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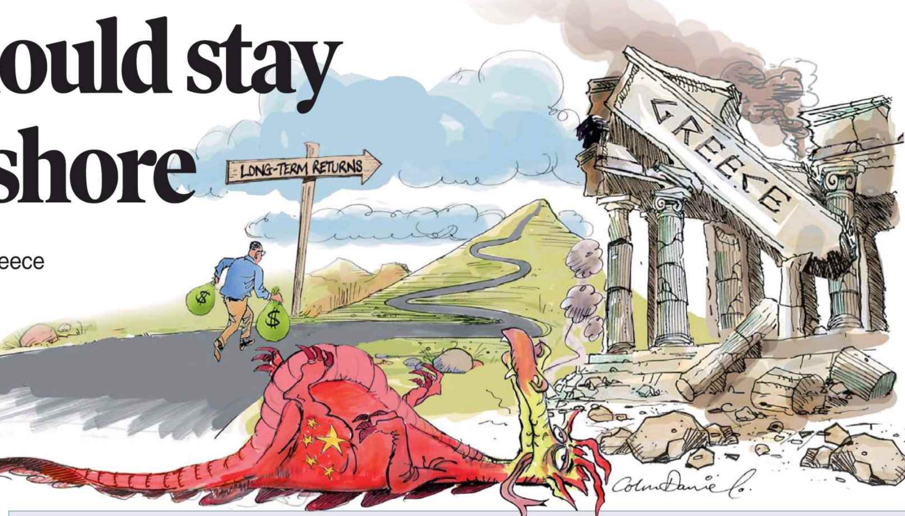
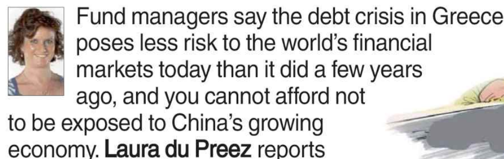
■ INEVITABLE FALLS IN EQUITY MARKETS PRESENT OPPORTUNITIES FOR LONG-TERM INVESTORS

Why you should stay invested offshore





Fund managers say the debt crisis in Greece poses less risk to the world's financial markets today than it did a few years ago, and you cannot afford not to be exposed to China's growing economy. **Laura du Preez** reports

As an investor in global financial markets, you may well be feeling a little rattled: the quarter to the end of June ended dramatically, with Greece closing its banks amid a crisis over the repayment of its loan to the International Monetary Fund, and China's stock markets falling 20 to 30 percent from their previous highs.

Many local equity and multi-asset unit trust funds have the maximum permitted exposure to international markets, and many investors who have heeded the advice of asset managers and financial advisers over the past five years also have relatively high exposures to these markets.

But if you are a long-term investor, asset managers suggest you put things in perspective.

Johan Strydom, the head of South African equities at Sanlam Private Wealth, says that, as an equity investor, you should hold your nerve and not overreact in the face of local and global volatility.

"Investing in equity markets is a long-term decision, and investors should not be influenced by short-term swings in sentiment.

"Markets go up and down over time, and this is currently a down phase. At a time like this, it is worth going back to basics and remembering that such pull-backs can give investors an opportunity to buy, particularly when taking a long-term view," Strydom says.

Graham Tucker, the manager of the Old Mutual Balanced Fund at Old Mutual Investment Group, also advises that you put current events in perspective. He says that global equities remain Old Mutual's asset class of choice, and the current volatility is likely to create investment opportunities.

CHINA 'ON TRACK'

Despite the headlines about the fall in the Chinese markets, Mark Mobius, the chairman of Templeton Asset Management's Emerging Markets Group, says the China "story" is still intact, because the country's economy is growing well. China remains an important global market to which you should be exposed, he says.

Despite a rescue deal struck this week, there is uncertainty about the future of Greece. However, Strydom says investors have already priced in Greece's potential departure from the euro zone.

Tucker says the Greek crisis is unlikely to derail the economic recovery in Europe.

"The Greek stock market constitutes a meagre 0.03 percent of the MSCI All Country World Index. Against this backdrop and a number of other factors, Greece poses less risk today than it did just a few short years ago," he says.

Tucker says the euro zone is currently in "a far healthier" condition, because Spain, Portugal and Italy are recovering, there are stronger backstops in place, such as the European Central Bank's quantitative easing programme and the European rescue fund; and European banks have significantly less exposure to Greek debt.

He says the uncertainty about what will happen in Greece will create volatility, but Old Mutual continues to prefer global equities and, more specifically, European equities, and will look for opportunities to buy more of these shares in the current volatility.

Strydom says the Chinese equity market is the bigger issue influencing investor sentiment.

He says the 30-percent pull-back means that shares are now trading at a more reasonable price-to-earnings ratio (P:E) of 18 times. It has been 15 over the past eight years and 19 over the past 10 years, he says.

The P:E of a share or a market gives you an idea of how expensive it is relative to the company's or the market's earnings (profits), and it can be compared with its long-term average.

MARKETS STILL HIGH

Strydom says the Hong Kong market appreciated by 140 percent between July last year and June this year. The market today is still 15 percent higher than it was at the beginning of the year. The Chinese market is still 80 percent higher than it was in June last year, he says.

It was no surprise that the market corrected after "periods of exuberance", and the fundamentals for investing offshore have not changed, he says.

Global interest rates, one of the biggest drivers of global equity markets, remain low, and "we expect the US to be extra cautious regarding raising rates", Strydom says.

Tucker says that, although the Chinese economy is still growing, the rate of growth is likely to slow.

There are some concerns that the market's recent fall will spill over into the economy and cause an even sharper slowdown in growth.

But Tucker says the Chinese government has plenty of ammunition to stop a sharp decline in growth and has already reduced one-year lending rates and deposit rates, with scope for further cuts.

Tucker says Old Mutual is of the view that US interest rates may be increased in September, but expects that rates will rise slowly.

"We would not be surprised by a bout of volatility as the hike draws near, but we are not overly concerned about this, given the muted nature of the cycle and the extensive communication from the Federal Reserve around it.

"All things considered, in the medium to long term, global equity remains our preferred asset class. We are underweight in US equity in a global equity context, given its strong performance over the past few years, and maintain our preference for European and Japanese equity, where we see better value," Tucker says.

Mobius says the decline in the Chinese market has bottomed.

He says three things contributed to the market panic in China:

◆ A rapid rise in the market last year that led to high valuations, prompting some investors to leave the market.

◆ A flood of initial public offerings (IPOs) that were very popular and resulted in huge profits being made. These IPOs went up 40 percent in some cases, and the new share issues drew money away from the rest of the market.

◆ The start of the Shanghai-Hong Kong Connect late last year. This investment channel allows investors in either the Shanghai or the Hong Kong market to trade shares on the other market using their local brokers and clearing houses. Mobius says that, although money moved into the Shanghai market, investors in mainland China were not initially encouraged to go into Hong Kong, so there was a difference between the performance of, and flows into, the two markets.

Mobius says the fall in China's market is a natural correction after too much euphoria.

The Chinese government's attempts to stabilise the market and stop the fall, using various measures, seemed to have had the opposite effect, he says. As the market continued to fall, trading in many stocks in China was suspended, bringing more uncertainty and fear.

Mobius says the situation in Greece also had an impact on market sentiment in China, because investors there are not isolated from global news, and international investors have been on edge about the situation in the euro zone.

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SELECTED QUARTERLY RETURNS ON PAGE 18

High valuations of local shares concern asset managers

Top-performing asset managers are less concerned about global events than they are about the high valuations of shares on the local stock market.

Prudential Fund Managers and PSG Asset Management say valuations, as measured by the price-to-earnings ratio (P:E) of the JSE, will be the factor that most influences the returns you earn in future.

Michael Moyle, the manager of Prudential Investment Managers' top-performing Inflation Plus Fund and the head of real return, says the FTSE/JSE All Share Index (Alsi) is on a forward P:E of 16, whereas the long-term average historic P:E of the JSE is 12.5.

The P:E measures how expensive the price of shares are relative to their expected profits or earnings (a forward P:E) or their past earnings (historic P:E).

Moyle says that, given the high P:E of local equities, and the fact that valuations are the biggest driver of returns, you should not expect the same good returns you earned from local shares, particularly because earnings have not been good.

He says that, in an environment of low economic growth, the performance of equities is driven by the growth in company earnings, but earnings forecasts are being downgraded.

His warning of lower returns is echoed by Shaun le Roux, the equity manager at PSG Asset Management. Le Roux says the current economic conditions are tough, and pockets of the market are expensive.

Returns in recent years have been driven by rising P:Es, and many market indices are trading as high as they have been in decades, Le Roux says. This is unlikely to persist, because company earnings growth is unlikely to be robust, he says.

Parts of the market are expensive because of a high demand for the shares of higher-quality companies – particularly in the financial and industrial sector, he says.

LOWER AVERAGE RETURNS

Investors in local equity funds have enjoyed average returns of more than 15 percent over the past five years, but the average one-year return for these funds dropped to just 5.62 percent to the end of June, according to figures from ProfileData.

South African equity funds invested in financial shares had one of the best average returns over the year to the end of June, delivering average returns of 18.38 percent, while industrial funds returned on average 13.43 percent.

The average returns of most sub-categories for funds that invest in global markets were above 10 percent, while most sub-categories for South African funds produced average returns below 10 percent.

Global equity funds produced average returns of 14.03 percent for the year to the end of June.

Moyle says the 4.79-percent increase in the Alsi over the past year, combined with an actual decline in expected future earnings, means the market is getting more expensive.

Forecasts by economists of a recession for South Africa are less of a concern than the valuations, because many local companies make their profits from offshore markets, he says.

Le Roux says the risks to the local equity market are high, because it seems that both the United States and South Africa are about to start a cycle of hiking interest rates.

Moyle agrees an interest rate increase in the US combined with the current high valuations is a risk. The local market reacted negatively when the US announced in 2013 that it would begin tapering off the easy monetary policy it embarked on after the 2008 global financial crisis.

Le Roux says the key to success in the current market is to pick shares with exceptional management teams.

The good news for investors is that asset managers are likely to find opportunities for those who are patient and have longer-term investment horizons in "unloved" sectors of the market.

Le Roux says it is a good time to look for companies with strong balance sheets among cyclical stocks that are deeply out of favour, including the construction, manufacturing and resources sectors.

Commodity markets are deeply distressed, and there will be some meaningful consequences, so investors need to be wary of companies with weak balance sheets.

STRONG WILL GET STRONGER

But it is an environment in which the strong will get stronger, he says.

Resource shares, such as Glencor and Anglo American, or industrial share Imperial, can be bought cheaply and could deliver for the patient, disciplined investor with a three- to five-year investment horizon, he says.

The possibility of rising interest rates creates a little more uncertainty, but good companies bought at good share prices don't require very low interest rates to do well, Le Roux says.

He says PSG's equity portfolios currently have relatively high levels of cash as the manager waits for good investment opportunities.

In its multi-asset funds, Prudential has sold some expensive equities and listed property and has moved into cash, Moyle says.

In funds with offshore exposure, Prudential is choosing to maximise exposure to global equity markets rather than invest locally, because the P:Es of global markets, particularly in Europe, are more attractive.

It remains neutral on government bonds, which it believes are offering fair value, but is staying away from global bonds, where yields are low.

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