FUNDS ON FRIDAY

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Know where to hide

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Oats – the breakfast of champions! Almost any morning of the week when you walk into the Gryphon kitchen, you'll find oats being prepared in its various forms. The thing with oats is that, while it seems so simple, there is an art to preparing it. If it's not done properly, it's not *lekker*, but you still have to eat it. Also, it takes longer than you expect, and it can't be rushed…it takes as long as it takes. Do you think it's a coincidence that market commentators talk about a Goldilocks market – we think not! We don't doubt for a minute that it was oats that the three bears were waiting to scoff down once they returned from their frolic in the forest. The thing with oats is it is understated, there is nothing glamorous or cordon bleu about it, but it is wholesome and healthy and provides great nutritional value.

Gryphon's multi-asset funds are the oats of asset allocation. It's a simple, affordable concept; the benefits may appear understated because of an apparent lack of sophistication. However, they offer true diversification on the investment buffet in order to ensure that all your nutritional requirements are met in investments. Sometimes the expensive, complicated options are higher in fascination and foam than they are in substance.

Equities to investments as smashed-avo-on-sourdough-toast is to breakfast. Trendy and cool and all the hip people love them. We enjoy smashed avo on toast as much as the next hipster, but we only indulge, when avo's are in season. It can be an expensive and often disappointing experience to disregard the natural cycle of things.

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Resisting the call of equities

Equities have put on quite a show for the past couple of years. How do we account for not participating in events but just watching from the side-lines, and how have our investors fared as a result?

The Scottish economist and philosopher, Adam Smith said, “Markets go in cycles, just like all rhythms of life.” Gryphon’s multi-asset funds are informed by data-based indicators that recognise these market cycles which include bull and bear markets. In our view, equity valuations were beginning to show cracks in mid- to late-2018 with our indicators signalling the topping of the market in August 2018. As a result, our multi-asset funds exited their equity holding at the end of August of that year; and we expected the market to bottom out after that.

Then came the big action in equities. After the major decline in local and international markets sparked by COVID in 2020, they rebounded. Still, we did not get back into the market. This rupture in the market was a glitch in the matrix – while we in no way foresaw COVID or its consequences, the market cycle that we observed was extended as a result of the COVID interventions (quantitative easing).

Our commitment to our philosophy is absolute – we react according to our indicators and do not jeopardise the integrity of this process, but we also constantly assess the environment. This meant that, without any signal to the contrary, we continued to stay clear of equities. While our credulity may have been stretched/challenged and we came under pressure from investors suffering FOMO, we had no option but to honour our methodology.

The benefit of hindsight has afforded us useful perspective (as it so often does). It has become increasingly evident to us that much of the economic growth reported subsequent to COVID was a function of nominal growth, not real growth. (The increased turnover was the result of increased prices, not an increase in volumes.)

In various articles published post COVID, we proffered our concerns as explanation for remaining on the equity side-lines. Below are some extracts from that time:

- *Equity markets have run ahead of fundamentals and are already discounting far more than just a full recovery from the COVID hit.*
- *The stimulus packages, while useful, lack substance. They do not augur recurring or productive growth as an income/salary would, i.e., they will create a high base effect that markets should look through.*
- *In our view, a sizeable portion of the various stimulus packages is likely to end up in savings accounts rather than being spent.*
- *The global economy was already struggling to grow before COVID.*
- *The Chinese economy is showing signs of having matured.*
- *The US Fed failed to deflate its huge balance sheet or normalise interest rates after the GFC. Every time it tried to implement measures to do so, markets would start falling or consumption weakened. So, what would be different this time and why?*
- *While many investors are euphoric about the US Fed “promising” not to raise interest rates until 2024, we are less sanguine: whenever the Fed has adopted this approach in the past, it has been due to the economy being in need of the support of lower interest rates – not an environment conducive to strong profit growth.*

- *The market currently has a fixation on inflation. A pickup in inflation would not necessarily mean real growth or demand picking up.*
- *Commodity prices are currently being driven by supply issues rather than by demand (this is the catch-up from COVID's effect on productivity).*
- *Markets still seem to run on FOMO and this euphoria is reflected in extremely low cash levels in portfolios; the Bank of America Fund Manager Survey has fund manager cash levels at low levels last seen in 2013. If all the cash is already invested, who is going to do more buying?*
- *When retail investors start to play an increasingly prominent role in markets, it is usually an indicator of the end of a cycle e.g., Gamestop, Bitcoin, etc.*

Again, with the benefit of hindsight, we recognise and appreciate the veracity of the data that informs our indicators – as an investment team, we only have access to the same information as every other investment team. Having a rules-based philosophy – *and sticking to it* – kept us from being swayed or swept up in the Corona contagion.

So, are we there yet? Is it time to get back into equities?

Based on the long-term data, equities are the asset class of choice for South African investors wanting to achieve inflation-beating returns. Contrary to a common misperception, we do recognise the contribution of equities in delivering on this objective. However, inflation-beating returns is a two-step process:

1. protect the capital
2. grow the capital

Our allocation to equities is determined by a 'buy' indicator and currently this reflects little appetite for investment in equities, local or offshore.

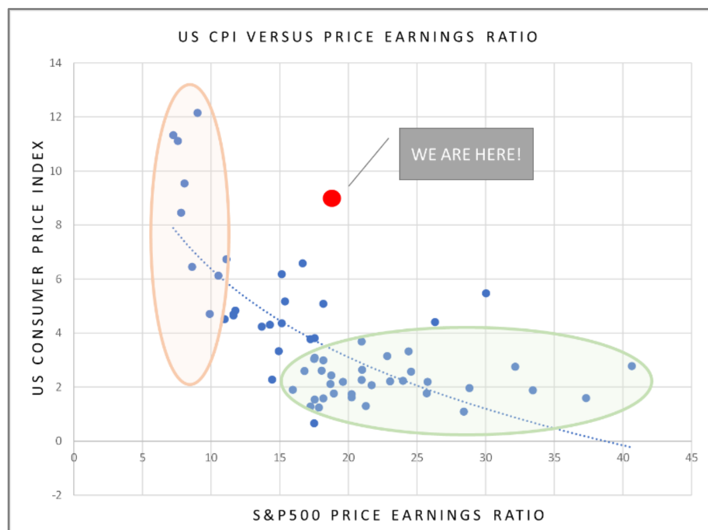
There are two factors regarding equities that remain of major concern to us, namely inflation and company earnings.

Inflation

While there are a number of geopolitical matters that are reasons for disquiet, our overarching worry remains the fact that markets appear to be discounting a swift return to low inflation, i.e., levels of around 2% in the USA.

Inflation, originally declared to be transitory, has turned out to be rather sticky; shifting from energy into other goods and, more recently, into services, with a real risk of it becoming endemic. This has resulted in the aggressive rate hikes seen from central bankers globally.

The impact of inflation on equity valuation is severe as the graph below illustrates.



Starting in 1961 (excluding 2009), this graph plots the annual change in the US consumer price index (CPI) against the price-earnings-ratio of the S&P 500 for each year.

This fitted curve graph illustrates the relationship that exists between inflation and price-earnings-ratios, i.e., when inflation is low (green-shaded area), price-earnings-ratios are elevated, i.e., greater than 20x. However, when inflation is high (orange-shaded), the price-earnings-ratios tend to drop quite steeply.

At the time of writing, the S&P500 was at 3 700; earnings at approximately $200 with a price-earnings-ratio of 18.5x.

What can be determined from the graph is that if inflation hovers at around 4% in a year's time, the price-earnings-ratio could be expected to decline to levels of approximately 15x.

This would result in an index value of 3 000 which is down about 19% from current levels.

Company earnings

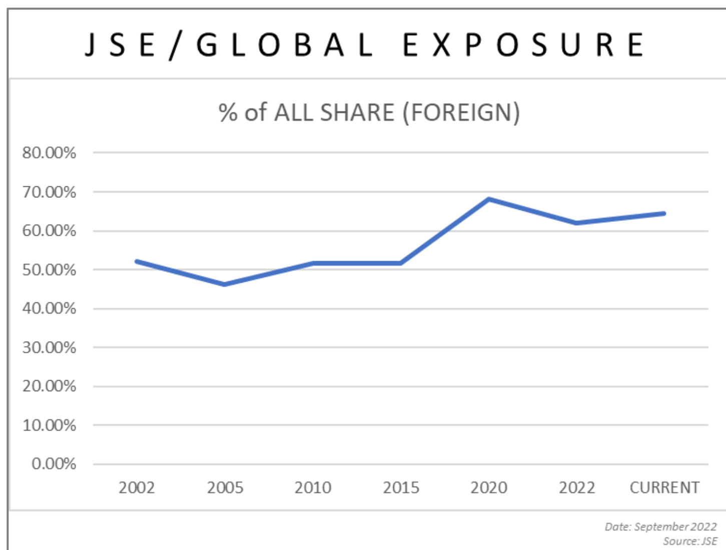
Earnings growth over the recent past has been stellar and operating margins in most industries are at elevated levels.

While there many reasons for margins and earnings to remain elevated, history and historical performance during periods of economic weakness in particular, gives cause for concern. We are perturbed that earnings forecasts remain too bullish.

A litmus test in this regard is the recent earnings disappointment from FedEX Corporation. This stock manifests the domino-effect of the slow-down in demand being experienced.

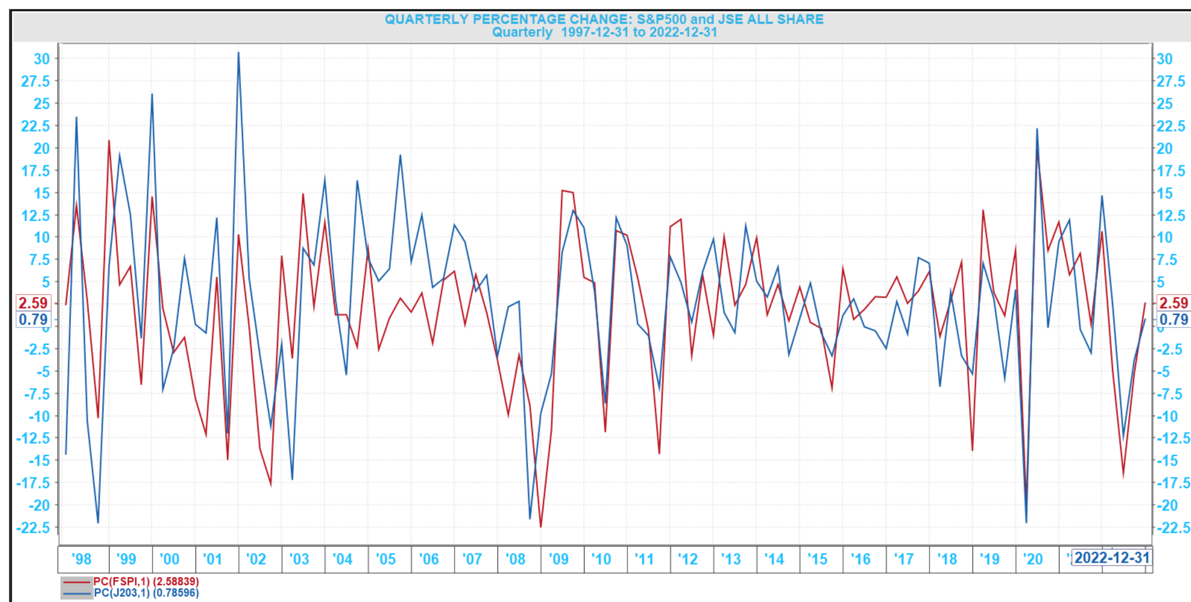
We are aware of the rhetoric in favour of South African equities, contending that they are cheap and offer terrific value to investors. There are two points to consider:

What constitutes SA Inc? As can be seen in the charts below, there isn't much in the JSE Top 20 that qualifies as *regte, egte* South African stock.



	COMPANY	LOCALE
1	Richemont	International
2	Anglo American	International
3	Naspers Ltd	International
4	Firstrand Ltd	International
5	MTN Group Ltd	International
6	Prosus	Local
7	Standard Bank	Half
8	Sasol	Half
9	BAT	International
10	Capitec Bank	Half
11	Absa	International
12	Impala Platinum	International
13	Mondi	Local
14	Gold Fields	International
15	Sibanye Stillwater	International
16	Shoprite Holdings	International
17	Glencore	International
18	Anglogold Ashanti	Local
19	BHP Group	Local
20	BID Corporation	Local

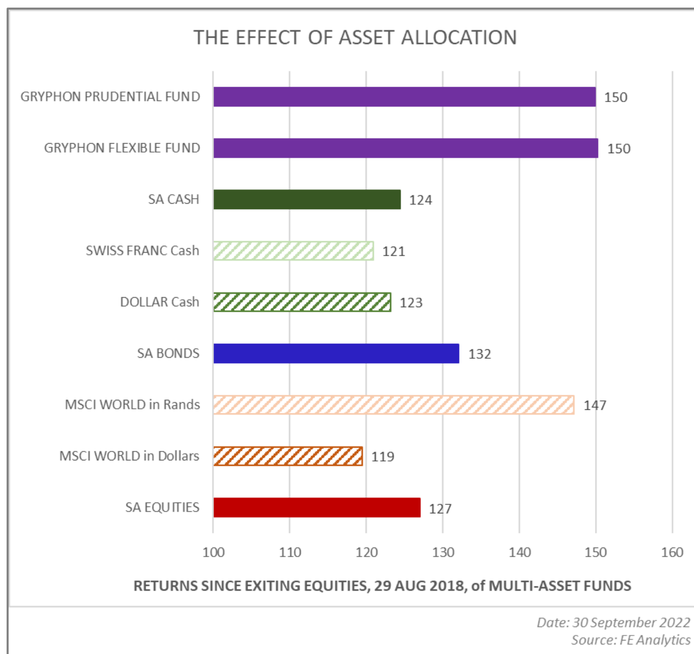
Secondly, we pay heed to the adage, "When Wall Street sneezes, global equity markets catch a cold," i.e., our market is unlikely to remain unscathed during a drawdown on Wall Street, as illustrated in the graph below. The graph plots the quarterly percentage change in the S&P 500 and the quarterly percentage change in the JSE All Share Index:



Now, what?

The short answer is we don't know.

Warren Buffet has two rules for investing: *"Rule Number One: Never Lose Money. Rule Number Two: Never Forget Rule Number One"*



Equity markets are volatile, and our 'buy' indicator could be triggered suddenly should markets sell off further, or it could be an extended period of time before value is restored.

Based on Buffet's rules for investing, we are prepared to wait for equities to reach the right buying levels. Until that time, we continue to subject holdings to CrossFit-type exercise and make them sweat using the other asset classes available. While some investors may consider cash a cop-out and about as exciting as kissing your sister, the table on the left reveals the returns delivered by the Gryphon multi-asset funds since exiting equities. Our investors may have had a rather dull, unremarkable investment journey but it's one that has resulted in returns that outperformed all underlying major asset classes, local and international, at very low levels of volatility. So, perhaps despite much hand-wringing and exasperated declarations to the contrary, there has, in fact, been somewhere to hide! The graph below illustrates this.

In conclusion, we recognise that human beings as a species are reluctant to change; research informs that we are hardwired to resist change. Part of the brain—the amygdala—interprets change as a threat and releases the hormones for fear, fight, or flight. We stick to our routines and rituals, our breakfast options, and we don't like to

shake things up unnecessarily – sometimes to our own peril. This story from Morgan Housel offers great insight to our commitment to white knuckles:

"37 000 Americans died in car accidents in 1955, six times today's rate adjusted for miles driven. Ford began offering seat belts in every model that year. It was a $27 upgrade, equivalent to about $190 today. Research showed they reduced traffic fatalities by nearly 70%. But only 2% of customers opted for the upgrade. 98% of buyers chose to remain at the mercy of inertia. Things eventually changed, but it took decades. Seatbelt usage was still under 15% in the early 1980s. It didn't exceed 80% until the early 2000s – almost half a century after Ford offered them in all cars.

It's easy to underestimate how social norms stall change, even when the change is an obvious improvement. One of the strongest forces in the world is the urge to keep doing things as you've always done them, because people don't like to be told they've been doing things wrong. Change eventually comes, but agonisingly slower than you might assume."

To resist considering alternate approaches to asset allocation is to invest without a 'seat belt'. Are you willing to take that chance?

Glacier Research would like to thank Reuben Beelders, Abri du Plessis, and Megan Fraser for their contribution to this week's *Funds on Friday*

Reuben Beelders,
CIO & Portfolio Manager
Gryphon Asset Management

Reuben is Gryphon's Chief Investment Officer, Chair of the Gryphon Investment Committee and is co-manager of the Gryphon Dividend Income Fund, the Gryphon ALSI Tracker Fund, the Gryphon Global Tracker Fund and the multi asset funds. Having served as the Head of Strategy, he has broad experience covering most asset classes. He has been an industry professional since 1996, has commercial and accounting experience, is a Chartered Accountant and is a Chartered Financial Analyst Charter holder.
Reuben is a self-confessed, unapologetic coffee snob as well as being an avid gymmer and cyclist.

Abri du Plessis,
Executive Director & Portfolio Manager
Gryphon Asset Management

Abri is a co-founder and Executive Director of Gryphon and embodies every aspect of Gryphon's ethos and philosophy. His main focus is Gryphon's multi-asset funds – a role that sees his wealth of quantitative experience put to effective use – but he also co-manages the Gryphon Money Market and All Share Tracker Funds and is a member of the Gryphon Credit Committee.

Abri's talent for structuring, positioning and creating also manifests in his DIY skills – he is an accomplished carpenter and builder.

Megan Fraser,
Head of Business Development & Marketing
Gryphon Asset Management

Megan has been involved in establishing business development networks in financial services for nearly 40 years. Having worked for Norwich, Investec IMS, Coronation, Stanlib, Fraters, SI, and Aylett & Co, she has a acquired a breadth of experience as well as valuable insights in this time. Her current role with Gryphon provides the opportunity to create awareness and appreciation for the unique, innovative investment approach delivered by this well-established, rules-based investment house. Beyond the office, her passions include reading, travel, holistic health, and trying to get the whole world to embrace meditation.