage of dislocations, including oversold local equities, at various stages over the past year. If opportunities present themselves we will do so again.

Of course, the best protection against risk is to buy cheap assets. Assets bought at low valuations by long-term investors can withstand a lot of bad news. As highlighted in previous commentaries, we are finding value in many local financial shares, select depressed cyclical companies, certain high-quality businesses and depressed emerging market shares. In addition, approximately 8% of the Fund is invested in precious metal ETFs and the miners of those metals and the offshore exposure is 50% hedged.

It is incredibly difficult to forecast short-term market movements in reaction to the result of the UK referendum. Indeed the whole process of separation should it occur is likely to take a number of years and bring into question the long-term viability of the European Union. Should assets or stocks sell off significantly below their intrinsic values this may offer us opportunities to take advantage of extreme volatility.

The local equity market is effectively an international market with many of our big shares having very little to do with the South African economy. They will be affected by any international sell off – not simply because they are listed in London.

We believe the Balanced Fund's diversified holding of undervalued assets should stand it in good stead in these uncertain times.

Commentary by Duncan Artus, portfolio manager, Allan Gray