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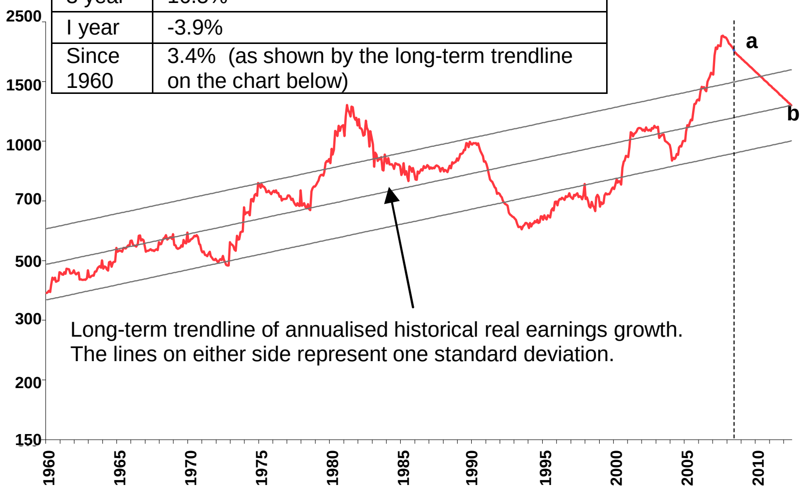
A simple, quantitative view of the future

We have cautioned for some time that future real returns from South African assets are likely to be far lower than the previous five years. The rolling level of annual real returns has already been declining at a rapid rate due to a combination of lower nominal equity prices and rising inflation.

FTSE/JSE All Share Index earnings in real terms

Annualised historical real earnings growth ending 31 July 2008:	
5 year	11.7%
3 year	16.5%
I year	-3.9%
Since 1960	3.4% (as shown by the long-term trendline on the chart below)



1. The red line as indicated by **a-b** above shows the decline in real earnings to reach the trendline in 4 years' time. This is a decrease of 8.5% p.a.
2. Multiplying the resultant ALSI earnings in point 1 by the ALSI's long-term average PE of 11.7 equates to a value of 16334. This results in a 4-year ALSI real capital return of -12.4% p.a.
3. How much would earnings fall if they were to immediately return to:

The upper standard deviation band	-18%
The long-term trendline	-35%
The lower standard deviation band	-49%

Periods of low returns create high returns

The world would be a far simpler place if assets only went up in price. We are not surprised by the current lower returns, and while it never feels great living through such a period, we are aware that periods of low returns create high returns, and vice versa.

A dispassionate look at expected real returns

We thought it would be useful to take a look at what real equity returns (excluding dividends) one could expect based purely on a 'quantitative reversion to mean' approach. In other words, what equity returns could we expect if we assume that 'earnings and valuations return to their long-term average'? We use a similar approach as a sanity check when assessing the expected returns from our own equity portfolio – we add up the expected returns (typically using a four-year time horizon) of our individual bottom-up stock picks.

Real returns are likely to disappoint

The graph and table highlight the expected real capital return from the FTSE/JSE All Share Index (ALSI) if:

- Real earnings revert to their long-term trendline in an orderly fashion over four years
- The long-term average price:earnings ratio (PE) of 11.7x is applied to the resultant earnings

As one would expect, the resulting picture does not make for very pleasant reading for investors with high real return expectations. As the chart uses real prices (i.e. net of inflation), investors wanting to calculate a nominal return figure can add their own estimate of future inflation. Although the merits of mean reversion can be debated, we feel the graph illustrates our key concern: earnings remain well above normal. The current above-average market PE of 13x does not sufficiently compensate for this risk for us to be bullish on equity returns in general.

The inevitable nature of the business and investment cycle

Earnings tend to revert to their mean (although the pace of the normalisation has differed over history). This is because when profits are above normal not only are profit retentions high, but new capital tends to be underpriced and readily available. This enables existing businesses to support expansions, makes marginal projects appear worthwhile, and attracts new (often less robust) competitors to compete away excess profitability.

We can still find equities to build a portfolio that we believe can outperform cash over our investment horizon

We believe that the equities in our clients' portfolios should outperform the market and returns on cash (in rands) on a four-year view. We believe these shares share a common characteristic: a current price that is attractive relative to their individual earnings level in a period where earnings are likely to disappoint on the downside.

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