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The ghosts of COVID past

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> *"To reach a port we must sail, sometimes with the wind, sometimes against it. But we must not drift or lie at anchor."*
>
> Oliver Wendell Holmes

In the near term, particular investment narratives can dominate, and if there are enough believers, become self-fulfilling. In time, fundamentals such as earnings growth, free cash flow generation and dividends will ultimately prove or disprove the narrative. As the country deals with a litany of woes, the most notable of which being the electricity crisis, the South African narrative of the day is overwhelmingly negative – perhaps the most negative we have seen in our professional lives.

Over the decades, South Africa has faced many crises - political, social and economic. Many of these were self-inflicted and South Africa-specific, and countless coincided with global economic and political developments. In most of these crises, the rand weakened, bond yields invariably spiked, and the valuations on South African listed companies collapsed. Notwithstanding, over the 47 years between December 1975 and December 2022, South African equity delivered a compound annual return of nearly 18%, outperforming all major asset classes, including the S&P500 in rands.

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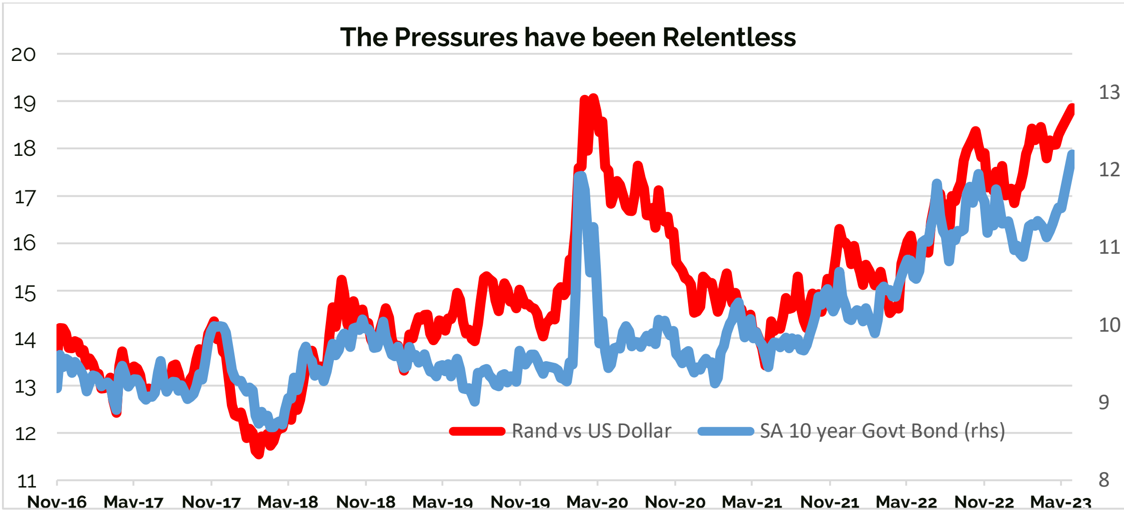
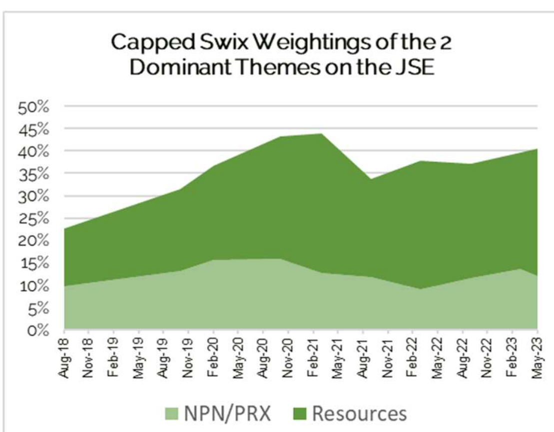
Our current crisis, like many before it, is complex and multi-faceted. Whilst there is little doubt the issues at Eskom are an own goal of seismic proportions, the global economic environment of elevated inflation and rising interest rates is proving difficult for many developed and emerging economies alike. Once again, as shown on the chart below, the rand has weakened significantly against the dollar and bond yields have reacted negatively. The horrors of the 2020 COVID crisis have made an unwelcome return to our capital markets.

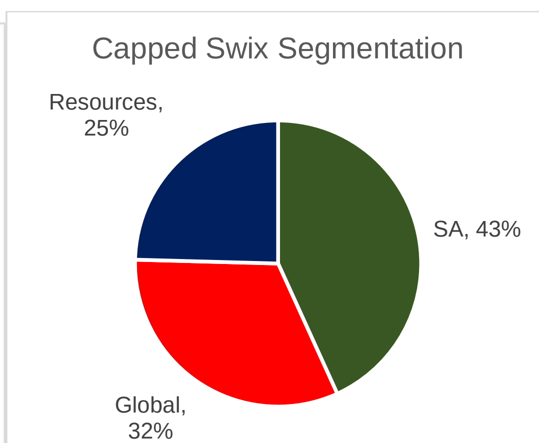


Source: Iress, CGAM, May 2023

Given incremental changes to Regulation 28 international limits, according to work done by SBG Securities and RMB Morgan Stanley, the average South African balanced fund has systematically reduced their weightings in South African equity from nearly 70% in 2005, to 40% today. Conversely, offshore weightings have moved from 10% to nearly 40% today.

The make-up of the JSE is unique – as shown below the combination of resources and the Naspers / Prosus groups make up 40% of the index. Coupled with large global industrial companies, that happen to be listed here, but don't operate within South Africa, we estimate 57% of the Capped Swix index is not in any way exposed to the South African economy.



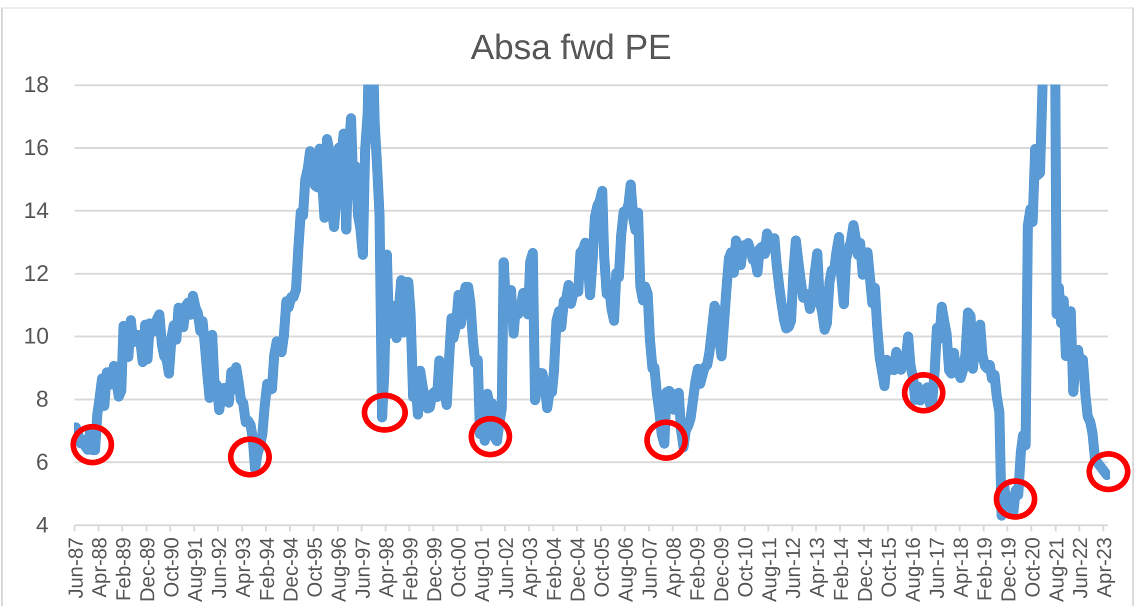


With the average South African balanced fund already having reduced exposure to the JSE to 40%, and the South African economic exposure being around 43% of that allocation, the average balanced fund investors have an approximate exposure of around 17% to companies operating in the South African economy. Professional asset managers have voted with their feet – the negative narrative has many believers!

The local opportunity set

Just like sailors referred to earlier, investors can't always choose the conditions under which they operate. Much like the wind, the investment landscape is ever-changing, and investors have to fall back on a reliable and repeatable investment process to help them navigate different conditions. The ClucasGray Asset Management investment process is centred around the interplay between earnings growth and valuation multiples.

In the case of valuation multiples, history provides some perspective. As a proxy for South African oriented companies, given their long history, South African banks illustrate the point well. The chart below shows the 35-year history of the Absa forward PE multiple. The red circles highlight previous troughs, each one correlating with a significant global or local event. In every single one of the events that we have experienced since we joined the industry in 1999, we have looked back at the valuations on offer as an obvious time to have increased exposure – forgetting that in the midst of each crisis, the future looked uncertain.



Source: Iress, CGAM, May 2023

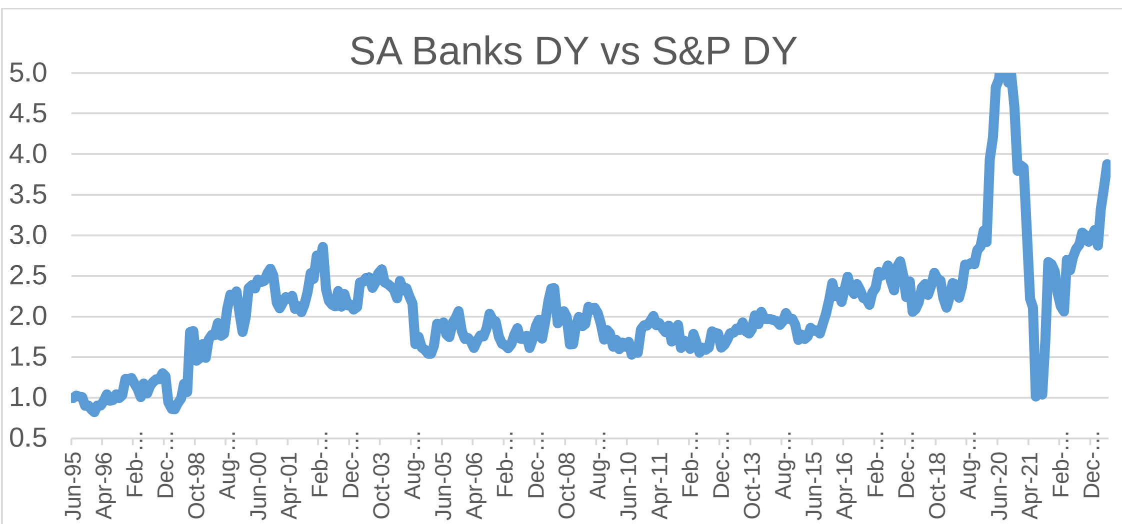
Is the current investment environment any more serious than the political turmoil of the late 1980's, the numerous emerging market crises of the late 1990s and early 2000s, or the Global Financial Crisis where the future of capitalism was at stake, or Nenegate, or the more recent COVID crisis? The current crisis feels worse, and perhaps more existential in nature, yet in each of those previous periods mentioned, we recall the rigorous investment debate, the lack of consensus, and the fear that South African equities were best avoided. History has judged those periods as opportune times to be buying good companies at the wrong price.

At the risk of belabouring the point, the table below highlights the breadth of companies trading on attractive PE multiples and elevated dividend yields.

COMPANY	12 m PE	12 m DY
ABSA	5,4	9,0%
STANDARD BANK	6,7	8,5%
OLD MUTUAL	6.8	7,2%
MOMENTUM	5.7	6,7%
BRIT AM TOBACCO	6,9	8,9%
MTN	7.8	3.0%
FOSCHINI	7,3	6,6%
TRUWORTHS	6,1	10,0%
REUNERT	8,7	5.9%
SPAR	9,2	3.5%
AECI	7,1	9,0%

Source: Bloomberg, CGAM, May 2023

Aside from the apparent absolute value in many South African companies, it is the relative value that is even more startling. The chart below shows the dividend yield of the South African banking index against the S&P500 over the last 28 years. Investors are now able to earn a dividend yield that is four times that of the S&P500 – the last time it was anywhere near as elevated as it currently is, was in the early 2000s. In the current climate of negativity, it is tough to comprehend but the ensuing decade proved a very good period for inexpensive domestic assets relative to US assets which then, as potentially now, appeared priced for perfection.



Source: Iress, CGAM, May 2023

Loadshedding undoubtedly creates a near-term headwind for economic growth. It has, however, also proved a stimulus for material investment by households and corporates into alternative energy solutions. Following a near decade-long period of negative real credit growth into the consumer economy, and a fixed investment strike by South African corporates, recent credit growth into both the retail and corporate sectors, has been encouraging. The chart below highlights that banks are once again seeing some real growth in their books.

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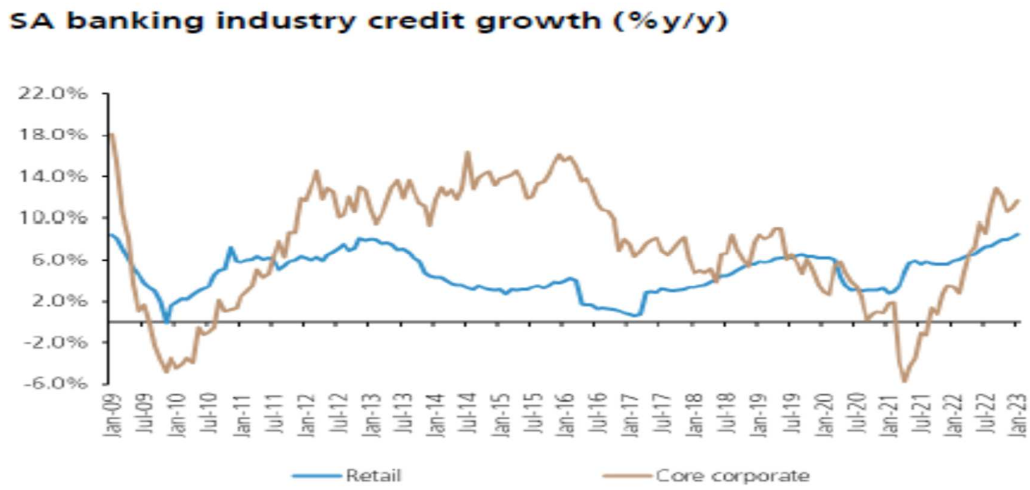

Source: UBS

Despite the narrative, it appears that key parts of the economy continue to show signs of growth. We looked at 15 of our equity holdings that operate largely within the South African economy. On average, we expect these companies to deliver compound annual earnings growth of 10% over the next three years – modest, if unspectacular, but real growth it is, nonetheless. On average, the forward PE multiple of this large sample of holdings is just over seven times. Good companies, large and small, are trading at very attractive valuation multiples.

We have always viewed asset allocation as a tactical tool to help us deliver industry-leading real returns to our investors. The ClucasGray Equilibrium Prescient Fund, our balanced fund, currently has a weighting to South African equities in excess of the 40% average alluded to earlier. In addition, the equity exposure to companies that operate in the South African economy is more than 43% average mentioned earlier.

South African investors feel like they have been sailing into a very strong headwind for the last number of years. We believe that with a combination of steady earnings growth, extremely attractive valuations, and a growing sense of urgency to unlock value, many South African companies have the potential to deliver very attractive returns to patient investors.

Glacier Research thanks Andrew Vintcent for his contribution to this week's *Funds on Friday*

Andrew Vintcent
Director & Portfolio Manager
ClucasGray Asset Management

Andrew has worked in the asset management industry for over 23 years, the first 16 of which were spent at two large institutions, RMB Asset Management and STANLIB. His roles spanned research, portfolio management and leadership, with significant portfolio management experience gained in managing both South African equity and asset allocation funds. In 2015, Andrew partnered with ClucasGray, a premier private client investment manager, as an equity investor in and portfolio manager of the asset management business. Andrew has managed the ClucasGray Equity Prescient Fund, the ClucasGray Equilibrium Fund and mirror institutional mandates of those funds since 2015 and is a director of ClucasGray Asset Management.