The investment environment and impact on portfolio positioning

The recent political events in South Africa had a tangible impact on the market climate. South Africa relies on foreign capital flows to fund its deficits, and with increasingly likely further downgrades of its sovereign debt looming, further volatility can be expected. While sentiment towards South African assets is very poor, the importance of the loss of independence of an institution like the Treasury is not something that should be underestimated.

We have seen a sharp decline in the rand in recent weeks and financial shares (especially banks) have been hit hard. Rand hedges have, on the other hand, enjoyed strong price appreciation.

Many commentators argued that the rand had been strong in early 2017, reaching levels of around 12.50 to the US dollar. It is worth noting the rand could only be viewed as strong when compared to the levels reached during the panic at the end of 2015. There is a case to be made that the rand remains undervalued on many measures and could strengthen materially in the event of more stable and predictable management of the economy. Similarly, because South African financial markets have been rocked by negative political developments for some time, it needs to be remembered that risk premiums have risen and a lot of the ‘bad’ news is reflected in asset prices.

We also need to acknowledge that we have a global backdrop that is supportive of strong returns from many South African assets, should the political situation stabilise. Commodity prices have recovered sharply over the past year and the drought in the north has been broken. The weak rand has underpinned strong improvements in the trade balance and the tourism sector has been booming. The global economy is also enjoying a period of synchronised growth, an environment that is usually very kind to emerging market GDP growth.

This is a time to remind yourself of the fund’s investment objective. When sentiment is really poor, we tend to get opportunities to buy quality businesses at significant discounts to their intrinsic value. This goes a long way to achieving the investment objective but requires a long-term view.

The fund remains cautiously positioned with an almost full weight offshore.

We are, however, cognisant of the fact that the loss of independence of the Treasury will necessitate higher funding costs, which have negative effects on the intrinsic value of domestic securities.

Accordingly, we are applying more conservative assessments of intrinsic value to ensure that we only own stocks that are trading at attractive margins of safety.

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The fund remains cautiously positioned with an almost full weight offshore and high levels of cash.

We are unafraid to be aggressive when others are panicking and have cash on standby ready to be deployed. We are, however, cognisant of the fact that the loss of independence of the Treasury will necessitate higher funding costs, which have negative effects on the intrinsic value of domestic securities. Accordingly, we are applying more conservative assessments of intrinsic value to ensure that we only own stocks that are trading at attractive margins of safety.

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Currently the South African political situation is uncertain, and markets don't like uncertainty.

The two key questions you will most probably have regarding your investment in the PSG Balanced Fund are:

- How has the fund fared during this time?
- What is PSG Asset Management doing with your money in light of these developments?

On the first question:

We generally don't comment on such short-term returns. We can however offer some comfort in reminding you that we build robust portfolios and avoid highly concentrated and/or correlated bets. Although the fund holds instruments which are highly impacted by the recent developments, like the equity of South African banks (6.9%) and South African government bonds (12.3%), we also hold counterbalancing instruments. These include domestic cash equivalents (12.4%), foreign cash (2.4%), offshore listed equities (22.1%) and domestically listed rand hedge companies (3.9%). So, roughly 40% of the portfolio is uncorrelated with the current South African sell-off which helps to limit the drawdown.

What are we doing at the moment?

Nothing different to what we do during any other periods of panic. We are gradually applying the large cash reserves in the funds into securities that others are selling on the market. This approach to investing has served us, and others, well in the past.

We are not predicting the outcome of the current political struggles. We are rather buying securities which are trading below a conservative estimate of their intrinsic value. We believe that owning such securities will, in the long-term, serve our clients better than owning cash. Remember that owning a piece of a good company is a far better hedge against inflation (and therefore currency depreciation) than domestic cash.

What should you be doing at the moment?

It is at junctures like these that we emphasise the importance of taking a long-term view as an investor in our funds. We cannot predict the future, but remember that generally fleeing to cash when others are fearful is a very expensive mistake. Very often, good returns are made in bad times.

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Currently the South African political situation is uncertain, and markets don't like uncertainty.

The two key questions you will most probably have regarding your investment in the PSG Stable Fund are:

- How has the fund fared during this time?
- What is PSG Asset Management doing with your money in light of these developments?

On the first question:

We generally don't comment on such short-term returns. We can however offer some comfort in reminding you that we build robust portfolios and avoid highly concentrated and/or correlated bets. Although the fund holds instruments which are highly impacted by the recent developments, like the equity of South African banks (4.1%) and South African government bonds (18.0%), we also hold counter balancing instruments. These include domestic cash equivalents (26.0%), foreign cash (3.7%) and offshore listed equities (13.9%). So, roughly 44% of the portfolio is uncorrelated with the current South African sell-off which helps to limit the drawdown.

What are we doing at the moment?

Nothing different to what we do during any other periods of panic. We are gradually applying the large cash reserves in the funds into securities which others are selling on the market. This approach to investing has served us, and others, well in the past.

We are not predicting the outcome of the current political struggles. We are rather buying securities that are trading below a conservative estimate of their intrinsic value. We believe that owning such securities will, in the long-term, serve our clients better than owning cash. Remember that owning a piece of a good company is a far better hedge against inflation (and therefore currency depreciation) than domestic cash.

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It is at junctures like these that we emphasise the importance of taking a long-term view as an investor in our funds. We cannot predict the future, but remember that generally fleeing to cash when others are fearful is a very expensive mistake. Very often, good returns are made in bad times.

Despite all the negative news at the moment, there are still good opportunities for investors and savers in South Africa to earn high yields. We all know that inflation is the enemy of savers and investors over time. What we have seen over the last few years is that as the rand sells off, inflation rises as import prices increase and the South African Reserve Bank (SARB) raises interest rates to maintain the inflation-targeting framework. What we are witnessing at the moment is the opposite of that effect, which is good news for savers and investors.

We are likely to see inflation falling over the course of this year. Lower inflation rates are firstly expected due to falling grain prices as good rains have been recorded in the northern maize growing areas of the country, which could lead to lower food prices in the latter part of the year. The good news for consumers is that this will lead to lower food inflation and will help the SARB in their aim to keep inflation in the target range. Secondly, the high base effect of the rand over the last year on import prices is also disinflationary.

So where is the positive news for investors then?

Interest rates in South Africa remain high, firstly due to interest rate increases over the last two years, as well as the introduction of more onerous bank capital regulations. These translate into banks paying higher rates to depositors like ourselves for the benefit of our investors. We are able to take advantage of higher rates for investors.

The opportunity is in a term we call real rates (i.e. the interest rate an instrument yields above inflation). The higher the real rate, the more beneficial it is to the investor. The most probable outlook that we see domestically is for real rates to rise: we anticipate inflation falling over the course of the year and official interest rates only following with a lag.

This will be most evident in fixed income funds. Fixed income funds lock in high real yield instruments before the inflation cycle turns and maintain those yields even though inflation and market interest rates are falling (i.e. the term 'fixed income' or 'interest'). We have mentioned in previous publications that we are finding high real yield opportunities in various fixed income markets. Cash/money market yields are attractive given their short duration nature. Government bonds return a high real yield given their credit quality and liquidity, and we are also finding attractive real yield opportunities in selected areas of the credit market.

The real opportunity for investors and savers will be in funds with a high, fixed rate exposure locking in yields that will not be available in the bank deposit market once the SARB signals that the interest rate cycle has turned. Investors will be able to benefit from the higher fixed rates in funds while inflation and market interest rates are falling, coupled with the fact that investors in funds don't have to be locked in for a fixed period to receive those higher yields.

We add to the bond positions on specific points of the nominal curve where the real yield remains attractive given the duration risk. We remain positive on valuations in specific areas of the credit market that offer attractive valuation metrics. We have maintained equity exposure in counters that offer attractive valuation metrics. We will continue to search for real yields that are attractive at an appropriate level of risk.

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Focus on the investment principles underlying our processes

The current macroeconomic environment presents a fluid political landscape, creating significant fear in the market. This is where we believe it is important as an investor to focus on the purpose of an investment in the fund. Specifically, the objective is to preserve capital while earning a steady income yield (ideally above inflation) and maintaining a high level of liquidity. This is where the year-on-year consistency of our investment process allows us to focus despite the noise, and exploit any opportunities which have arisen.

Why we still see value in the bank short-term funding curve

We believe interest rates in South Africa are still at high levels, relative to the prevailing economic fundamentals of lower growth and a likely sanguine outlook for headline inflation over the medium term. Without any significant surprises, we consider the pressure on the South African Reserve Bank (SARB) to continue hiking interest rates to be lower going forward. As such, we believe there remains sufficient margin of safety in current money market rates as well as the opportunity to lock in real yields (yields above the long-term inflation rate of 6%) to achieve our clients' investment objectives.

A key area where we have found significant value has been at the longer end of the negotiable certificate of deposit (NCD) curve. As a reminder, these rates are offered by South African banks for wholesale investors as a funding source for the banks, and are highly tradable instruments. We are currently able to purchase 6-month instruments at rates above 7.9% and 1-year instruments at close to 8.5%, i.e. at a buffer above the current repo rate of 7.0%. These are considered very attractive rates with real yields ranging from 2.0% to 2.5%. While it is currently noisy in the market, this in our opinion presents a sufficient buffer, should interest rates surprise on the upside.

How we are positioned

The fund has a significant holding in fixed rate NCDs across the major South African banks, but continue to hold a mix of floating-rate instruments for further diversification. Given the high level of tradability in NCDs, we are comfortable with the overall level of liquidity in the fund, an aspect which adds to the overall investor margin of safety. We will continue to look for mispriced corporate credit which meets our investment hurdles. These attractive opportunities usually present themselves if you can remain calm and focus on the investment objective, while other market participants are fearful.

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At PSG Asset Management, we construct our portfolios using a bottom-up approach
We do not attempt to forecast political or economic events, because even if we could do this accurately, we wouldn't have conviction about the ultimate impact of these events on the market.

Acquiring quality assets at the right price
Over the past 18 months we have written extensively about the divergence in valuations we have observed between cyclical and defensive companies.

In many cases, valuations of companies whose earnings are (perceived to be) more cyclical or uncertain than their defensive counterparts, have been trading at relative multi-decade lows, providing us with excellent investment opportunities. At the same time, those companies that had performed well over the last few years, or whose earnings streams are of a more defensive nature, had been significantly overvalued.

With US bond yields inflecting during mid-2016, coupled with an expected increase in global growth and inflation, we have witnessed a significant recovery in the share prices of companies that had previously underperformed, such as the portfolio's global bank holdings or more cyclical industrial companies.

Some of the best investments are made in times of distress
To provide some context, JP Morgan, one of the world's largest and oldest banks with a corporate history dating back to 1799 has been a long-term, high-conviction holding in the portfolio. As recently as 2012, after the 'London whale' incident, the company's share price was $31 and it was trading at a price to earnings (P/E) ratio of 6.5 times and a price to tangible book ratio of 0.94. Fast forward to March 2017 and after recovering by 63% from its 12-month low, its share price traded at $94, at a P/E ratio of 15 times and a price to tangible book ratio of 1.8. The fact that the share price of JP Morgan trebled from a point of deep pessimism in a space of five years, illustrates that some of the best investments are made in times of distress. A similar tale can be told about the portfolio's other global bank holdings and industrial counters such as Union Pacific, Colfax and Glencore which appreciated significantly ahead of the market over the past year.

Investing with a margin of safety
You are by now aware of our 3M investment philosophy, with the third M referring to a margin of safety. A rising share price in isolation is not necessarily an indicator of a reduced margin of safety. Our emphasis is always on the price we pay compared to the intrinsic value of the underlying security. We have, however, taken the opportunity to increase our allocation to cash. Market sentiment, especially in the US, continues to be one of greed. This has resulted in a reduced margin of safety in several holdings. We need to stress that all the stocks we mention above continue to trade well below intrinsic value despite recent share price moves.

Cyclical companies continue to offer value
We continue to hold the view that many high quality, defensive companies are trading at valuations that put investors' capital at risk or, at best, offer poor prospects of positive returns. Several more cyclically-exposed companies continue to offer good value. But, in most cases, their margin of safety and prospective returns are lower than they were 12 months ago.

Global opportunities exist
Long-term investors with PSG Asset Management know that we tend to find our best investment opportunities in times when fear or uncertainty permeate the marketplace. While global investors have been welcoming the increase in global growth recently, we think it is coupled with an elevated level of complacency given the geopolitical backdrop. In our view, the best hunting grounds for opportunities driven by fear and uncertainty currently exist in the UK − where Brexit-related fears have depressed the valuations of several domestically-focused companies – and among selected emerging market companies, Japanese industrials and in agricultural commodity-producing companies.

We are high-conviction managers and while well-diversified, we tend to have relatively concentrated portfolios. Fortunately, we are still able to find excellent opportunities and Brookfield Asset Management currently leads the charge as the portfolio's largest position. This company, which dates to 1899 and where management has around $7 billion of personal exposure, remains an outstanding, unique investment opportunity that we expect to compound at well-above-average market rates for many years to come.

While both the short and medium term will likely be characterised by uncertainty, we continue to stick to our 3M process and only invest in opportunities that we believe are likely to deliver attractive risk-adjusted returns.

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Increased cash allocation
The portfolio's cash holding increased to 30% at the end of March 2017. This is an increase from 24% in cash at the end of 2016 and 8% during the February 2016 lows, where the portfolio had 92% of its assets invested in equities. We are willing to hold cash because it effectively expands our opportunity set from risk assets at today's prices to the prices that will become available for risk assets in the future.

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