

Special report



Top five stocks mask value on ALSI

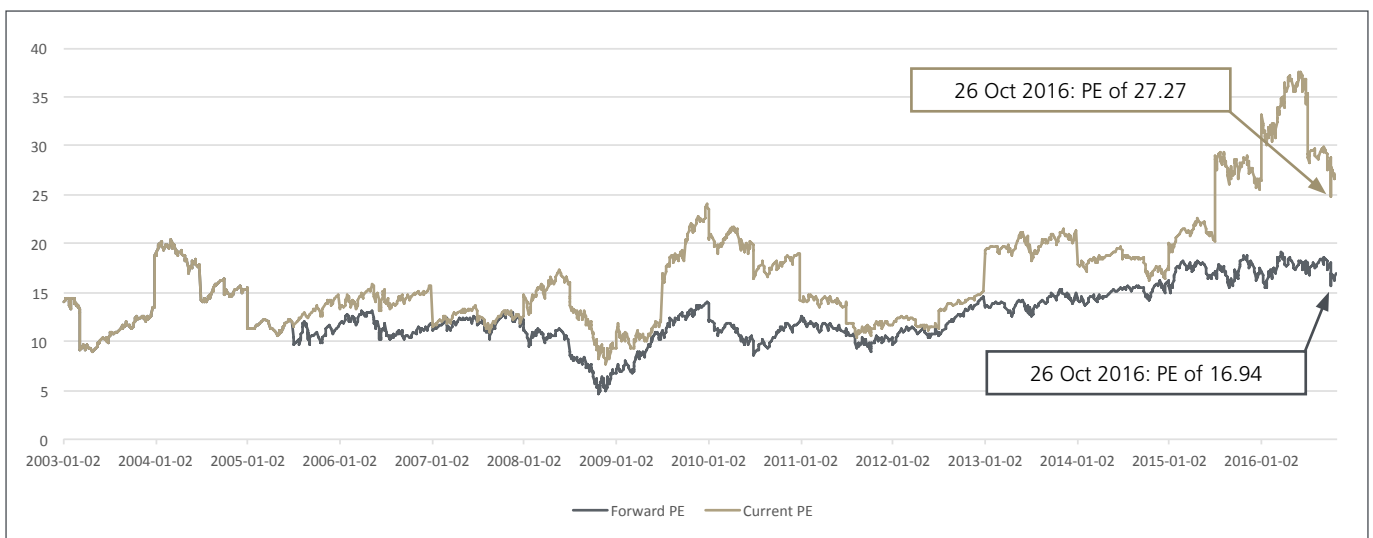
The valuation of the top five market cap stocks on the FTSE/JSE All Share Index (ALSI) have been masking value elsewhere in the domestic market. An analysis of the Top 40 Index of the ALSI shows that when these top five companies are excluded, then the forward price-to-earnings (PE) ratio of the index returns to a level similar to the average PE-level recorded over the past decade.

VALUATIONS ARE NOT STRAIGHTFORWARD, THE CURRENT PE COULD BE MISLEADING

The rational approach to invest tactically in equity (as with all asset classes) is to adjust the position according to a fair assessment of opportunity and risk; increase exposure when opportunities are presented, or lighten

your stake when conditions are unfavourable. One of the ways to gauge the relative opportunity or risk of equities is by comparing the price you pay relative to the profit they're generating. This is done through monitoring the PE ratio which tracks the share price as a multiple of the most recent year's earnings (profit).

PE ratio of Top 40 Index



Source: PSG Wealth research team, Bloomberg

While we recognise that valuation is often ineffective as an investment tool, it is the single most important determinant of long-term returns. Stocks on the ALSI look expensive when one uses the current price-to-earnings (PE) ratio's to measure value. The graph above shows that currently shares on the Top 40 Index are trading at PE ratios of around 30. The last time PE ratios were at such elevated levels was back in 1994,

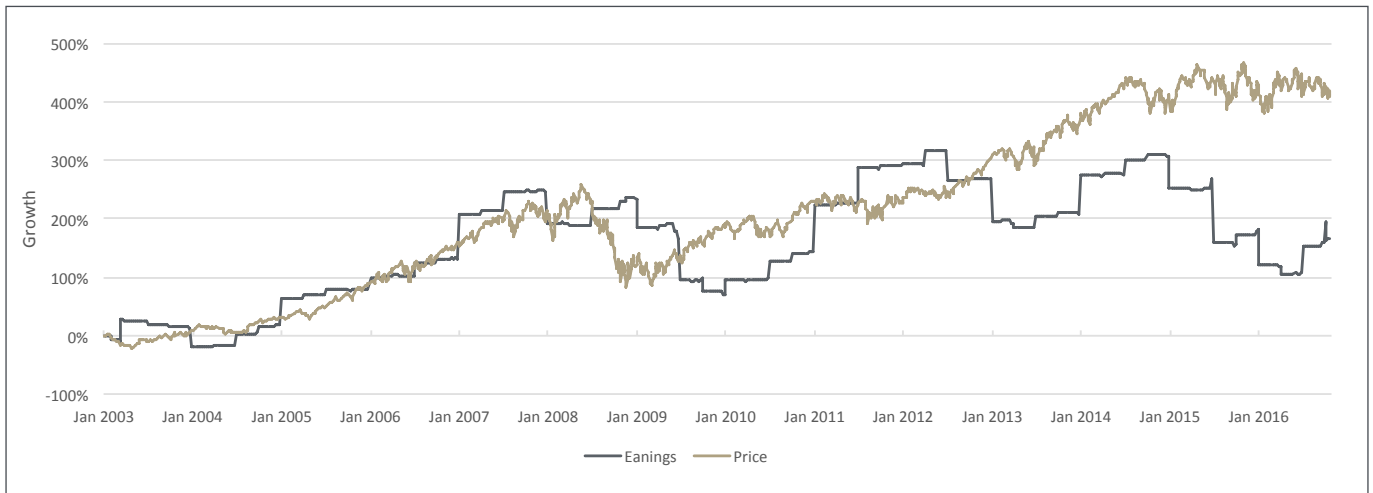
after which share prices fell back significantly. They also approached the level in 2008 before another substantial retraction returned the market to normality.

Current PE values seem expensive, because the PE's have been inflated, largely on the back of an earnings collapse. (Seen in the graph below).

Special report



Earnings versus price of the Top 40 Index

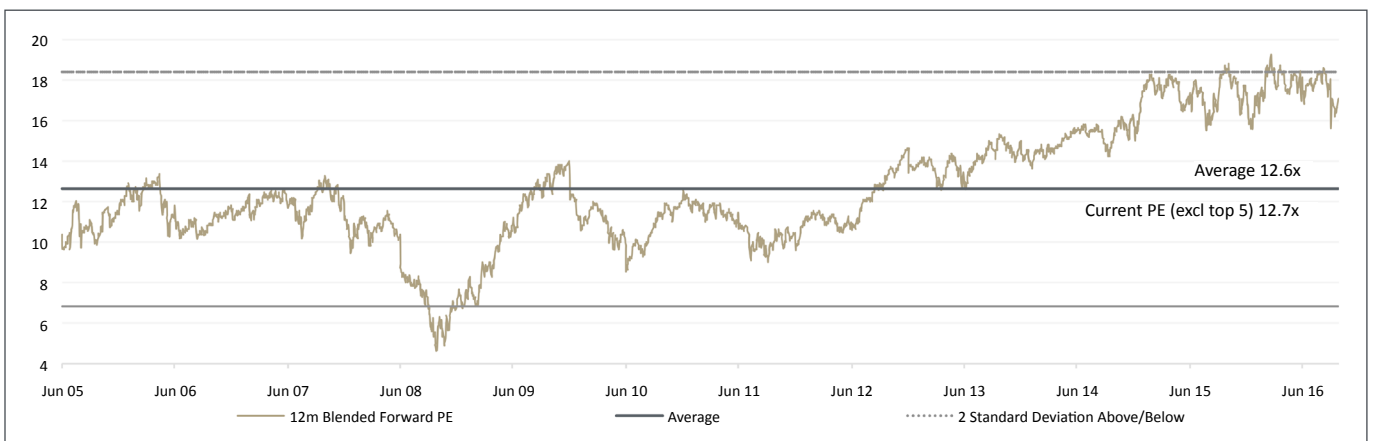


Source: PSG Wealth research team, Bloomberg

A stimulant for local counters has also been the slide in the local exchange rate. With a significant portion of the profits generated by the JSE's biggest listings now coming from abroad, South African stock prices have been stimulated by the depreciating rand.

However, when one uses the blended forward PE, which we feel is a more appropriate measure of current valuations, then the PE for the Top 40 is 16.8 times. Still expensive compared to the long-term average PE of 12.6. The analysis shows that the PE for the Top 40 Index is currently trading 1.5 standard deviations above its long-term average. (See graph below)

Earnings versus price of the Top 40 Index

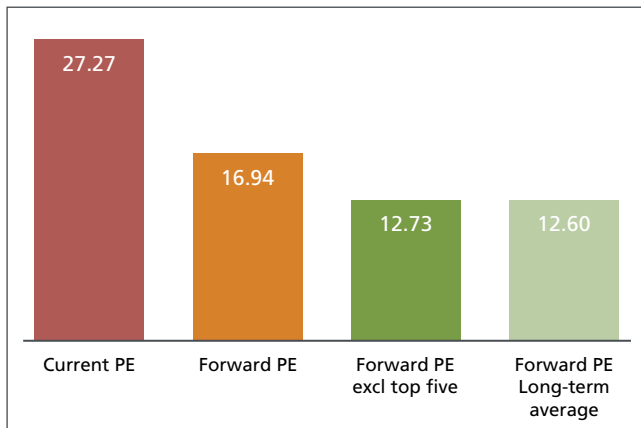


Source: PSG Wealth research team, Bloomberg Consensus

Special report



Different values seen when using different PE ratios

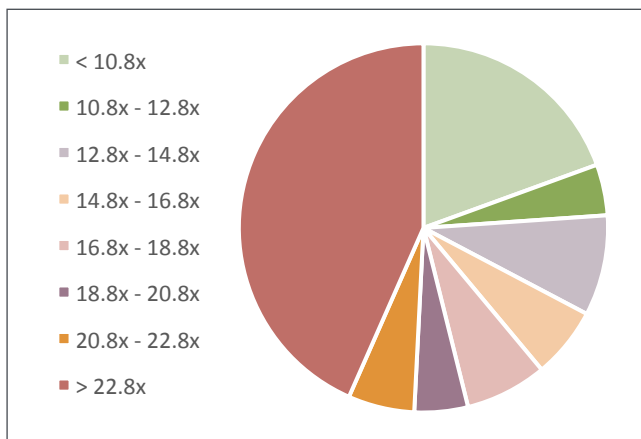


Source: PSG Wealth research team

IT IS IMPORTANT TO NOTE THE IMPACT THAT LARGE MARKET CAP COMPANIES HAVE ON PE VALUES

As stated above the PE for the Top 40 is 16.8 when one uses the blended forward PE. However, when one excludes the top five companies with the largest market cap from the TOP 40 Index, then the PE drops to 12.7. These companies (BHP Billiton, Anglo American, Richemont SA, British American Tobacco and Naspers) currently constitute 45% of the Top 40 Index. However, as the second pie chart indicates, they only account for 11.62% of the shares on the index.

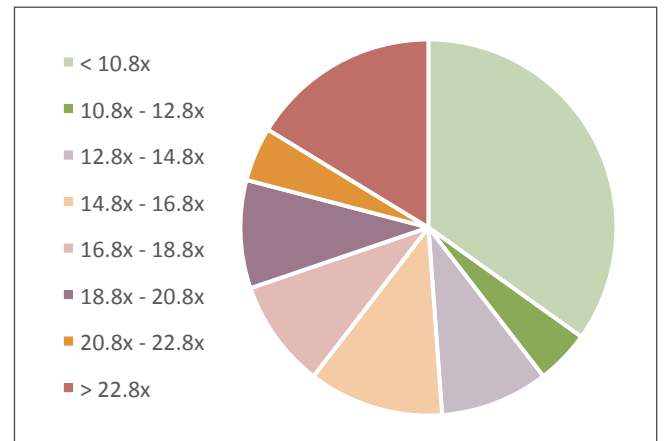
PE multiples of shares on Top 40 according to their weight*



Source: PSG Wealth research team

*The bright red and orange counters trading at PE's of 20 and higher currently constitute 43.38% of the Top 40 Index.

PE multiples of Top 40 shares*



Source: PSG Wealth research team

*Only 20.93% of companies on the Top 40 Index (the bright red and orange counters) are trading at PE's of 20 and higher.

Naspers alone accounts for about 19% of this index, trading at a forward PE of almost 42. Richemont and BHP Billiton both contribute over 8% to the index and trades at forward PE's of 26.3 and 22.5 respectively. These five companies are currently trading up to 3.47 standard deviations above their long-term averages.

Value of the top five market cap stocks on the Top 40

Name		Forward PE	Average	S.D away
BHP Billiton PLC	8.38%	22.51	13.00	1.42
Anglo American PLC	4.62%	12.71	13.37	-0.09
Cie Financiere Richemont SA	8.53%	26.35	15.16	3.47
British American Tobacco	4.24%	18.69	13.05	1.71
Naspers Ltd	19.38%	42.79	27.20	2.07

Special report



METHODOLOGY USED

The PSG Wealth research team focussed on the blended forward PE to reduce the impact of cyclicity and large once off earnings in the historic period PE ratio. The research team focused on the Top 40 instead of the ALSI given that better quality data was available for the larger shares. The TOP 40 contributes 81.2% of the ALSI's weight. Given this large contribution we believe a conclusion on the value of the Top 40 is applicable to the value of the market as a whole.

BOTTOM LINE

Over the long term, valuations tend to revert to the mean. Using historic PE multiples, the JSE currently seems very expensive. However, a thorough analysis reveals that the valuation is in line with its long-term average, especially when heavy-weight rand hedges are excluded. Indicating that value is still available to diligent stock pickers.