GRAYISSUE

A tale of two crises

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Greece and China have dominated financial headlines since March. With fear running high, we try to remain focused on the relationship between the price and value of individual securities. Looking first at prices, things in Greece and China certainly appear uncomfortable.

In Greece, 10-year bond yields rose above 18% in early July after Greeks voted against an already-withdrawn bailout proposal. Bond yields move inversely to prices, and higher yields suggest that investors are demanding more payment for the risk that the borrower could default. In Greece's case, it's easy to see why investors were so concerned. At the time, the country was late on a payment to the IMF, its banks were closed, and with prospects for a bailout looking grim, Greece appeared likely to miss further payments to other creditors.

In China, the CSI 300 Index of large Shanghai- and Shenzhen-listed shares fell over 30% between early June and early July and mainland Chinese indices tracking small or technology-oriented companies have been even more volatile.

Putting price volatility in perspective

When fearful headlines are constant, even a few months' perspective can be useful.

The week after its yields spiked, Greece reached a deal to secure bailout funds. A week after that, it made its late payment to the IMF and reopened its banks on a limited basis. Today, 10-year Greek bonds yield about 10%, the same level as a few months and thousands of headlines ago. In mid-2013, they also traded around 10%, but then the press was writing about hope for a Greek recovery. Following extraordinary government intervention, mainland Chinese shares slowed their descent. But if you slide a few feet down Everest, you're still near the top of a mountain: after its slide, the CSI 300 is still up 30% over the past year.

Direct effects on the Orbis Funds' holdings

When volatility is unusually high, it's natural to wonder about its effect on your investments. The Orbis Funds have no direct exposure to Greece, and all of the Funds' Chinese holdings are listed in Hong Kong or the US. While Chinese companies in other markets have been affected by the mainland volatility, hits to their share prices have generally been more muted.

More importantly, we don't think the recent price swings have been driven by substantial changes to most companies' fundamentals. If a security's price declines but its value does not, we view this as an opportunity. Unfortunately, we cannot time turmoil, but we have been willing to add to selected China-related shares, and we are happy for the Funds to continue holding others.

In our view, a stock market correction in China is unlikely to dull the advantages of online search as an advertising platform, so we believe Baidu's long-term value is intact. A market pullback is unlikely to make people stop playing the online games offered by NetEase, Sohu.com, and NEXON. And in a country where bricks-and-mortar retail was underdeveloped when e-commerce arrived, we believe Alibaba Group Holding (part owned by SoftBank) should continue to have excellent long-term growth prospects.

Although we think the direct effects of turmoil in Greece and China on the Funds' holdings are limited, there may be substantial indirect effects. The Greek debt saga may alter Europe in ways we can't predict. Similarly, the Chinese government's willingness to intervene in the stock market may have lasting effects on investor behaviour there. Top-down political analysis is not our strength, but one effect partly attributable to the volatile news flow is already being felt: having recovered somewhat in April, the price of oil is now down over 30% from May highs.

Effects of Greece and China on oil and energy shares

Other factors have weighed on oil prices recently, including a deal on Iran sanctions, an uptick in US drilling rigs, and higher-than-expected inventories at pipeline terminals, but Greece and China haven't helped. Though Greece isn't a major producer or consumer of oil, concerns about the integrity of the euro have strengthened the dollar, hurting commodities that are priced in dollars. China is the world's largest oil importer, and if economic uncertainty there reduces demand for oil, the already-oversupplied market could take longer to balance.

This paints a gloomy picture. So why do the Funds have meaningful positions in selected energy shares? The reason is the same for shares in any sector - the Funds invest in selected energy companies because they trade at an attractive discount to our assessment of long-term intrinsic value. Of course, this was the case a year ago as well. At that time, many of our analysts felt that oil prices were above normal levels, but we underestimated the risk of a sharp correction. The Funds' positions in energy shares have been painful for performance over the past year and the past few months. At the very least, lower oil prices have delayed earnings growth for the Funds' energy holdings, so intrinsic values have declined. Yet market values have declined too, so the question is whether the stocks' prices today are attractive relative to their fundamentals.

Though we don't have a "house view" on macro variables, many of our analysts believe oil prices will be somewhat higher than current levels over the long term. Investment in development is dropping, cheap oil has historically led to increased demand, and OPEC government budgets will come under pressure if low prices persist. Yet even if we're right, we have no idea when any eventual rise will happen. Given this, we prefer energy-related companies whose fundamentals do not critically depend on a quick price recovery. Apache and INPEX are good examples - Apache because it generates positive cash flow even at current oil prices, and INPEX because most of the company's value lies in a long-term gas project that we think can increase profits even if oil prices languish.

Periods of heightened volatility are always uncomfortable and often filled with fearful noise. In our view, this makes it even more important for us to remain focused on our core strength: fundamental, long-term, and contrarian stock picking.

Adapted from Orbis commentary by Tamryn Lamb, Head of Orbis client servicing in South Africa