FUNDS ON FRIDAY
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Covering every angle

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Many investors have placed – or are busy placing – investments offshore. We endeavour to consider an investment approach from all possible angles and must therefore remain mindful of the opportunity offered by a recovering JSE. After an intense and rigorous discussion in this regard, this is a question we received from an astute financial adviser:

“In keeping with Reuben’s* "always consider the alternate view", consider the scenario where an investor takes funds offshore and the ZAR strengthens significantly. Given that so many listed SA companies have large offshore exposure for their earnings, does it not follow that the JSE will probably not rise that much as a result and may, in fact, be quite weak - the end result being that the stronger rand is offset by a weaker market, strengthening the argument for weightier offshore holdings?”

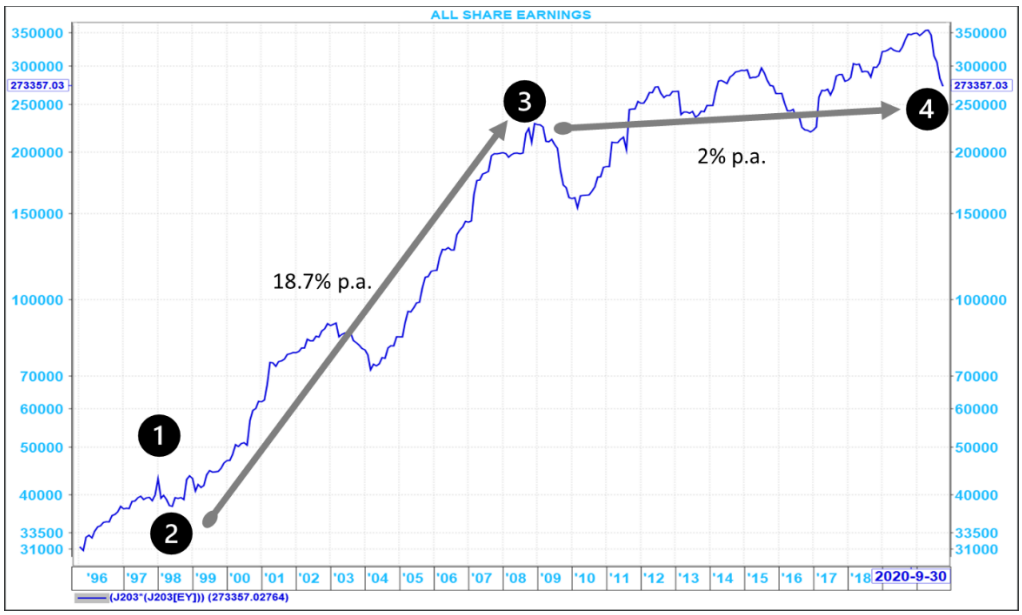
**Reuben Beelders, subscribes fully to Charlie Munger’s approach: “I’m not entitled to have an opinion on this subject unless I can state the arguments against my position better than the people do who are supporting it. I think that only when I reach that stage am I qualified to speak.”*

In considering a response, we took into account the following:

1. The current South African All Share Indices were reconstituted by FTSE in 1996 and so on IGRAPH, the "history" commences at this point.

   We are comfortable with this as a starting point, considering the elections in 1994 and the associated changes that subsequently occurred, both economically and socially.

   Let's make a few broad observations on how South African All Share earnings behaved over this period as illustrated in the graph below:



1.1 The pick-up from around 1995, follows a period of fairly muted growth from around 1990 (not included on the graph).

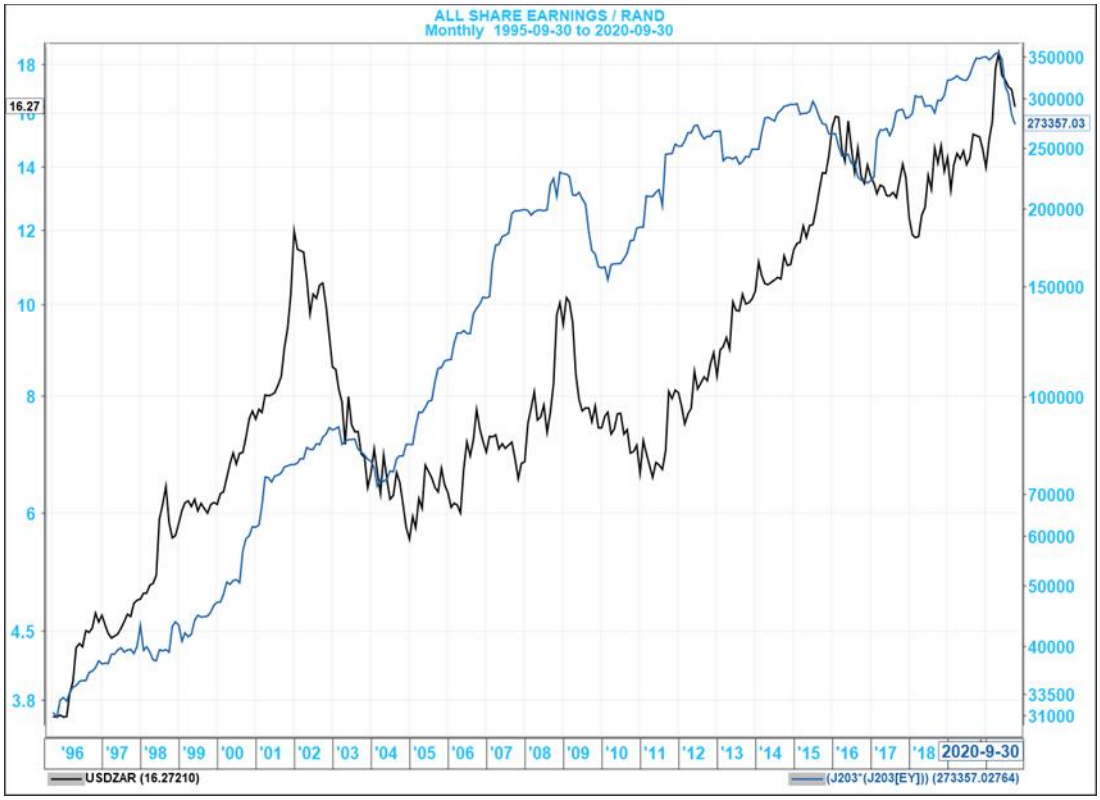
1.2 Earnings rise to a level of 43 917 on 31 December 1997 (marked ①) and then on 31 December 1998 fall to 37 916; a decline of 14% (marked ②)

1.3 From this point forward there is a very strong primary cycle recovery which extends to 2008. Over this period earnings grow to 228 657 as of 30 November 2008 (marked ③)

   Over this almost ten-year period the compound annual average growth rate in earnings was a significant 18.7% per annum.

1.4 Current earnings levels of about 273 357 (marked ④) are not that far from the level as of 30 November 2008. Over this almost 12-year period, the compound annual average growth in earnings is less than 2%.

2. How we explain the earnings profile with reference to the movement in the exchange rate?



While earnings leading up to the end of 2001 appear to follow the weakening currency, the reasons for the trend are apparent during the currency strength through the period of 2001 to 2007, is less clear.

A few observations regarding the value of the currency:

- ZAR weakens considerably to 31 December 2001, reflecting a value of 11.995.
- ZAR then strengthens to 5.635 as at 31 December 2004.
- Over the next three years ZAR weakens consistently; down 21% to 6.812 at 31 Dec 2007.
- 2008 global financial crisis: ZAR weakens dramatically to 9.525 (down 40%).
- A period of strength then follows - 6.556 at 30 April 2011.

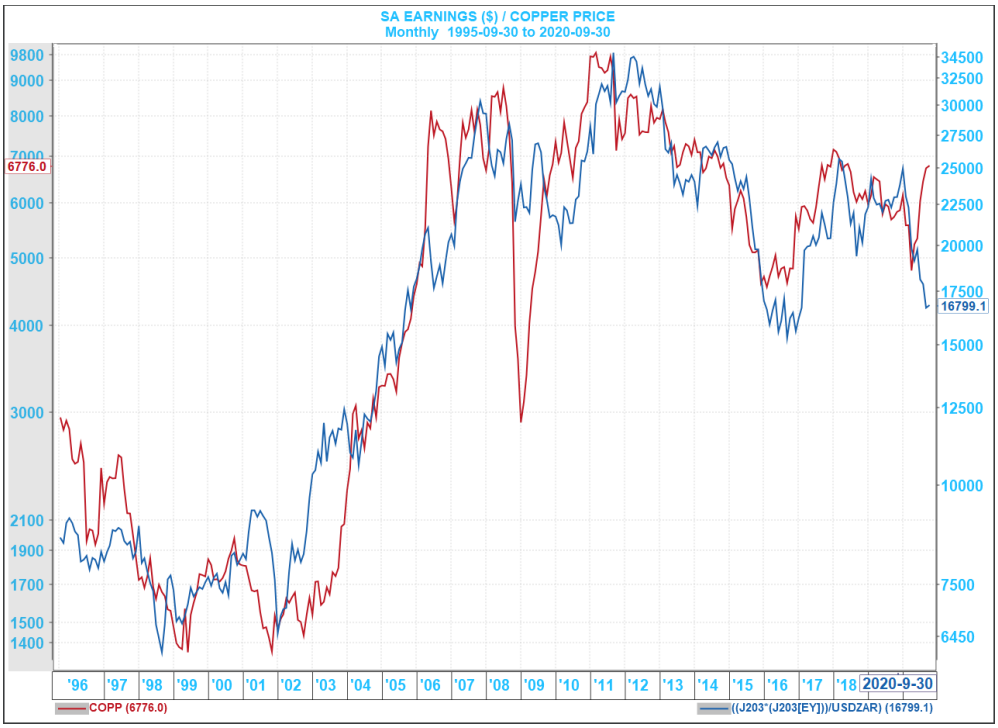
Considering the weakness from 2011 to 2020, those advocating that the currency contributes to earnings would have been disappointed with the lack of increase in earnings over this period. While the currency has weakened 148% over this period, earnings have only grown 31%.

3. At this juncture, most market commentators would ascribe the very poor performance from 2009 to “The Zuma Years” and the associated impact of the mis-governance that was experienced.

   While “The Zuma Years” were undoubtedly negative for the country, we are less sure of the causality. (We consider it prudent to caution against mixing politics (i.e. emotion) with investment returns).
   This statement could also be considered as relative to whatever the driver was of the significant increase in profits from 1998 to 2009.

   At Gryphon, based on our own research as well as the research of independent investment houses, we contend that South African economic growth is strongly influenced by the underlying business cycle, which closely follows the commodity cycle and prices.

   For the sake of equitable comparison, it must be taken into consideration that commodity prices are quoted in USD. Illustrated below, is the conversion of South African earnings to USD which then compares this series to the copper price as a proxy for the commodity cycle.

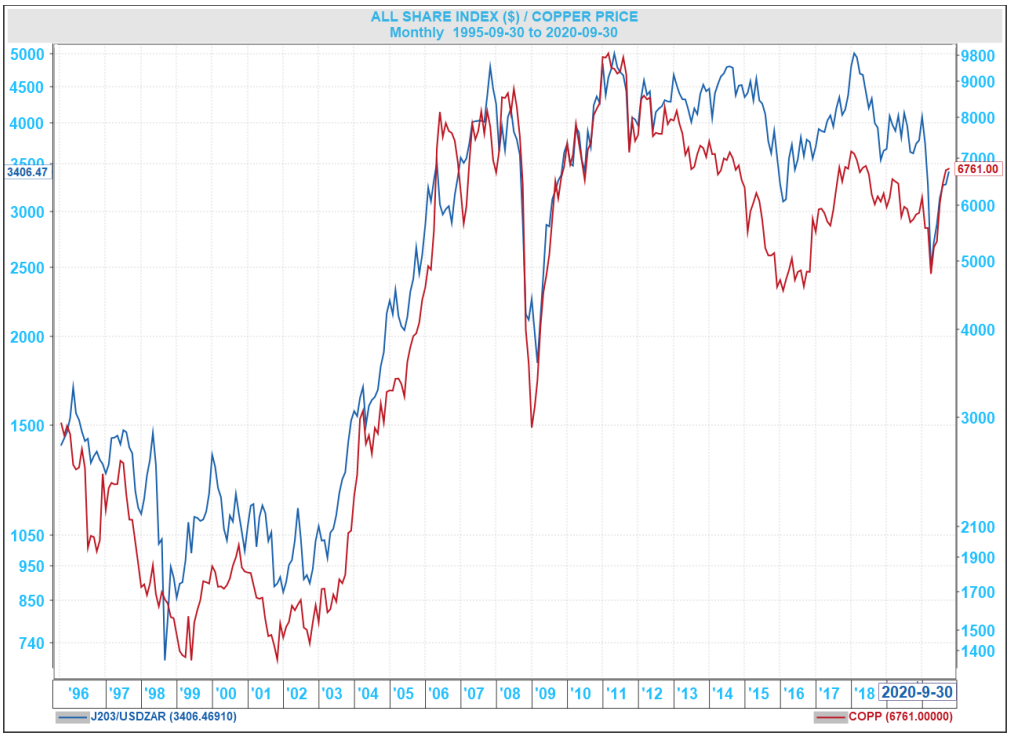


We believe that this chart reflects a far sounder explanation for the evolution of South African earnings.

South Africa remains a “commodity-based” economy. Commodities still constitute a major portion of the SA economy and is therefore an important driver of all other economic activity.

The global commodity cycle is a significant driver of our underlying economy and earnings are unlikely to recover unless this cycle does; because of the fact that the commodity cycle is so dependent on the global business cycle.

The graph below illustrates that the correlation between South African All Share Index (in USD) and the copper price is an obvious result of the relationship to earnings:



The current "pick-up" in the copper price (and all other metal prices for that matter) is a dilemma then? Our current assessment of the divergence between earnings and the copper/metal price is a function of the fact that supply disruptions due to COVID-19 have resulted in elevated copper/metal (and some other commodity) prices; this is not reflected in increased underlying demand.

4. Has the composition of the South African All Share Index changed from prior periods; can we expect the earnings of the All Share index to react the same way as in the past?

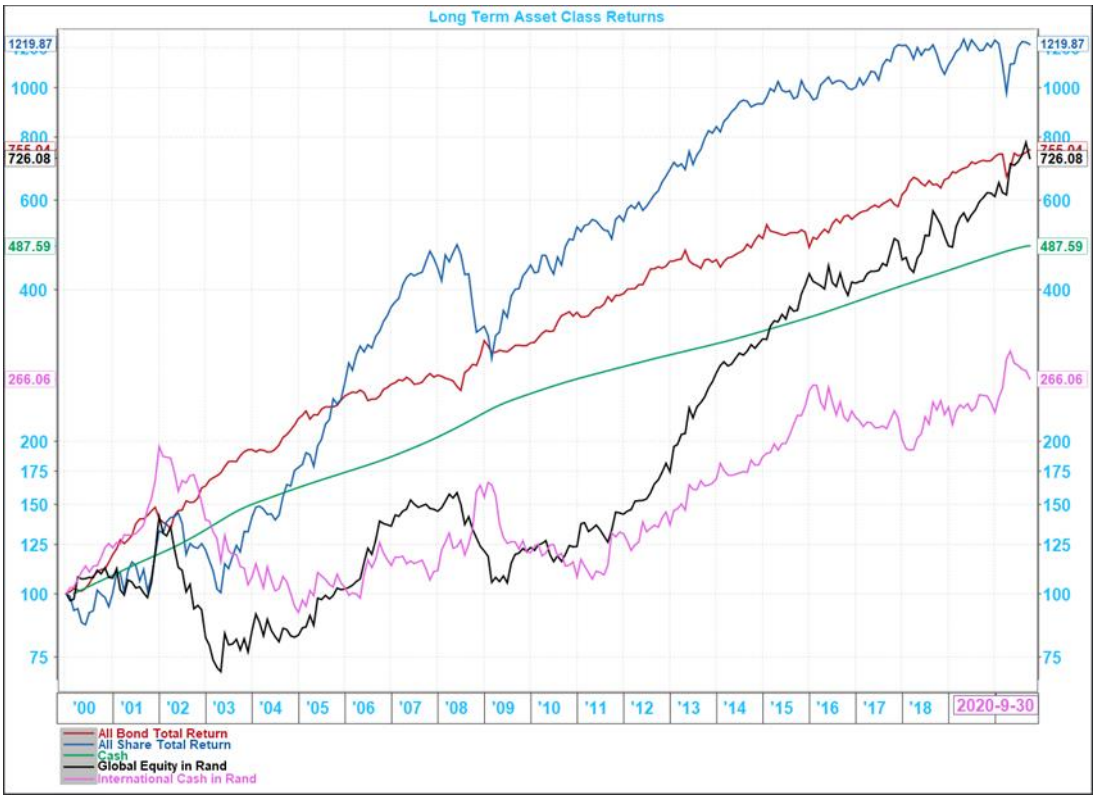
   We have shared previous research in which the various arguments about the "concentrated" nature of the All Share Index is addressed.

   Today, much attention is focused on the "concentration" due to Naspers/Prosus. Our findings, however, reveal that in 2008 the concentration "risk" associated with the Resource counters was certainly greater than the current situation.

   Historically, the ZAR has strengthened with commodity prices and so we would contend that All Share earnings are likely to follow a similar path as in the past, i.e. stronger commodity prices reflecting a stronger global economy, resulting in stronger economic growth in emerging markets and hence stronger earnings from the All Share Index. South African earnings are therefore more a function of the global economic cycle, rather than the local.

5. Given the above, the reality remains that South African investors need to choose the right asset class in order to generate inflation-beating returns.

   Over the past 20 years, South African equities have been the asset class of choice.



Understandably, there have been times when other asset classes outperform. By way of example, international equities, have reflected periods of outperformance, but entry and exit points would have impacted returns significantly.

We remain of the view that understanding the underlying commodity cycle and its impact on asset classes will assist investors in the choice of the asset class which generates the best risk-adjusted return at various points in time over the investment cycle.

The challenge is not in being right – the challenge is understanding as many of the moving parts as one can and to then have the discipline to implement an investment strategy accordingly. In the words of Kodo Sawaki, ‘The question isn't who's right. You're simply seeing things from different points of view.’

Glacier Research would like to thank Reuben Beelders for his contribution to this week's Funds on Friday.

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Reuben is Gryphon's Chief Investment Officer as well as a Portfolio Manager. Having served as the Head of Strategy, he has experience covering all asset classes and he chairs the Gryphon Investment Committee. 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