Investing in uncertain times: Considering the impact of Brexit on our portfolios

- **Brexit has resulted in heightened uncertainty and volatile financial markets**
- **We have been screening for opportunities in the UK and Europe**
- **A decline in UK property stocks has demonstrated the risk of owning overvalued securities**
- **SA financials and industrials provide a good opportunity to buy quality at a good price**
- **Elevated valuations in SA listed property increases the risk of poor long term returns**

A majority of voters in the UK referendum favoured the Brexit option which was unexpected and has rattled financial markets. This is because the economic and political ramifications for the UK and the EU are significant and uncertain. Financial markets have subsequently been more volatile and the pound has sold off aggressively. It is reasonable to expect these conditions to persist while the nature of the outcome is being resolved.

While the direct consequences for businesses operating in the UK or Europe are very difficult to predict, it is clear that a disorderly resolution of the terms of Brexit could have a very negative affect on a number of companies and sectors.

The direct impact on the fund to date has been moderate: we have no exposure to the epicenter of the sell-off, UK property stocks and the UK or European banking sectors.

This event brings an important principle to the fore. Our portfolios have been resilient not because we were anticipating the “leave” vote, but because we avoid overpriced securities. When you own securities which are trading at inflated levels you are more susceptible to incur capital loss in the event of unexpected shocks.

The sharp decline in listed UK property has caught the eye, with the likes of JSE-listed Capital and Counties trading 50% lower than where it was in December. The plunging stock prices reflect the change in sentiment that accompanies the uncertain outlook for the UK economy, and London property, in particular. Fear and uncertainty typically create an opportunity to buy at distressed prices and we have been actively screening for opportunities to buy quality UK or European assets at good prices for our clients, but we have not identified attractive opportunities within the UK property sector. Though the major listed UK property groups are trading at discounts to their published net asset values and might seem optically cheap, we believe that these published asset values are rather stretched.

The assumptions baked into the valuations extrapolate the recent lucrative environment for UK landlords many years into the future. Over and above very rosy rent assumptions, the rates at which the properties are capitalised are, in our view, a function of artificially low interest rates and result in unrealistic values. As an example, consider Capital and Counties which has dropped from a premium of 22% to a discount of 18% relative to its published NAV over the last six months. We are however not comfortable with the published NAV and our estimate would come in below the current share price. More generally, we will be interested when these property companies are trading at discounts to net asset values which have been marked down to more reasonable levels.

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The direct impact on the fund to date has been moderate: some of the businesses we own have some UK or European exposure, but we have no exposure to the epicenter of the sell-off, UK property stocks, and limited exposure to the UK or European banking sectors via our HSBC holding.

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We have also been adding to our SA Government Bond holdings, both in terms of exposure as well as extending the duration. We believe the real yields on offer more than compensate for the commensurate risk. In addition, the longer duration bonds partially hedge against the tough environment which equities (on a global basis) could face if developed markets were to move into a prolonged deflationary environment.

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Panic in any pocket of the financial markets gets us to the office very early, not dissimilar to queuing outside closed doors on sale day. Brexit was no exception. As pointed out above, the big markdowns were unfortunately on the stocks we believe to be low quality, or which we believe we might well pick up even cheaper at a later stage. The PSG Stable Fund continues to hold large amounts of cash we will not hesitate to deploy when the price is right.

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Managing money in a volatile world
One of the most frequent questions we currently have to answer is, "How do you manage client money in this volatile world?" The answer is simple for us: like we always do. As part of our DNA at PSG Asset Management we welcome uncertainty and fear in the markets, as this is when attractive opportunities arise – especially when quality assets go on sale. We believe that times like these are when we can add value to our clients' investments by buying high-quality assets at below-average prices.

Locally, markets remain uncertain
True to the nature of markets, this is exactly what happened in the South African bond market following the political turmoil of December 2015. Investors were very fearful of local bond market towards the end of last year and into the early part of 2016, which presented a buying opportunity for us in various portfolios.

Throughout 2016, poor investor sentiment has prevailed. Firstly, there was the overhang of the political turmoil of December 2015 and secondly, the possible downgrade of South Africa's credit rating to sub-investment grade. Thirdly, there was panic around Britain's decision to leave the European Union and lastly, we are currently experiencing the build-up to our local government elections, which is accompanied by substantial noise and populist rhetoric.

The South African bond market is stable, while global bond markets fall
The stable nature of the South African bond market throughout all of this volatility has been surprising. It appears that the bond market is viewed as a safe haven, offering stability in times when other risk markets are volatile. From an interest rate perspective, we have seen the Reserve Bank increase interest rates by 75 basis points so far this year.

Globally, we have seen a different trend unfold: bond markets are rallying to new lows as fears of political turmoil, receding GDP growth and low inflation are priced into macro forecasts. We have seen central banks in developed markets continue to support their local economies and markets. Even the US Federal Reserve, after its rate hike in 2015, has so far this year decided to place interest rate hikes on hold, as global fears of instability have risen. Outside of the US, growth and inflation in developed markets seem to be muted and the probability of rising short-term interest rates appears low. Against this muted growth and inflation macro backdrop we have seen around $10 trillion worth of bonds yielding negative rates. This has increased the global demand for yield, as developed market investors search for positive yields on their savings. South Africa has also been a beneficiary of this hunt for yield, with foreigners being net buyers of our bonds due to attractive real yields and liquidity being offered, despite the domestic economic outlook and political noise.

South African bonds remain attractive
South African bonds therefore remain an attractive asset class, as they offer high real yields, low credit risk and high liquidity. We remain in a low-growth economy with temporarily elevated inflation. However, this is not an environment that is massively negative for bonds. Global macro factors support the search for yield in South African bonds. We are adding to our bond position on specific points of the nominal curve where the real yield has become more attractive given the duration risk. Longer-dated bank NCDs also remain attractive on a real-yield basis given the level of risk and the expected path of inflation and interest rates. We also see specific areas of the credit market offering more attractive valuations. We will continue to search for real yields that are attractive at their levels of risk.

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The first half of 2016 has offered the fund good buying opportunities as local interest rate markets were considered fairly volatile, keeping interest rates higher from money markets to long bonds. Local markets were largely influenced by conflicting views of global monetary policy action in developed markets and uncertainty over the UK's referendum on whether to exit the European Union. Heightened political risks and fears of a downgrade to below investment grade status have had a similar effect. In our view, the market has been dominated by fear, presenting attractive opportunities in the process.

In Europe and Japan, yields have continued to fall which has furthered market fear. Yields across money market and bond maturities are as a result well in to negative territory, roughly to the extent that around USD12trillion of bonds are yielding below 0%. There is a growing sense that the ability of monetary policy to stimulate growth could be running out of steam. This, coupled with fears that South Africa is destined for junk status, saw the rand suffer a volatile six months of trading. The expected effect of a weaker rand would be for greater inflation pressures over the medium term, and a greater need for the South African Reserve Bank (SARB) to raise interest rates.

Local CPI is expected to peak towards to the end of 2016. The actual CPI prints in April and May came in at 6.2% and 6.1% respectively, lower than market expectations despite the weak currency. This is continued evidence that suppliers and retailers are not able to pass on higher import costs as a result of a weak rand to an already constrained consumer. We continue to watch local inflation as the possibility is growing that inflation expectations are currently too high against a low growth and demand backdrop. This could significantly change the profile of local interest rates should expectations change. We have therefore positioned the fund with higher duration and more fixed rate exposure to take advantage of higher current rates in money markets

Our view for the second half of the year is that growth will continue to be under pressure as the economy struggles to create jobs and influence underlying demand. This will place greater pressure on the SARB to balance their mandate of price stability and economic growth, with less interest rate hikes than what the market is currently pricing in.

We believe the following key events can significantly influence the trajectory of interest rates:

- The municipal elections on 3 August 2016
- Upcoming labour negotiations in the platinum sector
- Progress on Brexit
- US Monetary policy
- Minister Gordhan's October 2016 Budget speech and
- Rating agency decisions towards the latter end of the year

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In recent commentaries we have been especially careful to demonstrate the divergences that we have been observing within valuations on global equity markets and the opportunities this opened up to bottom-up price sensitive investors such as ourselves. What has got us most excited has been the chance to buy high quality businesses with excellent management teams at very good prices. These have typically been companies with more cyclical revenue streams, where depressed market conditions have presented the opportunity to buy good businesses on low valuations and low earnings. We wrote about this in a recent PSG Angle (www.psg.co.za/news/psgam/The-PSG-Angle-Exploiting-the-difference).

Although plagued by uncertainties, the first half of 2016 witnessed somewhat of a reversal of last year's performance trends which resulted in cheaper, less popular stocks outperforming some of the more expensive glamour stocks of 2015.

We have seen strong year to date performances from some of our higher conviction stock picks like Brookfield, Union Pacific, Colfax, Berkshire and Cisco. We would characterize these as very good businesses that had seen economic sensitivity weighing on their share prices to the extent that they became very good investment opportunities and core holdings in our global equity portfolios.

We have also seen very strong performance from some of the deeply cyclical holdings that we argued became materially mispriced in the commodity and energy panic of late 2015. It has been pleasing to observe the strong contribution to Fund performance in 2016 from the likes of Anglo American, Glencore, Arcelor Mittal and Weir.

We think it is important that investors in the Fund are aware that we are of the view that the gaps in valuation between the much loved expensive parts of global stock markets (low volatility, high dividend yields and growth narratives) versus the unloved value end remain at very elevated levels. Value stocks are the cheapest they have been in relative terms since the tech bubble of the late 1990s.

We continue to find very attractive opportunities for long term returns for our clients. These mostly reside within the universe of higher quality businesses that have become mispriced as result of fear over the near term cyclical forces that are driving their level of profits.

Furthermore, we continue to warn about the elevated valuation in the sectors that are currently popular with investors and where very low global bond yields are artificially driving prices sky high.

A majority of voters in the UK referendum favoured the Brexit option which was unexpected and has rattled financial markets. This is because the economic and political ramifications for the UK and the EU are significant and uncertain. Financial markets have subsequently been more volatile and the pound has sold off aggressively. It is reasonable to expect these conditions to persist while the nature of the outcome is being resolved.

While the direct consequences for businesses operating in the UK or Europe are very difficult to predict, it is clear that a disorderly resolution of the terms of Brexit could have a very negative affect on a number of companies and sectors.

The direct impact on the fund to date has been moderate: some of the businesses we own have some UK or European exposure, but we have no exposure to the epicenter of the sell-off, UK property stocks, and limited exposure to the UK or European banking sectors via our HSBC holding.

This event brings an important principle to the fore. Our portfolios have been resilient not because we were anticipating the "leave" vote, but because we avoid overpriced securities. When you own securities which are trading at inflated levels you are more susceptible to incur capital loss in the event of unexpected shocks.

We are actively screening for opportunities that will be presented should fear around Brexit result in mispriced assets in the UK or Europe. As always our focus will be on companies with strong moats and great management teams that will allow them to weather whatever storms come their way in the months and years ahead.

Calling uncertain macro and political outcomes are, at best, a shot in the dark and for that reason it is more important than ever to ensure that our investors our partnering with management teams capable of dealing with the obstacles that the future may throw at them.

One of the Fund's holdings, albeit a smaller one, Boustead Singapore Ltd, recently issued their annual report. The company, which has operations in the oil & gas, real estate and geo-spatial sectors, shared some of their thinking on both market conditions and creating long term value for shareholders. We thought the Chairman's comments were particularly insightful in this regard. Mr Wong Fong Fui, Chairman & Group Chief Executive Officer since 1997 and majority shareholder acknowledged the very tough trading conditions for their subsidiaries but observed:

"Our [Oil & Gas] division's business model which focuses on being asset light, cash flow driven and lean, bodes well for our ability to sail through even a prolonged consolidation period when weaker players are weeded out. In the long run, we will emerge as a stronger competitor than ever before."

While the company compounded earnings and book value per share by 15% and delivered a total shareholder return of 16.7% p.a. for the 10 years up to 2015, last year was particularly difficult with Boustead's like for like earnings and share price declining by 38% and 45% respectively.

But this is a business that had its beginnings in 1828 and has been through tough times before. Wong refers to the company as having *"ingrained adaptability to adversity into our mind-sets"*, which over time has allowed Boustead to exit sunset and enter emerging industries.

"Corporations that enjoy longevity do things differently. They evolve. They create a different business and adapt to prevailing times…change produces not only great opportunities but helps us to survive."

While history is littered with companies that refuse to adapt, we have confidence in Boustead's ability and willingness to do so, if necessary. Their large net cash cushion of $166m or 40% of market value also helps.

With interest rates so low or negative in many countries, cash has been viewed as a liability in recent times. Wong quotes an Australian fund manager Roger Montgomery in glowing terms: *"Investing for long periods in cash is not desirable, but in the short run cash is like an option over every asset class, with no expiration date and no strike price. Cash provides the option to sweep up a bargain when it becomes available and this must have some value above the fact it earns almost nothing. If the purpose of an investment portfolio is to grow and protect the wealth you've accumulated, doesn't it make sense to also hold an option."*

Companies seem to be taking ever racier bets making expensive acquisitions with the justification of cheap debt being widely available. We are of the view that this is fraught with danger should conditions materially change. Wong has a more elegant way of putting it

"A highly geared corporation can only sail straight into the eye of the storm because at least one hand has been chained, if not two. We, on the other hand, can navigate around the periphery because without gearing, not only are our hands free, our eyes are also free to spot acquisitions and investments which may be floating around."

The company is well equipped to pounce as new ones arise, and they will.

"In long-term investing, patience is a great virtue that will be rewarded. Just give us time to deploy our huge option so that we can enlarge your long-term benefit. We love fishing in stormy weather."

We take comfort that investing alongside a management team with a track record of value creation and adapting to prevailing market conditions will serve our clients well over the long run. We also love fishing in stormy weather and consider Boustead a very attractive opportunity for patient investors.

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In recent commentaries we have been especially careful to demonstrate the divergences that we have been observing within valuations on global equity markets and the opportunities this opened up to bottom-up price sensitive investors such as ourselves. What has got us most excited has been the chance to buy high quality businesses with excellent management teams at very good prices. These have typically been companies with more cyclical revenue streams, where depressed market conditions have presented the opportunity to buy good businesses on low valuations and low earnings. We wrote about this in a recent PSG Angle (www.psg.co.za/news/psgam/The-PSG-Angle-Exploiting-the-difference).

Although plagued by uncertainties, the first half of 2016 witnessed somewhat of a reversal of last year's performance trends which resulted in cheaper, less popular stocks outperforming some of the more expensive glamour stocks of 2015.

We have seen strong year to date performances from some of our higher conviction stock picks like Brookfield, Union Pacific, Colfax, Berkshire and Cisco. We would characterize these as very good businesses that had seen economic sensitivity weighing on their share prices to the extent that they became very good investment opportunities and core holdings in our global equity portfolios.

We have also seen very strong performance from some of the deeply cyclical holdings that we argued became materially mispriced in the commodity and energy panic of late 2015. It has been pleasing to observe the strong contribution to Fund performance in 2016 from the likes of Anglo American, Glencore, Arcelor Mittal and Weir.

We think it is important that investors in the Fund are aware that we are of the view that the gaps in valuation between the much loved expensive parts of global stock markets (low volatility, high dividend yields and growth narratives) versus the unloved value end remain at very elevated levels. Value stocks are the cheapest they have been in relative terms since the tech bubble of the late 1990s.

We continue to find very attractive opportunities for long term returns for our clients. These mostly reside within the universe of higher quality businesses that have become mispriced as result of fear over the near term cyclical forces that are driving their level of profits.

Furthermore, we continue to warn about the elevated valuation in the sectors that are currently popular with investors and where very low global bond yields are artificially driving prices sky high. We retain cash in the Fund to avail ourselves of opportunities that arise if pricing becomes more rational.

A majority of voters in the UK referendum favoured the Brexit option which was unexpected and has rattled financial markets. This is because the economic and political ramifications for the UK and the EU are significant and uncertain. Financial markets have subsequently been more volatile and the pound has sold off aggressively. It is reasonable to expect these conditions to persist while the nature of the outcome is being resolved.

While the direct consequences for businesses operating in the UK or Europe are very difficult to predict, it is clear that a disorderly resolution of the terms of Brexit could have a very negative affect on a number of companies and sectors.

The direct impact on the fund to date has been moderate: some of the businesses we own have some UK or European exposure, but we have no exposure to the epicenter of the sell-off, UK property stocks, and limited exposure to the UK or European banking sectors via our HSBC holding.

This event brings an important principle to the fore. Our portfolios have been resilient not because we were anticipating the "leave" vote, but because we avoid overpriced securities. When you own securities which are trading at inflated levels you are more susceptible to incur capital loss in the event of unexpected shocks.

We are actively screening for opportunities that will be presented should fear around Brexit result in mispriced assets in the UK or Europe. As always our focus will be on companies with strong moats and great management teams that will allow them to weather whatever storms come their way in the months and years ahead.

Calling uncertain macro and political outcomes are, at best, a shot in the dark and for that reason it is more important than ever to ensure that our investors our partnering with management teams capable of dealing with the obstacles that the future may throw at them.

One of the Fund's holdings, albeit a smaller one, Boustead Singapore Ltd, recently issued their annual report. The company, which has operations in the oil & gas, real estate and geo-spatial sectors, shared some of their thinking on both market conditions and creating long term value for shareholders. We thought the Chairman's comments were particularly insightful in this regard. Mr Wong Fong Fui, Chairman & Group Chief Executive Officer since 1997 and majority shareholder acknowledged the very tough trading conditions for their subsidiaries but observed:

"Our [Oil & Gas] division's business model which focuses on being asset light, cash flow driven and lean, bodes well for our ability to sail through even a prolonged consolidation period when weaker players are weeded out. In the long run, we will emerge as a stronger competitor than ever before."

While the company compounded earnings and book value per share by 15% and delivered a total shareholder return of 16.7% p.a. for the 10 years up to 2015, last year was particularly difficult with Boustead's like for like earnings and share price declining by 38% and 45% respectively.

But this is a business that had its beginnings in 1828 and has been through tough times before. Wong refers to the company as having *"ingrained adaptability to adversity into our mind-sets"*, which over time has allowed Boustead to exit sunset and enter emerging industries.

"Corporations that enjoy longevity do things differently. They evolve. They create a different business and adapt to prevailing times…change produces not only great opportunities but helps us to survive."

While history is littered with companies that refuse to adapt, we have confidence in Boustead's ability and willingness to do so, if necessary. Their large net cash cushion of $166m or 40% of market value also helps.

With interest rates so low or negative in many countries, cash has been viewed as a liability in recent times. Wong quotes an Australian fund manager Roger Montgomery in glowing terms: *"Investing for long periods in cash is not desirable, but in the short run cash is like an option over every asset class, with no expiration date and no strike price. Cash provides the option to sweep up a bargain when it becomes available and this must have some value above the fact it earns almost nothing. If the purpose of an investment portfolio is to grow and protect the wealth you've accumulated, doesn't it make sense to also hold an option."*

We would agree with this statement and this sums up how we view the cash holding in the PSG Global Flexible Fund.

Companies seem to be taking ever racier bets making expensive acquisitions with the justification of cheap debt being widely available. We are of the view that this is fraught with danger should conditions materially change. Wong has a more elegant way of putting it

"A highly geared corporation can only sail straight into the eye of the storm because at least one hand has been chained, if not two. We, on the other hand, can navigate around the periphery because without gearing, not only are our hands free, our eyes are also free to spot acquisitions and investments which may be floating around."

The company is well equipped to pounce as new ones arise, and they will.

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