CLUCASGRAY AM
ASSET MANAGEMENT
A juristic representative of ClucasGray (Pty) Ltd
An Authorised Financial Services Provider, FSP 21117

ClucasGray Asset Management

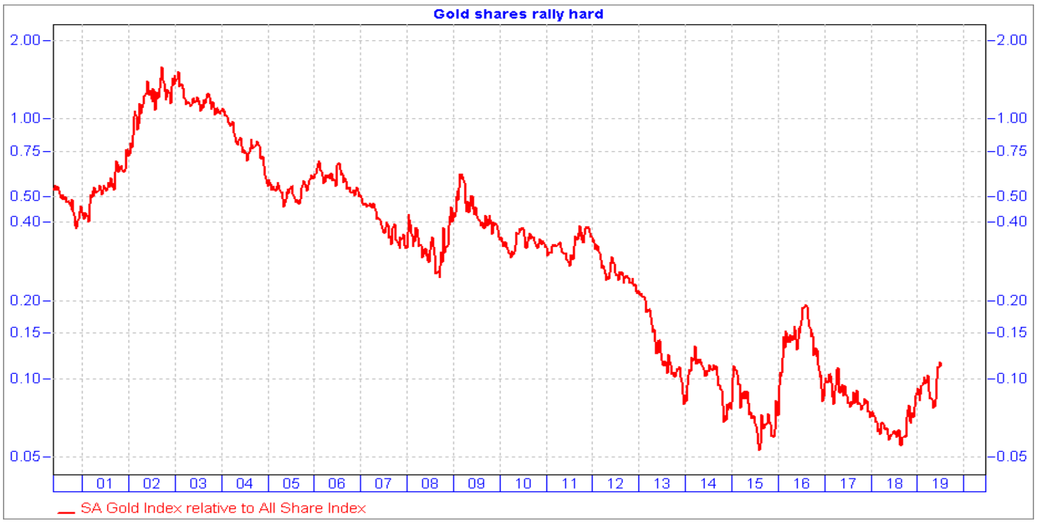
Quarterly Commentary

June 2019

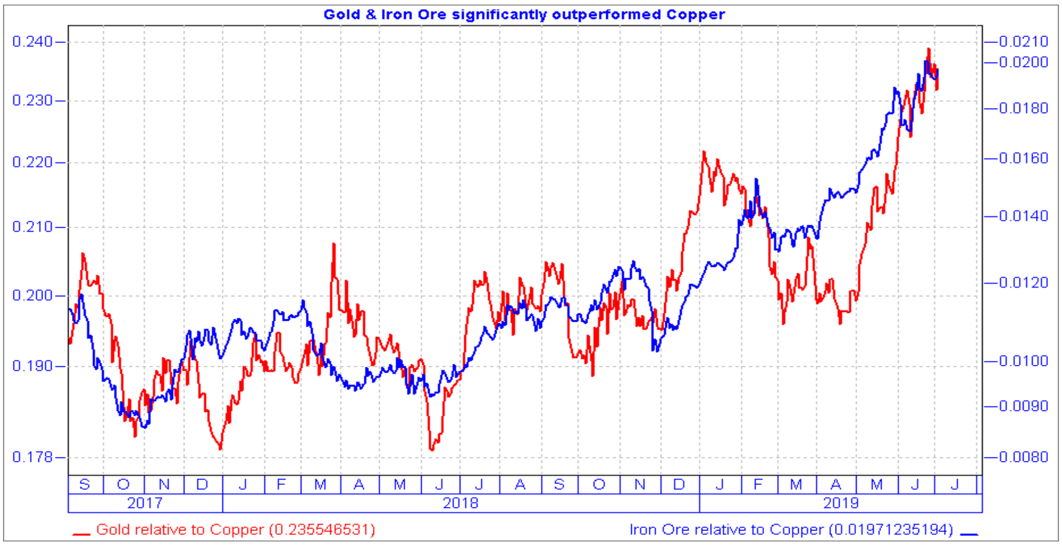
All That Glitters

"Gold and iron at the present day, as in ancient times, are the rulers of the world."
William Whewell, English Philosopher and Academic, circa 1820.

Over the last 20 years, we have witnessed a handful of genuine rallies in South African gold shares – the old adage that "markets take the stairs up and the elevators down" seems to work in reverse for gold shares. As evidenced by the chart below, relative to the All Share Index, the Gold Index has underwhelmed for decades, but in those periods when it performs, it is indeed a sight to behold – or a sight for sore eyes for those who don't own them!



Whilst Mr Whewell's quote emanates from a very different era and context, it has nonetheless relevance to the commodity markets of today. In the chart below we show the recent performance of both Gold and Iron Ore relative to Copper. As many readers would know, Gold seems to dance to its own tune, driven at times by fear and the long held perception of it being regarded as a safe haven asset. Copper and Iron Ore are more fundamentally driven – periods of stronger economic growth and demand outstripping supply typically lead to rising prices. The performance of Copper is symptomatic of the current economic environment – muted demand growth, notwithstanding what we believe is a constrained supply outlook over the medium term. Iron Ore on the other hand has risen sharply on the back of Brazilian supply disruptions following a deadly dam disaster, prompting a material scaling back of Brazilian production. Whilst the circumstances behind the supply shortages are tragic, this has proved a windfall for the large iron ore producers listed on the JSE.



More disappointingly there are a few larger companies that have endured a difficult period, most notably Sasol. Sasol's much vaunted Lake Charles project has been an unmitigated capital allocation disaster to date. Over budget and over time, they have conceded that the return on investment is going to underwhelm, and the share price reaction has been severe. Our investment thesis has been predicated on the core business being worth more than what has been reflected in the share price, providing optionality to investors when the Lake Charles project starts to contribute to earnings and cash flows. We believe that this remains the case.

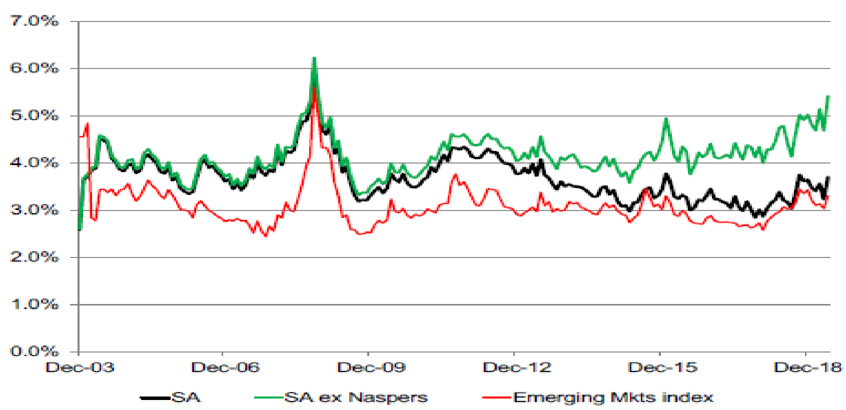
The Local Opportunity

"A pessimist is someone who complains about the noise when opportunity knocks." Oscar Wilde

As we frequently allude to, the ClucasGray Asset Management investment process strives to assess the interplay between valuation and earnings prospects of companies. An ideal investment would be a company that has the ability to grow real earnings sustainably over time, at an undemanding valuation.

RMB Morgan Stanley recently showed the forward dividend yield of the market, excluding Naspers (green line in the chart below) – we think it is a powerful illustration of just how seldom valuations have been this compelling. On the evidence of the chart, the only time this metric has been as attractive was in the midst of the global financial crisis of 2008/09.

Exhibit 7: SA vs EM 12 month forward dividend yield ratios – ex NPN, SA yields are now very high

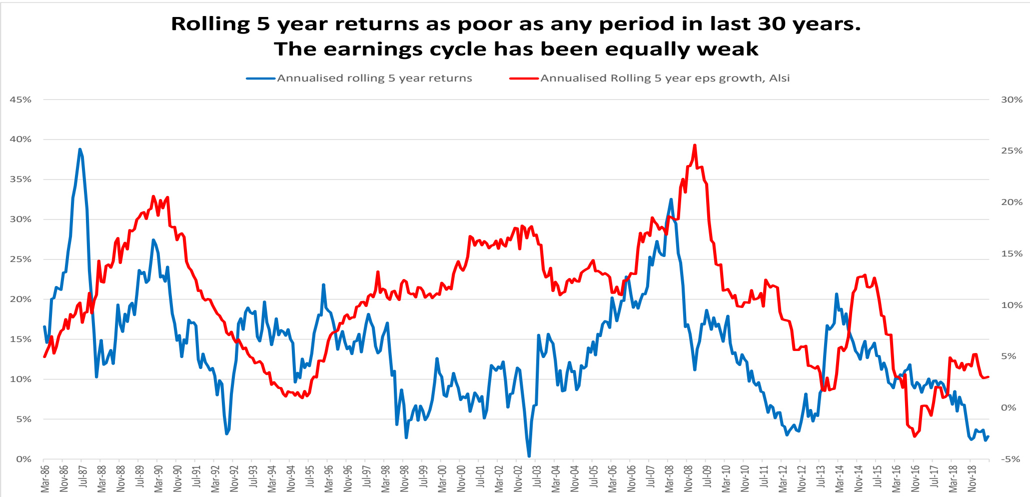


Source: IBES, Thomson Reuters, RMB Morgan Stanley Research

The large unknown in the South African economy is whether there will be any meaningful earnings growth over the next few years. Many of the issues facing investors are well documented, including but not limited to:

- uncertainty over land policies;
- restrictive interest rate policy, notwithstanding benign inflation, leading to stagnant credit growth and activity in the consumer economy;
- deteriorating property market fundamentals;
- sustained weak currency, and a crisis of confidence in business and consumers; balance sheet concerns in key SOE's, and resultant administered price increases;
- corporate failures in the private sector.

The point we often make is that the performance of the JSE, and the earnings base of many of the underlying companies have already endured a sustained period of low economic activity. The chart below not only shows how poor the rolling 5 year returns on the JSE have been, but also how weak the JSE's rolling earnings growth has been over the last 5 years.

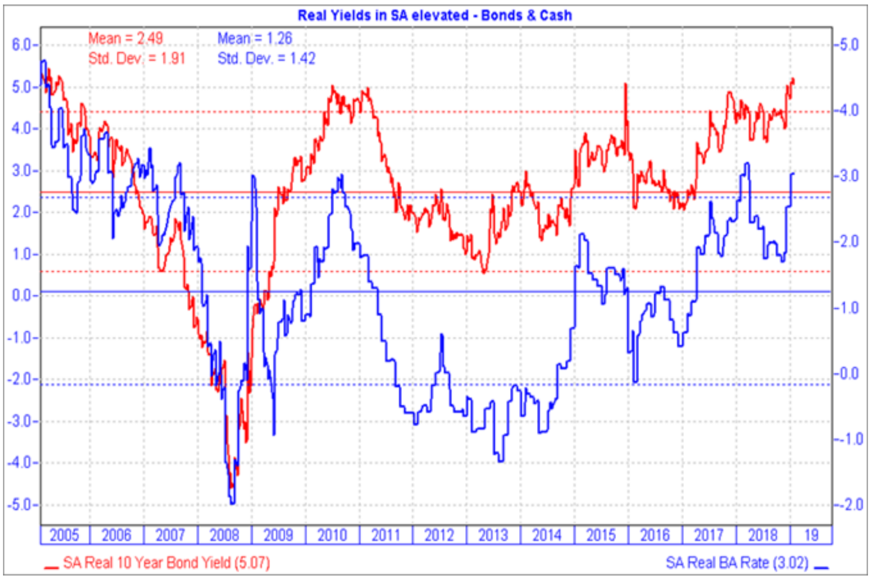


Rolling 5 year returns as poor as any period in last 30 years. The earnings cycle has been equally weak

Whilst we don't invest in an index, we find the above charts instructive – we have no insight as to whether we are indeed at trough earnings for the JSE. But what we do believe, is that the vast majority of the companies into which we have invested have in our estimates, a reasonable earnings outlook from current subdued levels. Coupled with the earlier chart on the overall (ex Naspers) dividend yields which are indicative of significant valuation support, we continue to believe that selective opportunities will deliver good returns for the patient.

Multi-Asset Investing

Market theory dictates that the greater the risk the greater the return – and equities over time would typically be the asset class most likely to deliver the higher returns. Theory can at times to at odds with reality. South African investors have for some time been blessed with high nominal and real interest rates (see the chart below for real yields) – the logic behind these is for another time and a different forum, but suffice to say that savers have enjoyed the fruits of this much more than borrowers and the consumption economy.



The significance of this is perhaps illustrated in the compound annual returns across the various collective investment scheme categories over the last 4 years to 30 June 2019:

Flexible Income	7.9%
Money Market	7.1%
Listed Property	0.4%
General Equity	2.5%
ClucasGray Equity Fund	**4.5%**
Multi Asset, High Equity	4.1%
ClucasGray Equilibrium Fund	**7.1%**

Source: FA Analytics

South African investors have for some time not been rewarded for taking undue risks, and with the high yield environment persisting, the status quo could well continue. Given the global abundance of negative yielding bonds, our elevated yields, and apparent the lack of local inflation, we would not be surprised if local bond yields were to compress further. We have continued to add to longer dated bonds in the ClucasGray Equilibrium Fund to take advantage of these yields.

However, as alluded to earlier, we see numerous compelling opportunities in local equities. Attractive starting valuations, the potential for an earnings recovery (albeit muted), and the possibility of declining bond yields (discount rates), lead us to conclude that whilst fixed income assets are indeed attractive, the real opportunity resides in local equities. As a result the exposure to SA Equity is currently as high as any point since the fund's inception in January 2015.

The Equilibrium Fund aims to deliver returns in excess of inflation and the peers over long periods of time. To date we have been able to deliver on these return objectives.

By adhering to our investment process, using the combination of dynamic asset allocation and good stock selection, we strive to continue to deliver on our investment objectives for our clients.

Conclusion

"By the time it is obvious, it is too late."

For a variety of reasons, South African equity markets have endured a difficult few years, reflective to an extent of the angst and uncertainty that seems pervasive. In some ways the biggest decision investors need to make is whether the issues facing South Africa are structural or cyclical – these are the same questions investors grappled with in the 1960's, 1980's, 1990's, early 2000's and countless other periods in our colorful history. History shows that many of these previous periods of stress were inflection points on the JSE.

None of us have any greater insights as to when the clouds of gloom lift. We believe that whilst much of South Africa's troubles are self-inflicted, it is easy to forget that the last 5 years have been a difficult period for all emerging markets, where equity returns have significantly lagged those of developed markets.

It would appear to us that numerous companies are pricing in a significant downward adjustment in earnings over the next few years, off the subdued base referred to earlier – symptomatic of a structural decline in the operating environment. This is at odds with our assessment of their prospects, and coupled with the attractive valuations alluded to earlier, we believe patience will in due course be rewarded.

If there is any interest to engage further, please don't hesitate to get in touch with us.

Kind Regards

Andrew, Grant and Nikki