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Seeking opportunities in the SA equity market

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Bottom-up process

In-depth and long-term knowledge of South Africa's companies, politics, economy and other local investment drivers provides a competitive advantage for fund managers which should not be underestimated.

This knowledge and expertise provide meaningful investment returns that are not easily replicated when it comes to finding offshore investment opportunities.

When seeking opportunities in the local equity market, a bottom-up valuation process that identifies quality businesses is key, alongside a comprehensive understanding of the local market. "Understand and know the South African market exceptionally well," says Du Toit. "Know the companies in incredible detail while being mindful of the South African environment, its nuances, politics, SOEs and the macro environment and be acutely aware of drivers of the economy and what is happening on a currency basis." This is informed by thorough research to know and understand companies, their management teams, competitive environment and all other drivers of performance. This also includes access to unlisted companies which we are sometimes more able to engage than listed companies (that, for example, may be in a closed period), to provide information that can impact investment decisions.

“As a result, one is able to pick better shares with conviction, when having a comprehensive knowledge of companies and their management teams. For example, we have met up with some management teams for 10 years and more – we can literally walk into the room and know if things are going well or going badly.”

Local vs offshore

With offshore, one doesn’t have that same competitive advantage. Du Toit says that when buying offshore shares, you need to take a broad view that is more thematic than stock-specific, as you just don’t have the competitive advantage.

“Concentrating on the local equity market allows one to have a lot more confidence and conviction in assessing estimates of what the value of South African companies are, that one isn’t able to have when buying offshore shares. As a South African fund manager, we know our South African shares very well, and are acutely aware of all the dynamics at play in the country, and therefore have a high level of conviction of our estimate of fair value of a South African company, which is not possible when analysing a share in America or China.”

It is difficult to expect the same alpha from offshore shares as what can be generated locally because if one looks at the big offshore stocks, which can have 50 or more analysts covering them, it is difficult to find something in those companies that this large pool of analysts cannot find. When it comes to offshore mid and smaller caps, local fund managers are not as aware of the macro and competitive environment in which they operate, whereas in South Africa, there is the ability to speak to analysts, suppliers, customers and competitors all the time to test one’s views on a particular company.

Understanding the rand is imperative to identifying local equity opportunities. Good insight into whether the rand is expensive or cheap is gained by looking at various impacting factors such as deficits, surplus, commodity prices and interest rate differentials, and when the rand is at extremes, this enables you to take positions based on a currency view. If the rand is at R13, for example, bias your capital allocation for rand weakness because the rand is unlikely to stay at that level.

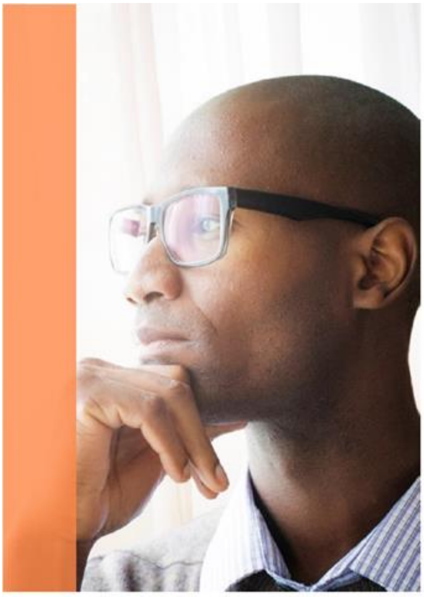
Rand hedge stocks provide a diversification benefit because the companies – which are largely big foreign companies or mining-related – provide a good balance to a portfolio.

Although there is some excitement in the fund management industry about the increased offshore allocation, Du Toit is of the view that there are enough offshore companies listed locally, such as AB InBev, Naspers and Prosus, to intelligently get enough diversification in a South Africa-only or locally-biased fund. Rand hedge stocks also provide access to emerging markets such as China, where Naspers and Prosus are a direct play, or through companies like Richemont, which derives half its sales from emerging markets.

While the South African equity market is dominated by rand hedge, large-cap stocks, there are opportunities across the full market. However, one must have a cautious approach to the small- and medium-cap sector, as the buying and selling opportunities are less agile than big caps. If something goes wrong in the investment thesis, it is not always possible to get out, and the cost of getting in and out is higher. “What this means is that to invest in a small cap, one requires a larger return because of the cost of getting in and out. That said, we are happy to buy small caps. One of the types of share we like is a primary growth share, that will compound over the next 10 years above the market, and we would want to own that in the long run.”

These companies tend to operate in a niche, are normally founder-managed, have stability and make good capital allocation decisions. “This is where good asset managers should be able to add value consistently over a sustained time,” Du Toit says. This would include companies such as Afrimat, Equites and Transaction Capital – all excellent companies, where management teams have done exceptionally well, and where one should invest in these shares over the long term. “Whilst preferring large caps, we consider all companies as long as they meet the additional return hurdle,” he says.

Considering the relatively small size of the South African equity market, there are additional ways to deliver more meaningful returns than the market, while not taking on unnecessary risk. Hedge funds provide greater degrees of opportunities with some fifteen strategies being deployed, by Oyster Catcher, compared to three or four in a long-only fund. Some of the strategies are simple. For example, when a company is being bought out, managers assess the probability of the deal going through and look at risk and reward, and if there is enough, they will apply a position in the hedge fund. If they see enough upside, they will buy or increase their position in the equity fund.



SIX STEPS

Seeking opportunities in the SA equity market

1. Establish an intrinsic value using bottom-up research
2. Compare opportunities on a real-time ranking table
3. Use of a proprietary momentum indicator to help size and time the entry and exit
4. Positions are appropriately-sized through a disciplined risk management process
5. Exposure to many independent positions

INTELLIGENT IMPACT THAT MATTERS

AMPLIFY

Opportunities should be carefully selected and vigorously debated by a bottom-up valuation process, where a fund manager tries to estimate what a company will be worth in four years’ time through a detailed analysis and putting on an appropriate multiple.

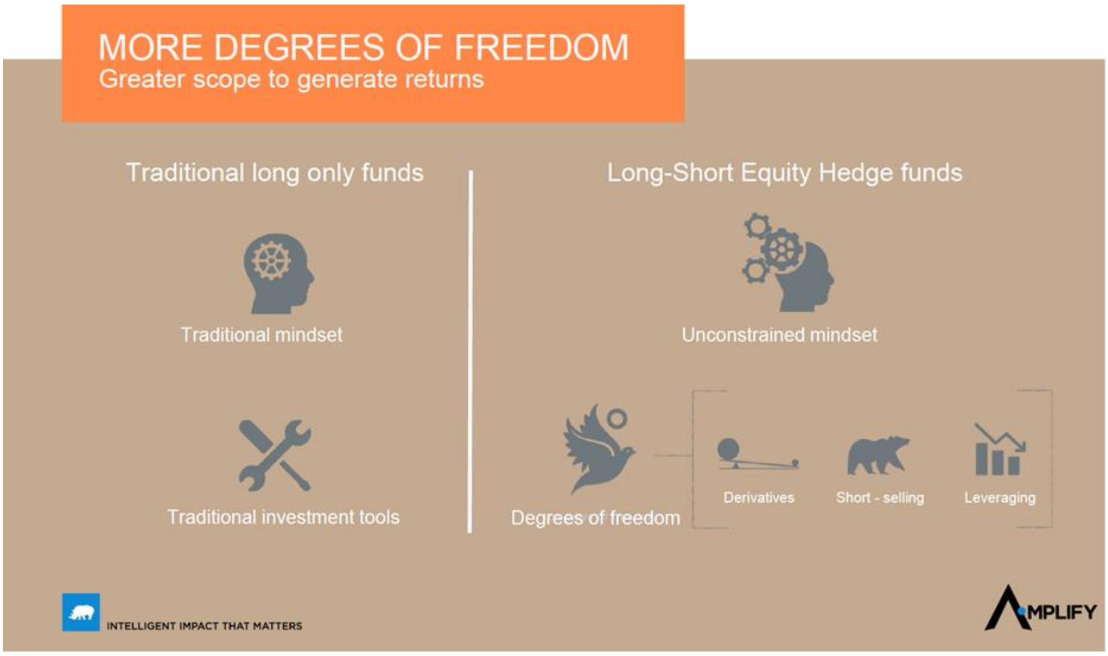
Four years is the optimal expected growth period as it ensures that the opportunities are not impacted by style factors in the market such as momentum and value. Other factors such as how good the company is at converting earnings into cash flow and whether it has to use cash flow to reinvest or pay it out to shareholders, should be considered. For example, a company like Clicks can pay out a lot of earnings in cash to shareholders, as opposed to a telecoms company, which constantly has to invest the bulk of that money back into infrastructure and to stay competitive.

Based on this estimate, and with a good idea of what the dividend is going to be, and knowing what today’s share price is, one is able to compile a ranking table which can be used to expertly allocate capital.

Another factor that should be considered is timing the market. “Experience shows that valuation-based investors sometimes buy and sell too soon. Sometimes, whatever the market is worrying about currently may not have significant consequences, but the share price continues to fall because of the reaction to the bad news. The use of momentum to buy shares once the information has turned and the same in the sell discipline, where a share price recovers and the market gets excited and it goes up more, to try get additional return. Experience in timing the market can result in 0.5% to 1% additional return over a 12-month period."

A disciplined risk process is key when searching for opportunities in the South African market. If there are risk factors that are difficult to quantify in terms of outcome for a share, these must be diligently identified and flagged, and not allocate to it as much as the valuation may suggest. "Ultimately you want to have many different positions," Du Toit says.

When investing in SA equities, be mindful that everything is relative. Looking at the current share price relative to what the share is worth, in terms of its assessment, if it is relatively cheap compared to the opportunity set, buy it. If not, one may potentially short it in a hedge fund, which is simply an equity fund with additional special opportunities, delivering that bit of extra return. "In the long run, an active equity fund manager with strong expertise should be able to get a market-plus-4% return in a traditional long-only fund while a hedge fund should deliver market plus 10% because of the additional tools and greater scope to generate returns.



Closing

Lastly, consider applying a robust ESG process to share selection. "ESG has become increasingly important, and it manifests itself in a number of ways. Determine an explicit ESG rating, and if companies come out with a poor ESG score, limit the investment amount in a particular share."

With ESG coming more to the fore, there is less capital being invested in dirty industries like coal, and companies like Sasol, or British American Tobacco, and the market is going to pay less for the cash flows that are going to come out of those businesses. But many of these businesses may still earn money.

"Due to the small size of the South African market, one can't specifically exclude certain shares but rather be very aware of ESG and actively engage with companies to discuss ways they can improve and make a positive impact. ESG is a journey, and one needs to engage with companies that maybe aren't getting things right and encourage them to improve – some of these issues can't always be solved overnight."

Glacier Research would like to thank Jonathan du Toit for his contribution to this week's *Funds on Friday*

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Jonathan began his career at Orbis and Allan Gray. He then joined Truffle Asset Management where he successfully managed the Truffle High Growth Hedge Fund, delivering annualised performance of 23% for over eight years. Jonathan left to start his own active asset management business with the vision to deliver returns that significantly exceed the client benchmark. He currently manages the Amplify SCI* Managed Equity Retail Hedge Fund and will also be taking over the management of the Amplify SCI* Equity Fund.