CLUCASGRAY AM
ASSET MANAGEMENT

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

# ClucasGray Asset Management

## Quarterly Commentary

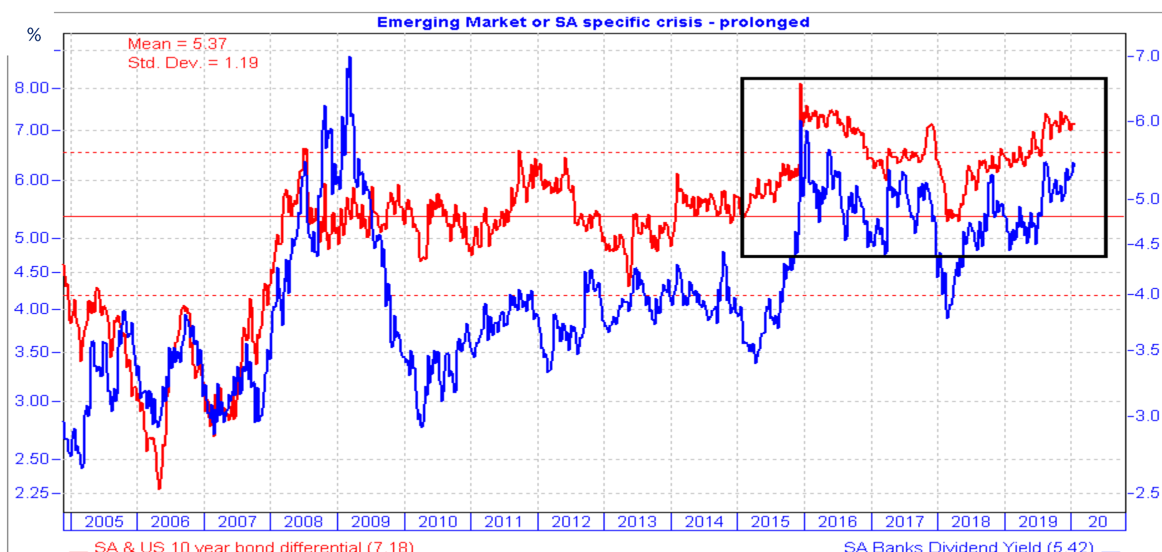
January 2020

*"These walls are funny – first you hate them, then you get used to them. Enough time passes, you get to depend on them. That's institutionalized." Shawshank Redemption*

There is seldom much good in dwelling in the past, but as with all decades, the 2010's have been particularly eventful. Who could ever forget the euphoria of the 2010 World Cup – the frenzy that welcomed Siphiwe Tshabalala's opening goal, the "continental support" behind Ghana in the quarter finals (Baghana Baghana to all South Africans), and the collective sense of national pride as the world watched, and South Africa delivered an outstanding event. Coupled with what was proving to be a strong economic recovery post the global financial crisis, South Africans could be forgiven for feeling a sense of optimism for the decade that lay ahead.

Given developments over the last few years, it would be fair to conclude that on many fronts, the initial sense of optimism may have been unfounded. There seems no point in rehashing the myriad issues that beset South Africa – suffice to say that Stage 6 load shedding may well have been an appropriate book-end to the decade!

The above quote from one of the all-time great movies is strangely relevant to our investment landscape, and interest rates in particular, over the last few years. As shown in the chart below, since the cataclysmic event of December 2015, when the peak of the emerging market crisis coincided with the firing of our Finance Minister Nene, the South African cost of capital, as evidenced by the yield differential between the SA and US 10 year bonds (red line) has been extremely elevated.




Source: Iress, January 2020

In the immediate aftermath of the spike in yields, investors **hated them** – there is little economic good that emanates from high interest rates, and consumers were about to face the wrath of the Reserve Bank who proceeded to increase interest rates twice over the following few months. The impact of this sustained and elevated cost of capital has had unfortunate consequences on the consumer economy, much of which we have discussed in numerous previous quarterlies.

Yet over time South African investors have started to get **used to** these high relative yields. Seemingly all are able to eloquently explain exactly why we need high interest rates – certainly they have proved a comforting crutch on which to lean on in periods of distress, in a way limiting the downside in the currency, and an attractive investment option for multi asset and income funds; but those minor benefits pale in comparison to the untold damage done to the consumer economy and domestic growth rates.

Bizarrely, the local investment industry is nearing the point where they may have started to **depend on** them – the ability to generate income in portfolios of around 9% without taking on equity risk in an environment where inflation is around 4% is a rarity afforded few, if any, investors around the world.

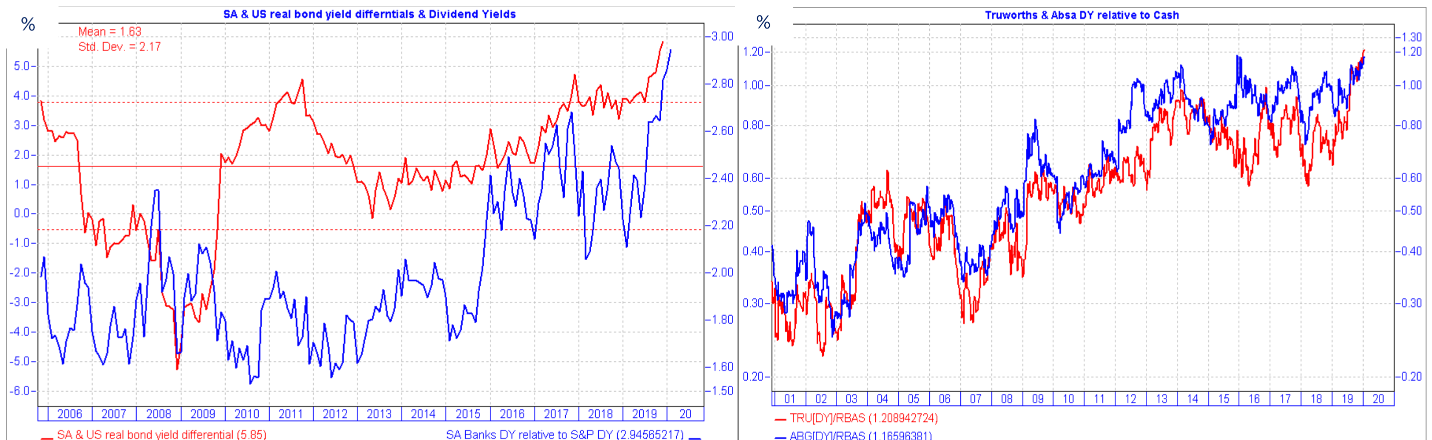
Has the nation perhaps become trapped in the prison of high interest rates and bond yields? History will be the judge of that, but one final point to make on these last four years – the chart above shows the banks dividend yields (blue line) alongside the relative yield line, as a proxy for certain domestic oriented companies. We find it instructive that in the same way bond yields have remained stubbornly elevated, bank dividend yields have remained at near record levels – we think the two are related, and any downward shift in bond yields should, in time, be mirrored by a re-rating of inexpensive equities.

***"Patience is bitter, but its fruit is sweet." Aristotle***

We acknowledge that we have been of this view for some time, and whilst it has been frustrating that in South Africa the thesis has as yet not played out, we continue to believe that when we reflect on these last few years, the timeless words of Aristotle will ring true.

It is increasingly a consensus view that South Africa will lose its final investment grade credit rating from Moody's in the next while. It is certainly an easy view to understand – growth has evaporated, debt levels and the commensurate interest burden have increased significantly, and other large rating agencies have already placed South Africa at below investment grade. We believe there are some mitigating factors in South Africa's favour, and options available to partially rectify the position we find ourselves in, but for the purposes of this discussion we won't dwell on them. To us the more interesting (and relevant) part of this discussion, is that if South Africa is indeed downgraded, what would be the investment implications thereof, and whether yields and valuations are already reflective thereof?

In the September 2019 quarterly we wrote extensively about the benefit enjoyed by savers, and the pain inflicted on consumers, of the high interest rate environment in South Africa. We alluded earlier to the elevated bond yields in South Africa relative to the US – the charts below are perhaps even more startling. Given the significant fall in SA inflation, the real yield differential between South Africa and the US has reached levels unprecedented in the last 15 years. Allied to that the dividend yield on offer in certain listed domestic companies, using the banks as a proxy here, are now three times higher than the S&P500 dividend yields (chart on the left).




Source: Iress, January 2020

Similarly, the chart on the right shows the dividend yields available on two large domestic companies, Absa and Truworths, are 20% higher than the yields on cash – 20%! Both business have their own individual issues – we happen to be invested in Absa, and not (yet?) Truworths – but to us the chart does highlight an example of the extreme valuation being presented to investors. In 20 years, select assets have not looked this aesthetically attractive. Clearly the short-term prospects for earnings growth are clouded by the economic backdrop. The interplay been ratings and earnings, at the heart of our investment process, will remain of paramount importance.

We continue to hold the view that numerous companies are inappropriately valued and expect patience to be well rewarded.

## ClucasGray Equilibrium Prescient Fund – a notable milestone

In January 2015 the ClucasGray Equilibrium Prescient Fund was launched with an objective of providing industry and inflation beating returns to investors. We are strong advocates of the benefits of balanced funds (like the ClucasGray Equilibrium Prescient Fund) to navigate through all market conditions – their ability to derive returns from a combination of security selection and tactical asset allocation has meant that over long periods of time, these funds have delivered attractive real returns.

We are pleased to announce that the ClucasGray Equilibrium Prescient Fund now has a 5 year track record. As at the 21st January 2020 (the first date we can get 5 year figures) the Fund is ranked 5th out of 124 balanced funds, and has delivered top quartile returns over 3 and 5 years – an achievement we can briefly reflect on with some pride, but we remain mindful of the need to diligently strive to continually meet our investment objectives for clients. Whilst nearly 3% real returns are pleasing in the context of the environment, we believe these funds have a proven ability to deliver real returns in excess of 5% over long periods - certainly that remains our objective.

## ClucasGray Equity Prescient Fund

The final quarter of 2019 proved to be a good one for investors in the ClucasGray Equity Prescient Fund. The Fund gained over 6% in the quarter, outperforming both the Swix and the peer group. Whilst it was indeed a pleasing end to the year, with a number of key holdings performing well, 2019 will long be remembered more for what we did not own. The performance of the Gold (+100%) and Platinum (+200%) indices defined the year, and whilst the fund has a meaningful exposure to resource companies, some of which performed well, the lack of direct exposure to either of these sectors had a bearing on relative performance. The ClucasGray Equity Prescient Fund has delivered compound returns of 11.4% per annum since its inception in October 2011, ahead of the peer group returns of 8.7%. These returns have been achieved through steadfastly adhering to our investment process, and taking advantage of opportunities when they have presented themselves.

As we have previously mentioned, a growing number of companies are offering extraordinary value, and whilst the catalyst to unlock value is always unknown, we believe that some form of corporate action is likely to be a growing theme. There is some evidence of this already, with Clover having delisted, Metrofile now the subject of a potential buy-out, and Zeder and Remgro have both benefited from decisions to drive shareholder returns.

## Conclusion

Who knows what 2020 has in store for investors – as has become the increasing norm in modern markets, the investment backdrop is likely to remain incredibly noisy, often resulting in seismic fluctuations in asset prices. As an old acquaintance once said: "Modern day news flow is the equivalent of drinking water from a fire hydrant." That was even before Twitter went mainstream – we can only imagine what he thinks of the current news cycle!

By continuing to adhere to our disciplined investment process, we aim to meet the challenges that the next decade will bring – and we strive to position portfolios to take advantage of any dislocations in asset prices. Given the opportunities that currently exist, we believe that, like the words of Aristotle above, the fruits of our patience will indeed be sweet.

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

Kind Regards

Andrew, Grant and Nikki

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