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An Authorised Financial Services Provider, FSP 21117

ClucasGray Asset Management

Quarterly Commentary

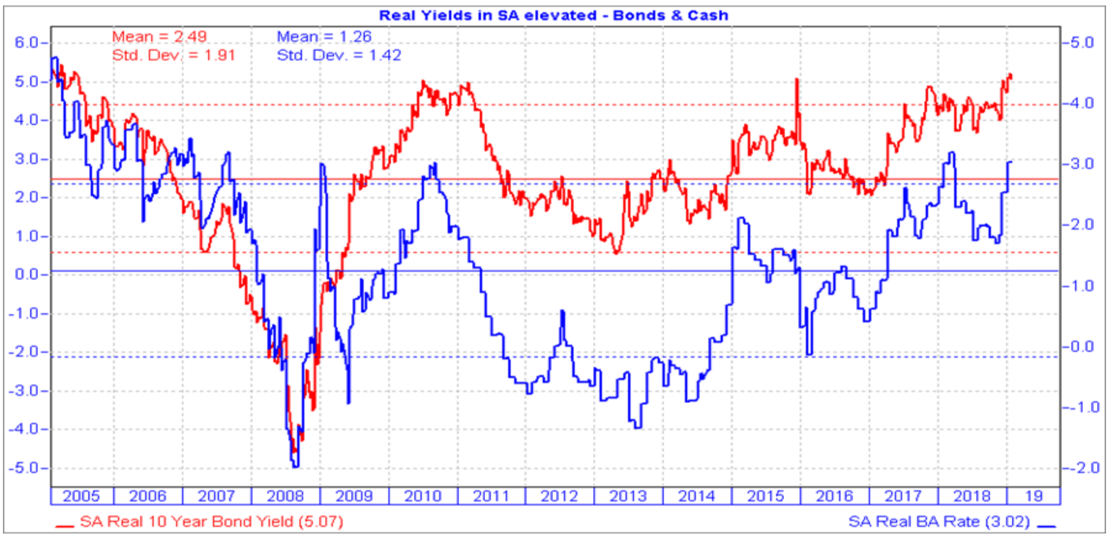
March 2019

“Everybody, sooner or later, sits down to a banquet of consequences.” Robert Louis Stevenson

The above quote, penned nearly 150 years ago, remains as relevant today as it did then. There is nothing earth shattering about it, as we all grow up learning there are invariably consequences, good and bad, for our actions. Yet somehow it seems to hold particular relevance today.

The first quarter of 2019 proved a productive one, with equity and balanced funds delivering pleasing gains, following a protracted period of underwhelming returns. However, it has not been the markets that have captured the attention of most – revelations in the State Capture enquiry have been alarming, and the unwelcome arrival of Stage 4 load shedding proved a cataclysmic blow to the nations’ collective confidence. It is not for us to speculate on the accuracy of the allegations, suffice to say that the corrupt and dishonest may enjoy the fruits of their ills for a while, but ultimately they have to face the consequences of their actions.

On matters more economic, the South African Reserve Bank has for some time eloquently articulated their views on why they believe monetary policy in South Africa remains accommodative. The reasons are well documented – elevated administered prices, volatile currencies, and structural inefficiencies in the economy which can’t be solved by lower interest rates. The reality is that these have been present for some time, and whilst inflation may be near the mid-point of their target range, the demand driven components of inflation are extremely benign. As shown in the chart below, South Africa has high real interest rates, an elevated cost of capital which is proving restrictive for corporates and consumers to operate under. The consequences of their actions are already evident in the anaemic growth rates in the consumer facing economy, poor retail sales data, and negative real consumer credit growth.



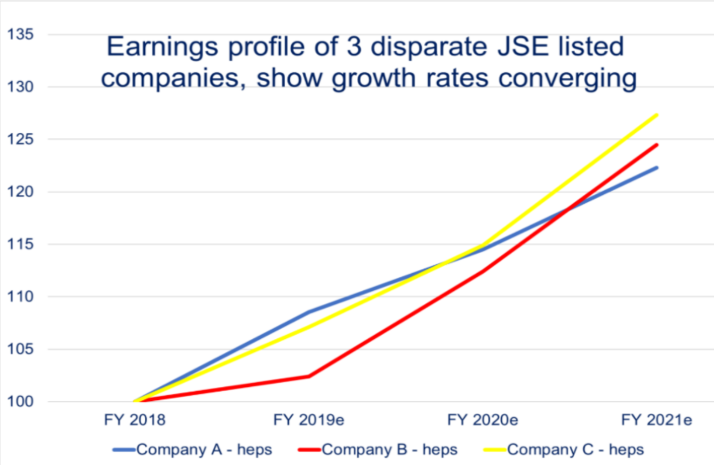
As discussed in previous quarterlies, the ClucasGray Asset Management investment process seeks to assess the interplay between the prospects for earnings growth, and the potential for a rerating of any investment. We believe that different business models deserve to trade at different ratings, so we strive to determine what we believe to be an appropriate multiple for the quality of earnings that a company produces, and the prospects for these earnings to grow. For us, the manner in which a company derives their growth is of critical importance – organic growth would typically be of a higher quality than acquisitive growth, and should be rated accordingly. South African investors are currently witnessing numerous companies, large and small alike, having to face the consequences of their recent acquisition sprees – acquisitions that for the most part were made to sustain an earnings growth rate commensurate with their rating. It is, sadly, seldom a sustainable strategy.

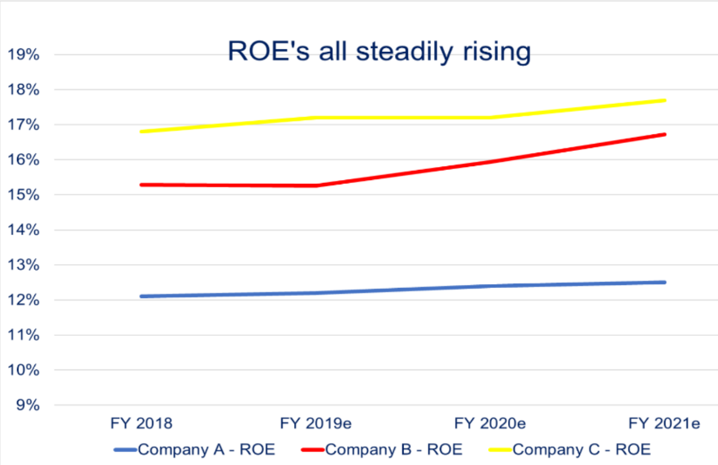
Valuations are a prerequisite for investing, not just a philosophy

It is indeed comforting to be invested in well known, high quality companies that have delivered good returns for investors over many years. However as Howard Marx often says, "Investing in what is comfortable is rarely profitable". One of the many lessons learnt over the last few years, is that shareholders in companies that are priced for perfection, with a slowing earnings profile have little place to hide. We prefer valuations to be a tailwind to investing, not a headwind.

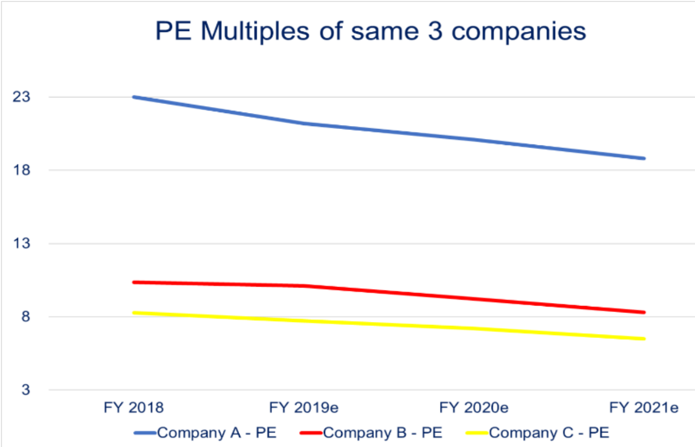
We have attempted to illustrate some of our thinking by analysing the earnings and valuations for 3 disparate companies listed on the JSE. Company A is, for good reason, a highly rated industrial company with a global presence; Company B is a locally oriented mature industrial company; Company C is a well-capitalised, large bank. Companies A and B have nothing in common, except that both have ungeared balance sheets.

As shown in the charts below, growth rates of the companies are converging over the next few years, and all have a steadily improving ROE profile. Admittedly the earnings growth rates are relatively pedestrian, ranging from 7% to 8.5% per annum for the next 3 years. Given the global presence of Company A, their cost of capital is structurally lower than the others, hence a lower ROE is to be expected – nonetheless the improving ROE profile of all is encouraging.





It is in the final chart where we believe they differentiate themselves. We certainly don't believe that low PE's are the only metric via which to make an investment decision – we acknowledge that the prospects for strong earnings growth can justify elevated multiples. However, given the convergence in earnings referred to above, we find the dislocation in ratings between these companies instructive. Company A has a forward PE to 2021 of over 18x, whereas the other 2 are below 8x.



There are many variables that go into formulating an investment case, with valuation being a key element in our final investment decision. When we look at the relative investment prospects of the three companies, we deem it unlikely that Company A can rerate from it's current elevated levels. Companies B and C will not only deliver a steady earnings profile, but have the added optionality of a potential rerating. Both Company B and C feature prominently in our portfolios.

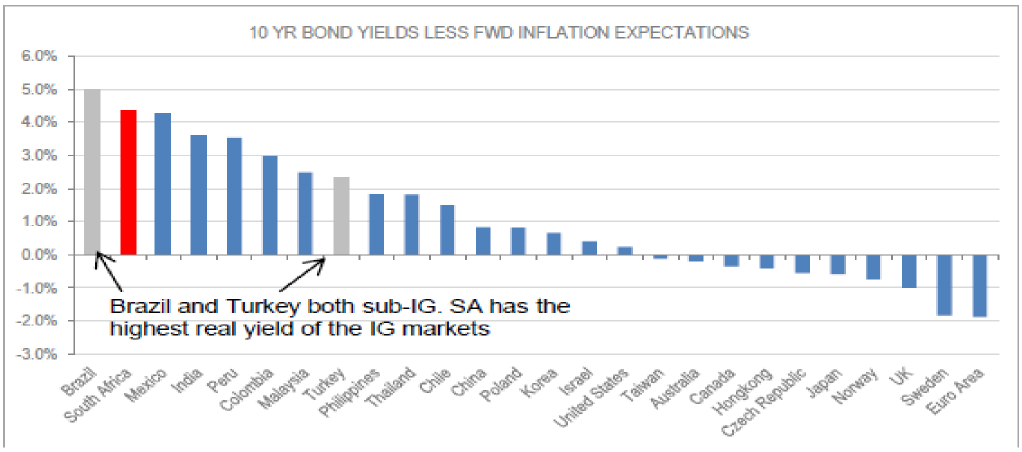
We concede that companies seldom rerate until the growth in earnings is imminent, and acknowledge that our forecasts could well be incorrect. Notwithstanding, we believe current valuations provide investors with significant comfort, and if (when) the economy recovers, patience is likely to be well rewarded.

"Sometimes the only way to stay alive is to embrace paranoia." Fictional character, Fagan, in Oliver Twist.

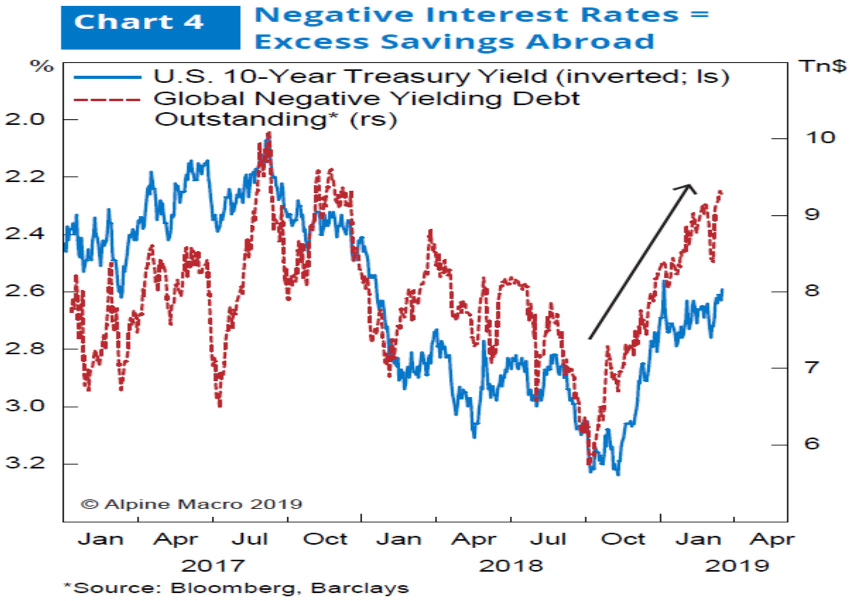
South African investors have endured much over the last 4 years – a prolonged emerging market crisis, coupled with a few political and economic issues of our own, has resulted in a sustained weak currency environment, elevated interest rates and subdued consumer activity. Unlike Fagan though, we believe at times it can be rewarding to take advantage of periods of paranoia.

We face the seemingly never-ending concerns around rating agency sovereign downgrades – we have no greater insights than others in attempting to second guess their decisions. Relative yield analysis forms an important part of our asset allocation process, and as highlighted earlier, real interest rates in South Africa are high. Investors are able to earn real yields of between 3% and 5% in cash and bond instruments – a luxury not afforded to investors in many parts of the world.

South African real bond yields are the second highest in the investable universe, as evidenced in the chart from RMB Morgan Stanley below. Brazil, the only sovereign with higher real bond yields, has a Moody's rating two notches below that of South Africa.



In addition, as the chart below highlights, the quantum of negative yielding credit instruments has risen significantly over the last 6 months – Alpine Macro estimate these to currently be in excess of $9 trillion. South African investors may have much about which to be concerned, but elevated bond yields do look attractive.



We are of the view that these yields have presented investors with an opportunity in longer duration bonds – they are symptomatic of the prolonged and sustained environment of a weak currency and elevated interest rates, under which the economy has struggled. A reduction in relative real yields could well have broader repercussions across the local investment landscape. Historically falling yields have often proved a catalyst for improving domestic earnings and a rerating of select equities.

ClucasGray Equity Fund

2019 is off to a good start for equity investors, both globally and on the JSE. The ClucasGray Equity Fund is up 5.7% in the first quarter, compared to the JSE Swix which gained 6%. Over the last 3 years, the fund has gained 6.9% per annum, which compares favourably to both the Swix (+3.7%) and the peers (+2.0%).

The quarter proved an interesting one in that the market was driven by strong returns from resource companies, and the large global industrial companies listed on the JSE. Performance was assisted by the likes of Exxaro, Anglos, Clover, British American Tobacco and Naspers – all of which returned over 15% in the quarter and are material holdings in the fund. Clover has featured prominently in the fund for some time - it is the subject of a buy-out offer from a foreign led consortium and has increased more than 50% over the last six months.

It was a disappointing quarter for financials and retailers – it seems December retail trading was particularly poor, and whilst there were early signs of an improvement in January, the onset of stage 4 load shedding and the fears around its impact on economic growth, saw a number of domestic companies sell off materially. We have taken advantage of divergent movements in the equity market, and positioned the portfolio in companies we believe to be attractively valued relative to our estimates of their earnings prospects.

ClucasGray Equilibrium Fund

The ClucasGray Equilibrium Fund returned 5.5% for the first quarter – a pleasing start to the year. Returns were broad based, with global and local equity markets delivering strong returns, coupled with good returns from longer dated bonds to which the portfolio has been increasingly exposed. Over the last 3 years, the fund has gained 6.9% per annum, ahead of inflation of 4.5%, and the peer group returns of 3.3%.

Over the course of the last year we have been systematically increasing the overall equity weightings within the fund. Our conviction in the opportunity set currently being presented in South Africa, has meant that the portfolio's weighting to both local equity and longer duration bonds is currently the highest since the inception of the fund. We are by no mean oblivious to the ever present risks that South African investors face, but believe many assets are pricing in an outcome to various pending events that is excessively negative. We will continue to use the combination of asset allocation and security selection to strive to deliver on our investment objectives of industry leading real returns for our investors.

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

Kind Regards

Andrew, Grant and Nikki