GRAYISSUE

Insuring your investment portfolio

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Sun International, a long-term holding in our clients' portfolios, recently reported their financial results. These revealed tough operating conditions in their markets and notably the temporary closure of their rapidly growing Chilean operation due to the recent earthquake in that country. As an unexpected event, no analyst could have forecast this.

On further investigation, we found that Chile experienced many large earthquakes over the last century and is a known 'earthquake zone'. Fortunately, Sun International considered this and had earthquake insurance for both property and loss of profit. Insurance premiums well spent in hindsight.

Balancing the risk of losing money with the risk of missing out on future returns

This example has interesting parallels with our current view of local investment markets. Our December GrayIssue (issue no. 99) discussed the two basic and opposing risks that investors need to balance: the risk of losing money and the risk of missing future returns. In our asset allocation funds we try to manage the trade-offs that naturally occur when navigating between these two extremes for our clients. Readers of our recent commentaries would know that we currently focus a larger part of our attention on managing the risk of loss.

We have been early movers and the market has continued to rise

It is fair to say we have unfortunately been an early mover as the overall market has continued to rise, though in a less linear fashion. If we take a fresh look at valuations, as at 12 March 2010, we find that:

- The FTSE/JSE All Share Index (ALSI) price/earnings ratio is 18.8 compared to its long-term average of 11.5
- The ALSI dividend yield is 2.1% compared to its long-term average of 4.5%
- The earnings of the overall market are not obviously low by historical standards

We believe the market is already discounting a strong and sustained earnings recovery

This is confirmed by our bottom-up research, with many shares discounting a strong and sustained recovery in earnings next year. Some shares are arguably pricing something even better. If the earnings recovery matches expectations, it is tough to see why investors should expect to achieve returns in line with historical averages, given that many current values have already discounted future strong and sustainable earnings.

What if the future turns out differently? What if an unexpected event occurs, the financial equivalent of the earthquake in our Sun International story? There is little margin of safety in current valuations to absorb or 'insure' against an event like this.

Expecting the unexpected

An observer of financial history would know that unexpected adverse events have occurred on many occasions in markets, just as earthquakes have always occurred in Chile. While forewarned with such knowledge, we cannot predict their timing or even if such events will indeed occur at all.

Our fixed income weighting is our insurance

We do however have the choice, just as if we ran a casino in an earthquake zone, to 'buy' some insurance for our portfolios when values reach levels that have historically suggested a high probability of risk of loss. One can consider the above average weighting that we currently hold in fixed income (cash and bonds) as our insurance.

This insurance has a short-term price, but we believe it is worth it in the long run

Of course, insurance is not free, and there are trade-offs in all decisions. The recent lower returns of our funds relative to other managers reflect the 'cost' of our insurance. This is due to our high weighting to fixed income compared with a portfolio that has had higher exposure to equities.

If no 'earthquake' happens and the future earnings environment that the market is discounting materialises, the approximate 7% yield on the fixed income portion of our asset allocation funds provide compensation for our insurance. Insurance is expensive to buy when risk of loss is obvious and unfolding. We hope our early move towards investing in some insurance against risk of loss in equities will prove to be prudent should the market experience any aftershocks.

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