GrayIssue

Examining the value in South African equities over time

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The local equity market (FTSE/JSE All Share Index - ALSI) has recovered substantially (+80% in rands and +190% in US$) from its global financial crisis lows. It is within 1% of its all time 2007 US dollar high. The consensus forecast is a rise in real earnings to above their previous peak. The average manager has 67.3% of its domestic balanced portfolio in local equities.

The majority of investors naturally become bearish at the bottom of the market and bullish at the top as the mood of the moment is reflected in prices. This is a powerful force that is exceptionally hard to resist. It is human nature to seek comfort with the majority whether intentional or not. (We have written at length about investor behaviour. Please refer to GrayIssues 82 and 91).

Then and now

During my annual December clean up, I came across and reread the reports we wrote in the months around what turned out to be the bottom of the ALSI in 2003 (the index was 7 361). At the time (see accompanying April 2003 GrayIssue) we argued that we believed local equities would provide superior real returns based on the prevailing poor sentiment, valuations and earnings levels.

We also mentioned that value had broadened across the market as opposed to being isolated in certain sectors, which further increased our confidence. Today, we struggle to find substantially undervalued medium to big companies in any of the major sectors. To us, this suggests there is a high probability the market is overvalued. Investing, after all, is probability based, so we may be wrong, but it is instructive to compare the current conditions and level of the ALSI to those when we wrote the 2003 GrayIssue.

Trends can change

Since 2003 South Africa has experienced a strong rand, declining interest rates, a structural leveraging of the consumer, significantly increased foreign ownership of domestic equities and historically high commodity prices. Add the outcome of these trends to the low entry point and we get an ALSI that is up five times in US$ terms. In addition, the world that continues to buy our commodities and financial assets has since embarked on a great monetary and fiscal experiment with uncertain outcomes.

We therefore believe that given current price levels, there is a low probability that an investment strategy premised on a continuation of these trends will provide superior real returns.

It should always be emphasised that for any asset 'the current price tag is far more important than historical averages'*. In other words, there is no preordained right for an asset to achieve its historical average real return – it all depends on your entry price.

ALSI	April 2003	December 2010
Dividend yield (%)	4.1	2.2
Real earnings move to revert to long term trend line (%)**	+23	-16
PE (x)	9	17.1
Real ALSI price move to revert to long term trend line (%)**	+51	-32
ALSI Earnings Yield divided by the long bond yield (%)	108	71
Spot Rand dollar exchange rate	7.93	6.6

* Jeremy Grantham, GMO, **Based on trend line from 1960 – 2010

Commentary by Duncan Artus, portfolio manager, Allan Gray

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GRAYISSUE

Is there value in South African equities?

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The local equity market (FTSE/JSE ALSI) has performed poorly (-15%) year to date and is down 34% off its peak in May 2002. The extreme weakness of the Rand towards the end of 2001 boosted the short-term earnings of many S.A companies. The subsequent recovery in the Rand and weak offshore markets has resulted in investors lowering both their earnings' expectations and the values willing to be paid for those earnings respectively. The poor performance has been felt across virtually the entire market.

The value disparity that existed in the market 18 months ago, where we believed large segments of the market were over and undervalued, has narrowed considerably. Value has broadened across the majority of the market. Good indicators of the breadth of this value are:

1. It is becoming increasingly difficult for us to identify shares that we believe are substantially overvalued.
2. Our bottom up research is identifying an increasing number of opportunities in large market capitalisation counters that our clients previously had little or no exposure to.
3. An increasing amount of companies are being bought out and/or de-listed by business people across all sectors of the market.

The above indicators are typical of an overall market that is attractively valued.

The starting point or price paid is the most important variable a rational investor would use when estimating future equity returns. "It matters to the measurement when the measurement begins."* The expected return from equities depends on the initial dividend yield, growth in earnings and changes in valuation. Generally speaking the lower the dividend yield and/or higher the PE on the original date of purchasing a market on a normal level of earnings - the lower the expected future return. A brief comparison between the local All Share Index and the US S&P 500 Index highlights the good relative value offered by local equities.

Looking at the table:

	ALSI	S&P 500
Initial dividend yield (%)	4.1	1.8
The current level of earnings	Average	High
Valuation levels		
Long-term average PE (x)	11	14
Current PE (x)	9	28

Furthermore, it is likely that SA is about to enter a period of declining interest rates. Domestic interest rates are high relative to the developed world and scope for a material decline in rates exists. This will be positive for local economic activity and allow companies to increase their current low levels of gearing (industrial shares in particular) which should be positive for underlying earnings. It should also become apparent that equities are more attractive relative to other investment choices. Ten-year bonds currently yield 8.3% after tax versus the 10.8% earnings yield offered by equities. The bond market has to a large extent already discounted the expected drop in interest rates. As detailed in previous commentaries we believe that equities offer good value relative to bonds.

We believe local shares are attractively valued and should deliver long-term superior returns from current levels. As Warren Buffet once said, "We like to do business in a pessimistic environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."

* Bill Miller: Legg Mason Value Trust Annual Report

Commentary by: Duncan Artus, Trainee Portfolio Manager & Stephen Mildenhall, Chief Investment Officer, Allan Gray Limited