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Understanding performance in the current environment

Attention has been focused on the performance of Allan Gray's equity mandates and, specifically, the Allan Gray Equity Fund over the past 6 to 12 months, even though the absolute performance of the Fund has been strong (at over 27%) for the year to June 2004 and it has in fact outperformed the FTSE/JSE over this time. It has however underperformed the average fund in its category by a small amount and it is important for us all to understand this.

Our investment philosophy is to invest in companies trading on the stockmarket at a substantial discount to our estimate of their fair value. In the short-term, prices on the stockmarket are driven by human sentiment, which often tends to be irrational. This over-optimism and over-pessimism causes the prices of companies to move away from fair value, which gives us opportunities to buy. Over the long-term, prices of companies will move towards fair value thereby allowing the holders of their shares to profit.

When parts of the market move to extremes of valuation i.e. when companies that are already expensive go up in price and become even more expensive and those that are cheap fall in price and become even cheaper, our philosophy correctly applied will lead us to avoid the shares that are going up and be buying the shares that are falling. This can lead to significant underperformance in the short-term, and is exactly what happened during the two periods of massive market disparity during our 30-year history, which coincided with our only two periods of significant underperformance. Most of you will remember the most latter of these two periods, when in 1997 and the first quarter of 1998, the stockmarket was (as it turns out) irrationally in love with I.T. and financial services companies which traded on P.E ratios of 90 and 40 respectively on often manufactured earnings. At the same time resource companies were hated and most traded on P.Es of under 10 on depressed earnings.

It is during these difficult times that our faith in the logic of our investment philosophy is most tested, but it is these very same times that create the massive opportunity to outperform as the traded prices of companies return to their fundamental value, as they inevitably do. The result of the last market madness was that our clients were very well rewarded. Our client's annualised share return for the seven years from the beginning of 1997 to the beginning of 2004 (including this period of underperformance) was 24.9%p.a. versus 9.7%p.a. for the FTSE/JSE All Share Index. Had a client invested R100 000 with us on 1 January 1997, their portfolio would have been worth R474 239 on 1 January 2004 compared to R191 380 had they earned the FTSE/JSE All Share Index returns.

In a previous GrayIssue, no. 31, our Chief Investment Officer, Stephen Mildenhall, discussed the three major sectors of the market (resources, financials and industrials) relative to the overall market. The extent of the disparity between sectors in 1997/98 was the most extreme it has ever been and over the last six years this disparity has narrowed significantly. However for investors that are concerned that we are seeing the beginning of another 1997, we believe that conditions are very different. At a stock specific level, the disparity in valuation in the market is in fact at historic lows. This should make sense as, for as long as investors have the memory of the madness of 1997, they are likely to avoid similar mistakes and behave more rationally. During this time, the opportunity for Allan Gray to deliver the extent of outperformance it has over the past several years is reduced. It is however, equally unlikely, while these circumstances continue, for managers to deliver significant underperformance. One can see this in the reduced difference of manager returns, which are at the lowest levels in many years.

This brings us directly to the reasons for our recent performance. With the narrowing of disparity in the market based both on sector and size, our portfolios have tended to be less different to the index and average manager than in the past few years. However one of the areas that our portfolios are different has been in our overweight position in selected resource shares. The recent strength of the Rand has hurt resource shares and as a result our short-term performance has suffered, yet we continue to hold these shares because we have a long-term view and believe in their underlying value.

We continue to find attractive long-term investment opportunities whilst we continue to apply the same investment philosophy and process as we have for the last 30 years. We remain confident that while short-term price movements may have resulted in slight underperformance, the returns for our clients will be rewarding over our long-term investment horizon.

Commentary by Greg Fury, Chief Operating Officer, Allan Gray Limited