GRAYISSUE

What do low global bond yields mean for South African investors?

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Adapted from the Chief Investment Officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2014.

More than half of global government bonds now yield less than 1%[1]. Many European and Japanese government bonds now carry a negative yield. What does this mean for South African investors?

The markets are assessing a higher probability of deflation, or at least an extended period of low inflation, in many developed countries. Future returns on global government bonds from today's starting point will be low, with the most likely outcomes ranging from small positive returns to significant negative returns. The spread, or extra return, that is promised, but not guaranteed, by lending to less creditworthy corporations is also on the low side. It is certainly much lower than it has been in previous cycles when investors have suddenly become concerned about the ability of borrowers to repay their debts.

Today's dilemma

Some commentators leap straight from this bearish assessment of global bonds to a bullish view on global equities. But there is a problem with this approach. In aggregate, corporate profits are high by historic standards. If one normalises corporate profits downwards, aggregate equity market valuations are revealed to be significantly higher than their long-term averages. If corporate profits and valuations were to normalise, substantial losses could be incurred by the major equity market indices.

Following this logic, it would seem prudent for balanced (or multi-asset class) funds to maintain significant liquidity reserves. These reserves allow investors to deploy more capital to long-term assets, such as bonds and shares, when valuations become more attractive. But it can be hard to hold these reserves, as short-term interest rates are low and they act as a drag on portfolio returns for as long as the 'music keeps playing' and valuations continue to rise.

This dilemma is compounded in our domestic multi-asset unit trusts, where retirement fund regulations restrict our foreign exposure and prevent us from holding as much liquidity in the major global currencies as we would like. Although the rand has depreciated significantly over the last four years, we continue to believe it remains vulnerable. This means that there is a risk that the rand-denominated liquid reserves we are holding to purchase long-term assets at more attractive valuations in the future, may also lose some of their global buying power. As Charlie Munger said: "It's not supposed to be easy."

How are we approaching this dilemma?

In our flagship Allan Gray Balanced Fund, our net equity exposure of 56% is significantly below the maximum allowed 75%. If, or when, the cycle turns and the market once again offers us long-term assets at more normal or even attractive valuations, we have the capacity to increase net equity exposure by closing our hedges and deploying cash reserves. While we wait for this opportunity, we hold a portion of our reserves in hedged equities and precious metals. The hedged equities should provide better long-term returns than bank deposits if we and our offshore partner Orbis can continue our track record of picking portfolios of shares that outperform the market indices. However, the price one pays for this long-term stock-picking alpha is volatility of returns. This can be seen clearly from the excellent year the Orbis Optimal funds had in 2013 followed by a very disappointing year in 2014.

Perhaps most importantly, we continue to research the investment opportunities offered by the market rigorously, and continue to execute our investment process without being swayed by the mood swings of Mr. Market. By constantly exercising the discipline of selecting shares (and other securities) that we calculate to offer better value relative to the available alternatives, we should hopefully be able to compound better long-term returns than those provided by the overall market, even if market returns overall prove disappointing.

1. Source: Bank of America Merrill Lynch

Commentary by Ian Liddle, chief investment officer, Allan Gray