GRAYISSUE

Allan Gray Stable Fund: examining the Fund's objectives and its performance

8 December 2010
Issue no. 112

When we launched the Allan Gray Stable Fund a decade ago, we aimed to meet the needs of investors with a low tolerance for capital loss over any two-year period. These investors may ordinarily have deposited their capital with a bank. The Stable Fund aims to provide these investors with a superior long-term return to that which they could earn on bank deposits, while seeking to minimise the risk of capital loss over any two-year period.

How does the Stable Fund seek to achieve its objective?

1. Equity market exposure at the right price (i.e. buying cheap shares)
The Stable Fund takes the risk of investing in the equity markets when the risk is low because equity prices are low. When equity prices are high, the risk of capital loss over a two-year horizon is much higher, and the Stable Fund will carry a much lower exposure to the equity markets. The local market is offering far fewer opportunities today, with the FTSE/JSE All Share Index (ALSI) trading around 31 500 points, than it was on the launch of the Stable Fund in July 2000 when it was trading at 7 570 points.

Fortunately the Stable Fund has the flexibility to look for low-risk opportunities in equity markets around the world, not just in South Africa which represents a small fraction of the world's equity markets. These opportunities are accessed by investing in the Orbis funds. The bulk of the Stable Fund's current equity market exposure is contributed by exposure to foreign equities, particularly Japanese equities. The stunning underperformance of the Japanese market relative to the South African stock market over the last decade (see **Graph 1**) signals that Japan is now a good place to look for low-risk equity market exposure (remember low risk = low prices).

The optimistic sentiment presently being expressed in most stock markets around the world does warrant some concern, and the combined South African and foreign net equity market exposure of the Fund is therefore a relatively low 14.7% at present (see **Table 1**).

Equity market exposure is the most powerful tool in the Stable Fund's toolbox. But it is vital to recognise that this tool is only to be used at the right price. Sometimes we are blessed with lots of shares selling cheaply on the stock market (when the news is bad, the mood is sour and people are pessimistic). But at other times, such as those we find ourselves in today, good news, a positive mood and optimistic people can push stock market valuations to high (and thus risky) levels. In these circumstances, it is much better for the Stable Fund to wait patiently for darker days, than for it to be swept along with the general euphoria.

2. Exposure to other asset classes
While waiting patiently for opportunities in equity markets, the Stable Fund has the flexibility to expose itself to alternative asset classes that may present opportunities for better-than-cash returns at low risk from time to time. The Fund's investment into the Newgold debenture in 2005 has proven rewarding so far, as has its purchase of inflation-linked bonds at attractive prices in the first half of 2010. The Fund's exposure to hedged equities both in South Africa and offshore via the Orbis Optimal funds allows the Fund to benefit from any equity alpha generated by Allan Gray Limited, or by Orbis, without bearing overall stock market risk.

Performance
The performance of the Stable Fund over the last 10 years has exceeded our initial expectations and its benchmark of the return on call deposits plus 2%. After applying an assumed tax rate of 25%, the Fund has returned 12.7% per annum (p.a.) versus the benchmark of 7.7% p.a. The maximum drawdown over this period was 4.3%.

Despite the extreme volatility in equity markets over the last three years, the Stable Fund has marginally underperformed its benchmark (7.1% p.a. versus 7.7% p.a., each after tax), but it has outperformed the ALSI (1.9% p.a.) and consumer price inflation (CPI) of 6.7% p.a.

Graph 1 | Nikkei 225 (in US$) divided by the SA ALSI (in US$)

Source: I-Net Bridge

Nevertheless, underperforming a benchmark is always disappointing, and the recent underperformance of the Stable Fund is no exception. At the time of the stock market lows of March 2009, the Fund had increased its net equity exposure to 31.8%, but the subsequent benefits from this equity market exposure have been offset by disappointing returns on the 20% of the Fund invested offshore. The strengthening of the rand since the first quarter of 2009 and some disappointing equity alpha combined to drag back the overall returns of the Fund.

In seeking to earn better-than-cash returns the Fund does take on limited risk, and it is important to recognise that this risk can either work out in favour of or against the Fund over shorter periods. We remain confident that the 20% of the Fund currently invested offshore has the potential to contribute to benchmark-beating returns in future and thus make up for the recent underperformance.

One of the major risks for investors in the Stable Fund is that they personally do not earn the same returns as the Fund, because of ill-timed switching into and out of the Fund. Fund investors who subscribe to the Fund's objectives and sit tight for the long run should benefit from our efforts, and fortunately most of our clients fit this description.

There is a fair probability that Fund investors who switch into riskier alternatives at times such as these, because they 'don't want to miss out on the bull market' or because they 'need a higher yield' or because the 'Fund is underperforming', will ultimately earn inferior long-term returns, as will the investors who switch from riskier alternatives into the Stable Fund only after suffering the capital losses from the next downturn - whenever that may be.

Table 1 | Asset allocation as at 30 November 2010

Asset class	% of portfolio		
	Total	SA	Foreign
Net equities	14.7	5.3	9.4
Hedged equities	25.4	16.1	9.3
Property	0.1	0.1	-
Commodities (gold)	4.6	4.6	-
Bonds	8.0	8.0	-
Money market and bank Deposits	47.2	45.8	1.4
Total	100.0	80.0	20.0

Commentary by Ian Liddle, chief investment officer, Allan Gray