Sanlam

Investment Management
Unconstrained Capital Partners

cognitio

study | inquire | investigate

Q3 2011

Rational thinking. Smarter investing

contents

introduction

It's easy to become frustrated or impatient with the volatility of the current equity markets - even to the point where you want to capitulate and give up on your equity investments. Adding to this frustration is undoubtedly the fear that we may go through another period of equity returns like we saw in 2008.

With emotions running high and the huge uncertainty in global equity markets, in this second edition of Cognitio, we discuss why this is unlikely to be a repeat of 2008 and our thoughts on the impact that range-bound markets could have on your equity returns.

The article entitled "Are we doomed by range-bound markets?" explores the different periods that make up a stock market cycle and interestingly we tend to spend more time in range-bound markets than we do in bull or bear markets. The news is not all bad, and we identify how we apply our investment approach to maximising the different sources of return that come from investing in equities.

With a significant slowdown in global growth expectations, we have been asked by many of our clients if this is a soft patch for growth or more like quick sand. The honest truth is we don't know. We have, however, previously stated that we are likely to remain in a below-trend growth environment for longer than we would like. In this period, and especially following a balance sheet financial crisis, companies with above-average growth are few and far between.

Our investment approach is focussed on looking for companies whose share prices do not reflect their future profit potential. This could either be because the company has been negatively impacted by the economic cycle and will return to normal profits as the business cycle improves or the business has a sustainable competitive advantage that should translate into growing demand for their products at good returns for shareholders.

introduction

The danger in current times of uncertainty is that if everyone shifts their capital to companies that are perceived as safe havens and, in so doing, drive the prices of these companies to levels well above fair value.

Our article, “The risk of overpaying for growth”, discusses the importance of not getting caught in the trap of overpaying for growth in companies that may be the flavour of the month. Our valuation-oriented approach will generally imply that we are contrarian. We are not invested in the current flavour of the month as we believe this will translate into sub-par returns over the longer term.

Finally, we would like to welcome Francois Krüger to the SIM Unconstrained Capital Partners team. He will be joining us officially on 1 November 2011 and will be responsible for operations and most importantly looking after you, our clients.

Recommended reading

We have often been asked for interesting books which we would be happy to recommend to our clients. The Age of Deleveraging, Investment Strategies for a Decade of Slow Growth by A Gary Shilling is a sobering review of the impact the global financial crisis could have on economic growth and investment returns. Shilling is an investment advisor and author of a newsletter Insight. He is well known for his deflationist views and his forecasting record. He has published several books and writes frequently for Forbes, Wall Street Journal and New York Times. Once you get over the author’s self-congratulatory testimony of his previous predictions, there are some key insights worth putting in your pipe and smoking.

"The more things change, the more they stay the same[1]" - this is not a repeat of 2008.

The pace of global earnings downgrades has accelerated. This has resulted in continued strong performance from companies with an element of defensiveness in their business vs. cyclical sectors that are plagued by short-term earnings uncertainty.

This reactive behaviour has been driven largely by a plateful of new risks that have emerged and resulted in a drift towards quality. However, this is not a new financial crisis, despite the fact that commentators have called this a crisis of confidence. We are simply dealing with the consequences of decisions taken in response to the 2008 crisis. Two years ago, in our quarter three 2009 commentary, we highlighted some key risks for investors. These are repeated below:

1. *The global economy sinks into recession following the inventory recovery, resulting in earnings dropping below normalised levels.*

2. *Excess liquidity (high cash levels) continues to drive equity levels well above fundamental valuations. This could take some time to manifest - possibly as the next bubble.*

3. *A squeeze in commodity prices due to severe constraints on supply. Many new projects were cancelled or put on hold due to lack of funding and lower commodity prices, which made these projects unviable. Continued strong growth from BRIC economies could result in commodity prices overshooting fundamentals. Speculators have already acted, as evident in the high levels of investment into exchange traded funds (ETF). Investments in Platinum ETF's are already back at their previous highs.*

4. *The long-term impact of US government expenditure exceeding receipts by 185% is one of the better understood risks, which could have many outcomes. However, dollar weakness would be one of the more significant threats coming out of this eventuality.*

The point needs to be stressed: the events we have experienced in 2011 are a direct result of politician's response to the original crisis. The market has underestimated the knock on effect of these risks. Most notably, the impact of austerity measures in Europe and the US on growth have dominated the one-off negative impacts in the first half of 2011 and will likely continue to do so for the foreseeable future.

If the US were a company, it would be trading at a big discount!

The downgrade in the US debt rating by Standard and Poor sent shock waves (albeit short lived) through global financial markets. The rating agency took enormous flack for their decision, but if you analyse the financial statements of America as you would a company, you would require an enormous margin of safety before investing. Here is an extract I came across from a study done by Mary Meeker entitled "USA Inc.: America's Financial Statements.

- Revenue of $2.2 trillion vs. expenditure of $3.5trillion (of which $2 trillion relates to social security, Medicare and unemployment insurance)
- US balance sheet net asset value: -$44 trillion

Clearly the inability of politicians to agree on the correct measures to address the imbalances above will leave a dark cloud of uncertainty for some time and the risk of potential "Japanisation" of the developed world.[2]

[1] A proverb making the observation that turbulent changes do not affect reality on a deeper level other than to cement the status quo
[2] i.e. deflation, zero interest rates, ageing population, low growth rates, rising debt to GDP

Local has been lekker!

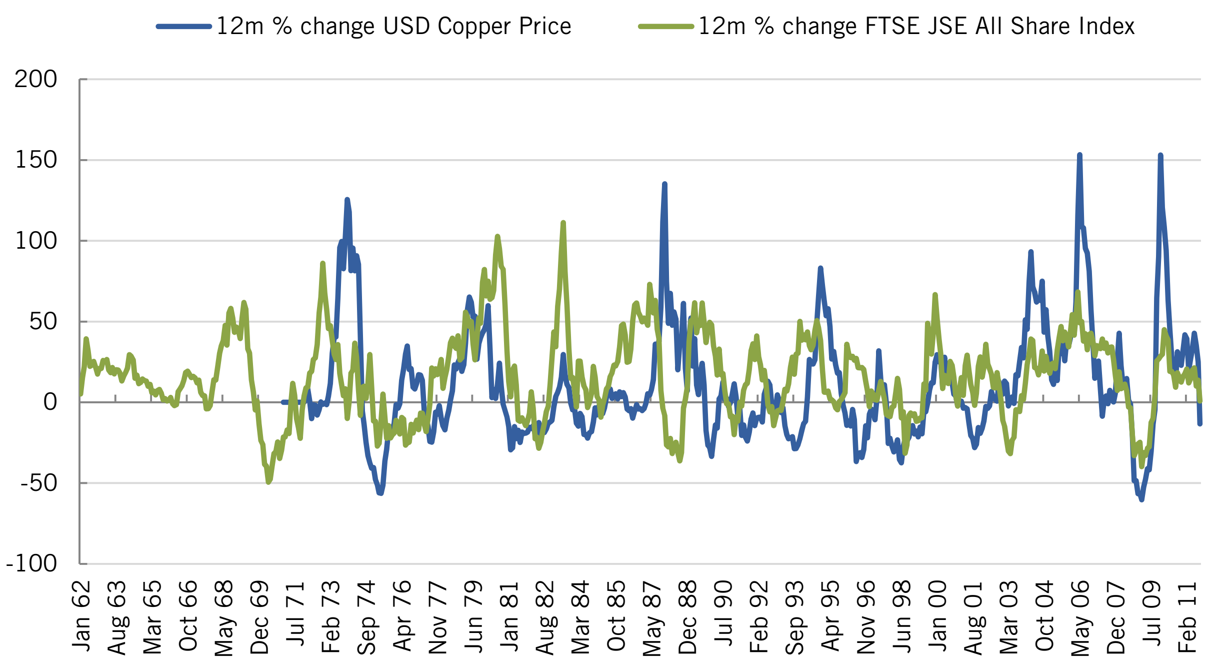
SA has not been able to completely escape the global impact of the slowdown. The latest GDP numbers highlight that the primary and secondary sectors of our economy are in fact shrinking by 5% (second quarter 2011). Overall GDP growth in SA has slowed from 4.5% in the first quarter to 1.3%. This will have an impact on reported results of companies exposed to these sectors, in particular mining, manufacturing and agriculture.

Year-to-date, the FTSE/JSE All Share Index has declined by 5.8% (total return). However, with the rand/dollar exchange rate having weakened by 17%, much of the out performance of the SA market versus global equity markets is due to rand weakness. In dollar terms, the level of the FTSE/JSE All Share Index is now below the peak we saw in 2007 – that's zero returns from SA equities in dollar terms over four years.

Companies whose profits are leveraged to the rand substantially outperformed the rest of the market. In particular gold stocks were up 20% in the quarter – since the start of the global financial crisis, however, investing in SA gold shares would have been a poor decision, with the sector underperforming total equity returns by 12%.

The FTSE/JSE Resource Index declined by 9% during the quarter and was negatively impacted by a sharp decline in commodity prices. We have been concerned about the unsustainably high level of commodity prices in the shorter term. Following a rapid rise in commodity prices that came to an end in February this year, we have now seen dramatic sell off (copper is off 26% from its peak).

Chart 1: Dr. Copper



Source: SIM Unconstrained Capital Partners

Industrial stocks performed in line with the overall market, with the already expensive retail sector continuing to outperform. We do not see much value in this sector currently.

Stocks in the financial sector fell less than the overall market. Earnings in this sector are already depressed and barring any "fat tail" events should continue to see an improvement, albeit slowly.

"The future ain't what it used to be", Yogi Bera

As we have recently seen, and something that is consistent with the past, people are not only averse to the risk of bad outcomes, but also to the uncertainty about the degree of risk itself[3]. People do the things everyone else is doing even though they know it may be wrong.

The contrarian investor should now be looking at equities (as opposed to bonds and cash). Within equities, one should focus on companies that others have avoided. These stocks are likely to deliver returns in the future that are ahead of those that may be the current flavour of the day. Sectors that we believe are currently the flavour of the day are gold, retail, luxury goods and staple food companies whose prices are trading at a significant premium due to the flight of capital towards defensive companies that have short-term growth certainty[4].

We are in the midst of a balance sheet recession that could potentially lead to many years of below-average growth from the developed world. In this period, it is important to identify companies that are generating profits well below their potential and to ensure you do not overpay for future growth.

We have continued to invest in companies where the defensiveness actually comes from the margin of safety and not just the short-term predictability of earnings. In the short term, these companies continue to trade at a large discount to their fair value due to heightened macroeconomic and short-term earnings uncertainty.

Despite all the near term uncertainty, we continue to focus on current valuations and potential opportunities. With the exception of the 2008 market collapse, the PE multiple of 12.5x is now back at the same level we last saw in 2003 and well below the average over the last 20 years of 14.5x.

Of course we don't know if markets will quickly recover. The major risk now is that markets remain cheap and below long-term averages for a while[5].

We have seen some significant opportunities emerging in the recent sell off of assets that face greater short-term uncertainty. These opportunities require one to act not with the heard, but based on underlying facts. There's little to be gained from making decisions based on the environment today. In addition to identifying mispriced opportunities, we pay careful attention to the environment in which a company is likely to be operating in three to four years' time.

[3] Daniel Ellsberg, known for the release of the Pentagon Papers on the US government decision making regarding the Vietnam War.
[4] Refer article in this edition of Cognitio, entitled "The risk of overpaying for growth"
[5] Refer article in this edition of Cognitio entitled, "Are we doomed by range bound markets".

The relevance of margin of safety and value: Why it is so important not to overpay for a company

Introduction

Our clients are well aware of the importance and emphasis we place on valuation and why it is important not to risk overpaying for an investment in any company. This article attempts to put the risk of overpaying into perspective by using the Constant Growth Gordon Dividend Discount Model (DDM)[1] to assess the long-term growth (g) and Return on Equity (ROE) that is required by a company in order to justify the price or value that you pay (the value in this case is determined by the price-to-earnings multiple (PE ratio) that you've paid for the company). We will reference a few practical examples in this analysis by using an example of a stock that we own (Lewis) and one that we don't own (Truworths).

Understanding the "theory" behind the analysis

The Constant Growth Gordon model

By using the constant growth Gordon model formula (referenced in the footnote below), you're able to back out an enormous amount of information that is implicit in the "price that you're willing to pay" for a company. In the analysis, we back out the implied long-term growth (annual growth in dividends expected to justify the price you've paid), discount rates (this is the annual rate of return that you would expect from your investment to justify owning it), PE ratios, and implied Return on Equity (a measure of the profitability of the company) to justify the price you're paying. Table 1 puts this into perspective:

Table 1: The Constant Growth Gordon model: Illustrative table

Long term growth (g)	Discount rate	PE ratio	Required relative growth factor*	Payout ratio	Implied ROE
3%	14%	4.2	-62.5%	45%	5%
4%	14%	4.7	-50.0%	45%	7%
5%	14%	5.3	-37.5%	45%	9%
6%	14%	6.0	-25.0%	45%	11%
7%	14%	6.9	-12.5%	45%	13%
8%	14%	8.1	0.0%	45%	15%
9%	14%	9.8	12.5%	45%	16%
10%	14%	12.4	25.0%	45%	18%
11%	14%	16.7	37.5%	45%	20%
12%	14%	25.2	50.0%	45%	22%

* Relative growth in dividends

Note: Long term growth (g) is the expected growth rate in dividends, Payout Ratio is the % of a company's earnings that is paid out as dividends.

Source: SIM Unconstrained Capital Partners

---

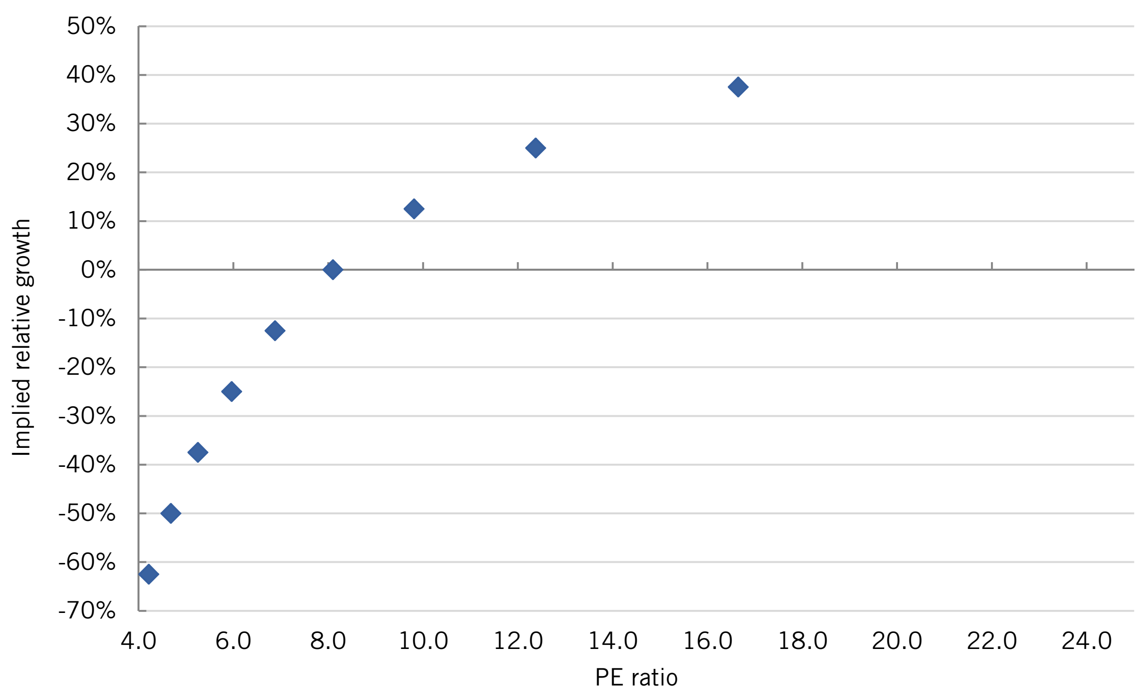
[1] Constant Gordon Growth DDM model: P = [d*(1+g)]/ (k-g) where P = price of a stock, d = current dividend, g = long term growth, k = discount rate (required return).

Table 1 highlights the required long-term growth in dividends and ROE that justifies the PE ratio. By referencing the highlighted row, for example, if you pay an 8 times PE ratio, assuming a 14% required return and a dividend payout ratio of 45%, the company needs to grow its dividends at an annualised rate of 8% (in nominal terms) a year into perpetuity and generate an ROE of 15% to justify its current price (valuation). Assuming inflation of 5.5% and real growth of 2.5%, this is reasonable.

On the other hand, if you were willing to pay a 16.7 times PE ratio for a company, this would imply that the business would need to grow its dividends at an annualised rate of 11% (in nominal terms) a year into perpetuity and generate a ROE of 20% to justify its current PE ratio. This implies that a 16.7 times PE ratio company needs to grow at a rate of 37.5% faster (annually into perpetuity) relative to an 8 times PE ratio company to justify its relative valuation (PE ratio). The margin of safety in this case is marginal (at best) for the 16.7 times PE ratio business, but very high for the 8 times PE ratio company. To look at it differently, if you assume inflation of 5.5%, it implies that the business would have to grow at a ***real*** rate of 5.5% ***annually*** to justify the price you've paid!

To look at this graphically, refer to chart 1 that highlights the relative annual growth rate in dividends required (y-axis) to justify the PE ratio that you pay (the relative growth rate is referenced relative to a PE ratio of 8 times). This simply means that a low PE ratio company needs to grow its dividends at a rate much lower than a high PE ratio company in order to justify its current valuation; hence it will have a larger margin of safety and a lower probability of disappointment. In the event of disappointment, the "risk" of potential loss of capital is lower.

Chart 1: PE ratio vs implied relative dividend growth factor

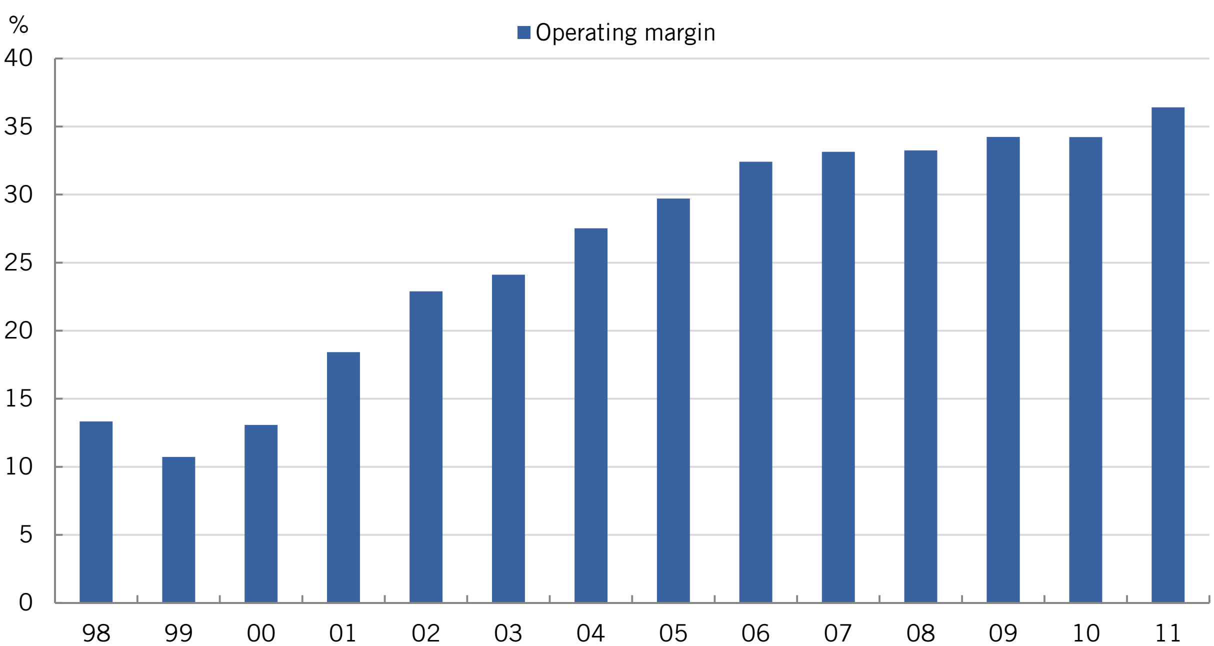


Source: SIM Unconstrained Capital Partners

In summary, the cheaper the company, the higher the margin of safety and the less you need to rely on this "promise of future growth" that often does not transpire when you invest in overvalued companies. There are, obviously exceptions. These are generally companies that are still in the early stages of a high growth phase (like MTN was five to ten years ago). In addition, there may be companies that are trading on high multiples today because their earnings are on a highly depressed base, so when earnings "normalise", the rating (i.e. PE multiple) looks more attractive. This is generally the case for more cyclical businesses (e.g. resource companies).

In order to demonstrate this practically, let's consider two companies: Lewis and Truworths. Lewis[2] is a conservatively managed business with reasonable ROE's that is cheap (its PE ratio is 9.5 times and its dividend yield is 5%). Truworths[3], on the other hand, is expensive and is trading on a PE ratio of 16.5 times and a dividend yield of 3.5%. Using the constant growth Gordon Model, this implies that Truworths needs to grow its dividends at an annual rate of 22% a year faster than Lewis to justify the difference in the valuation. There is little margin of safety in the Truworths valuation relative to Lewis. This is especially evident when you consider that Truworths margins and returns are significantly above "normalised" (sustainable) levels. This can be referenced in chart 2 showing how the group's margins have grown rapidly over the past number of years making it one of the most profitable retailers in the world (earnings before interest and tax (EBIT) margins have more than doubled to 37%). We believe that the risks are now to the downside!

Chart 2: Truworths operating margin

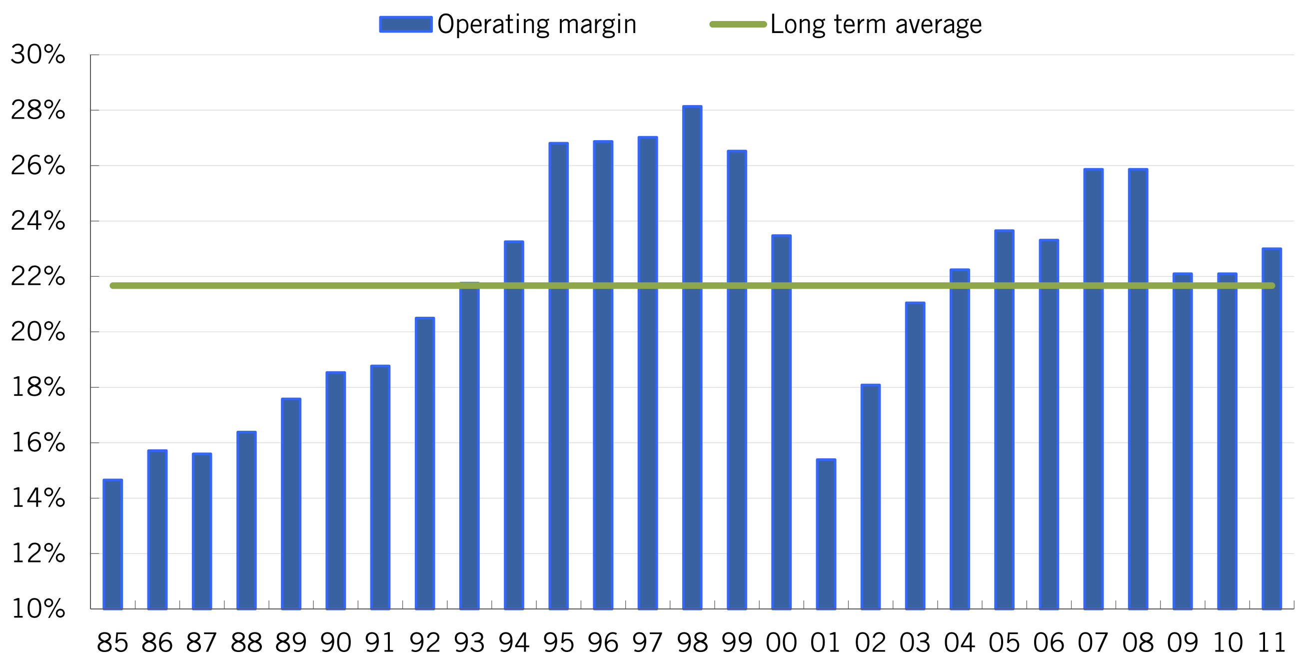


Source: Deutsche Bank

[2] Lewis share price at 7300 cps (27th September 2011)
[3] Truworths share price at 7148 cps (27th September 2011)

In contrast, Lewis has had fairly stable margins and ROE's over time. It is neither at peak levels, nor at depressed levels – in fact it is close to its long-term average (refer to chart 3 below):

Chart 3: Lewis operating margin



Source: SIM Unconstrained Capital Partners

In conclusion, the risk when buying expensive companies (like Truworths), especially when margins and returns are at peak levels, is that the margin of safety is non-existent. The risk of a loss of capital over time is significantly greater than when you buy cheap companies (with a high margin of safety) that are well managed (like Lewis). We're not saying that Truworths is a poor company. To the contrary, it is an exceptionally well managed retailer. However, even a ***great business*** can be a ***poor investment*** if the price that you pay is not fair!

are we doomed by range-bound markets?

"Fasten your seatbelts and lower your expectations"

That certainly seems to be top of mind for many of our clients currently. At an annualised 4%, returns from equities since the peak in 2008 have been disappointing to say the very least - and a far cry from the compounded annual returns over the previous seven years of over 20% a year.

Range-bound markets typically follow periods of above average returns and generally whittle away at investors return expectations and patience levels over time.

The following is an appraisal of the lessons we can learn from previous periods during which equity returns remained "range bound". Specifically we unpack the potential sources of return that come from investing in equities and how these differ through secular bull, bear and range- bound markets.

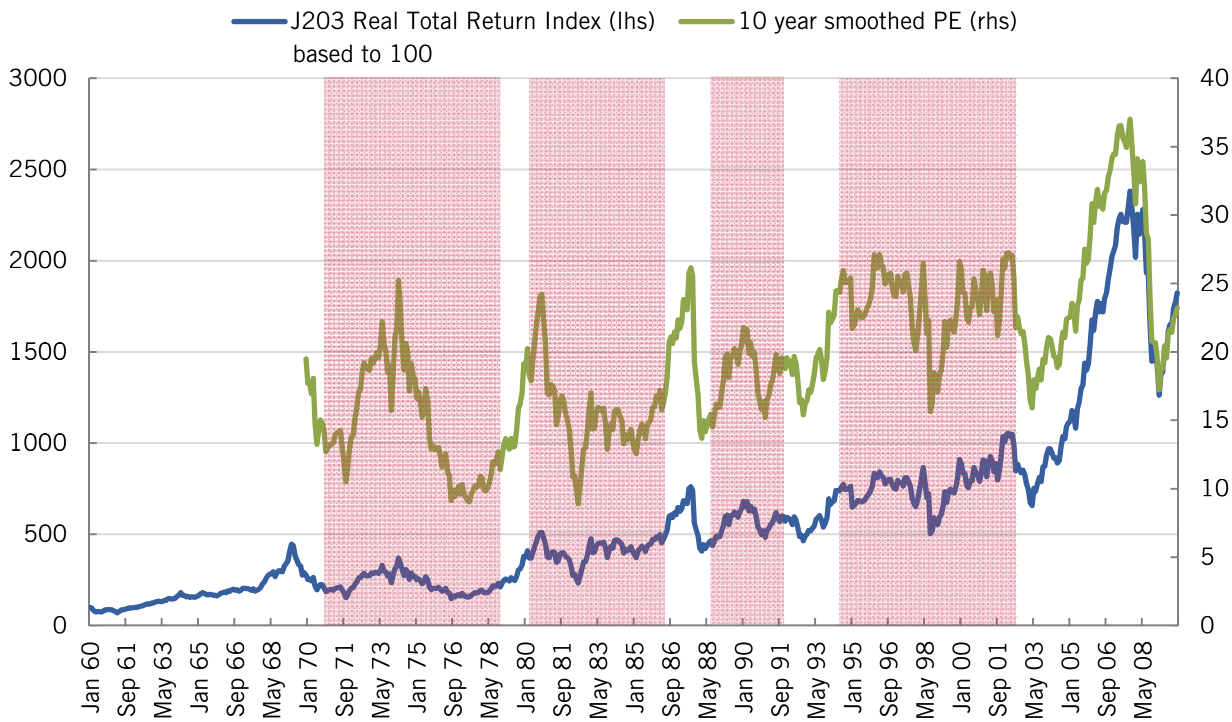
Investing in equities has given clients the best opportunity for meeting their retirement objectives in the long term. Over the past 60 years, equities have delivered returns of 5 to 6% above inflation. But it's important to remember it has not all been plain sailing though, with many periods during which equity returns were disappointing. It is important to understand that equity returns come with a significant amount of volatility and long periods when returns are below average. That is how averages are created.

What are range-bound markets?

In his book "Active Value Investing", Mr Katsenelson describes range-bound markets as periods during which price-to-earnings (PE) multiples contract. We touched on this in our fourth Quarter 2009 report when we described the four periods that make up the stock market cycle. The period we currently find ourselves in is characterised by corporate earnings catching up to the higher price expectations that took hold during the "hope" phase of the market. We warned that returns during this "earnings recovery phase" have traditionally been more muted.

Range-bound markets typically follow strong bull markets. They are different to bear markets during which both earnings and the PE ratio tend to contract. Chart 1 illustrates the four periods over the past 50 years that can be classified as range bound. During this period, the average return was in line with inflation. The average rangebound market lasted for 73 months versus only 43 months for a bull market and a much shorter 18 months for a bear market.

Chart 1: Range-bound markets



Source: SIM Unconstrained Capital Partners

Range-bound markets can include periods of rising and falling prices but over a long period of time prices in real terms generally don't change much. Simply put, a period of above-average returns will be followed by a period of below-average returns as range-bound markets erode the returns of bull markets[1].

As Mr Katsenelson points out, range-bound markets can feel like Chinese water torture. Investors may lose interest (much as we have seen recently) and seek better returns elsewhere. During a range-bound market, every attempt to establish a long lasting or definitive direction fails (Does this feel familiar?).

The good news is that during range-bound markets, equity returns still keep up with inflation (just!) and the difference in returns compared with other asset classes is not nearly as significant as in bull and bear markets. The difference in returns between equity and bonds is biggest in bull and bear markets with very little to choose between the two asset classes in range-bound markets (refer table 1).

[1]After enjoying strong returns in the USA of above 15% per annum in the 90's, returns in the latest decade were zero.

Table 1: Bull, Bear and Range Bound

	Months		Growth (a)	PE (b)	Dividend (c)	Total Return*	Less: inflation	Real return	ALBI (nominal)
		Bull							
	95	May ‘61 – Apr ‘69	4.9%	18.3%	4.9%	28.1%	2.4%	25.6%	4.8%
	28	Jun ’78 – Oct ‘80	43.7%	22.3%	4.9%	70.9%	15.0%	55.9%	6.8%
	15	Jun ’86 – Sep ‘87	18.1%	40.8%	2.3%	61.2%	16.9%	44.3%	23.8%
	24	Nov ’92 – Nov ‘94	9.6%	24.6%	1.3%	35.6%	9.5%	26.1%	9.4%
	54	May ’03 – Nov ‘07	20.6%	11.8%	1.1%	33.6%	4.3%	29.3%	9.5%
Average	43.2		19.4%	23.6%	2.9%	45.9%	9.6%	36.3%	10.9%
			39.3%						
		Bear							
	30	May ’69 – Nov ‘71	2.9%	-31.9%	2.1%	-26.8%	6.6%	-33.5%	-1.0%
	10	Oct ’87 – Aug ‘88	20.4%	-38.7%	1.6%	-16.8%	11.6%	-28.4%	9.2%
	14	Dec ’07 – Feb ‘09	10.9%	-42.9%	0.7%	-31.3%	9.5%	-40.8%	9.3%
Average	18		11.4%	-37.8%	1.5%	-25.0%	9.2%	-34.2%	5.8%
		Range Bound							
	77	Dec ’71 – May ‘78	16.6%	-9.8%	3.8%	10.6%	10.8%	-0.2%	6.6%
	66	Nov ’80 – May ‘86	8.2%	3.0%	3.1%	14.3%	14.4%	-0.1%	11.1%
	49	Sep ’88 – Oct ‘92	5.0%	7.7%	1.5%	14.3%	14.2%	0.0%	20.1%
	100	Dec ’94 – Apr ‘03	14.3%	-9.9%	0.9%	5.2%	7.1%	-1.9%	19.1%
Average	73		11.0%	-2.2%	2.3%	11.1%	11.6%	-0.5%	14.2%

* (a) + (b) + (c)
The total return for FTSE JSE All Share Index is made up from the return from growth in earnings (a), change in PE ratio (b) and dividend yield (c).

Source: I-Net; SIM Unconstrained Capital Partners

An important point to note is that the source of returns differs dramatically during these different phases of the stock market. In a bull market, the expansion in the PE multiple and growth in profits contribute equally to total returns, with dividends making up a very small portion of the return. In range-bound markets, the dividends are the biggest contributor to total returns. Thus good stock selection is important in range-bound markets.

Our investment philosophy is premised on ensuring the return from each investment opportunity adequately rewards our clients for its associated risk. This is best understood by considering the potential sources of returns that come from investing in equities (refer table 1).

The anatomy of company returns

Starting valuation

The return from an investment is a function of the price you pay (relative to earnings) and a company's long-term average return on invested capital (ROIC), which impacts directly on the decision to either pay more dividends or reinvest for future growth in profits. Over the long term, however, it is the ROIC that matters most. The rising and falling PE multiple during different market cycles ends up having a very small impact on total returns over time. This matters a lot, especially when the PE multiple of the market is neither very high nor very low (as it is now). Expanding PE is a finite source of total equity returns and, while at times this produces the best returns, changes in the PE as a source of return cannot be considered in isolation.

As we have shared with our clients previously, the level of the PE when you invest only matters to future returns when the market or the share price is at extremes. In bull and bear markets it is the change in PE multiple that has the biggest impact on returns. Specifically in bear markets, the contraction in the PE multiple is accountable for more than the overall decline in total returns.
Current examples of stocks in our client's portfolio that have a current starting valuation that is significantly in investors' favour include Anglo American, Old Mutual and Investec.

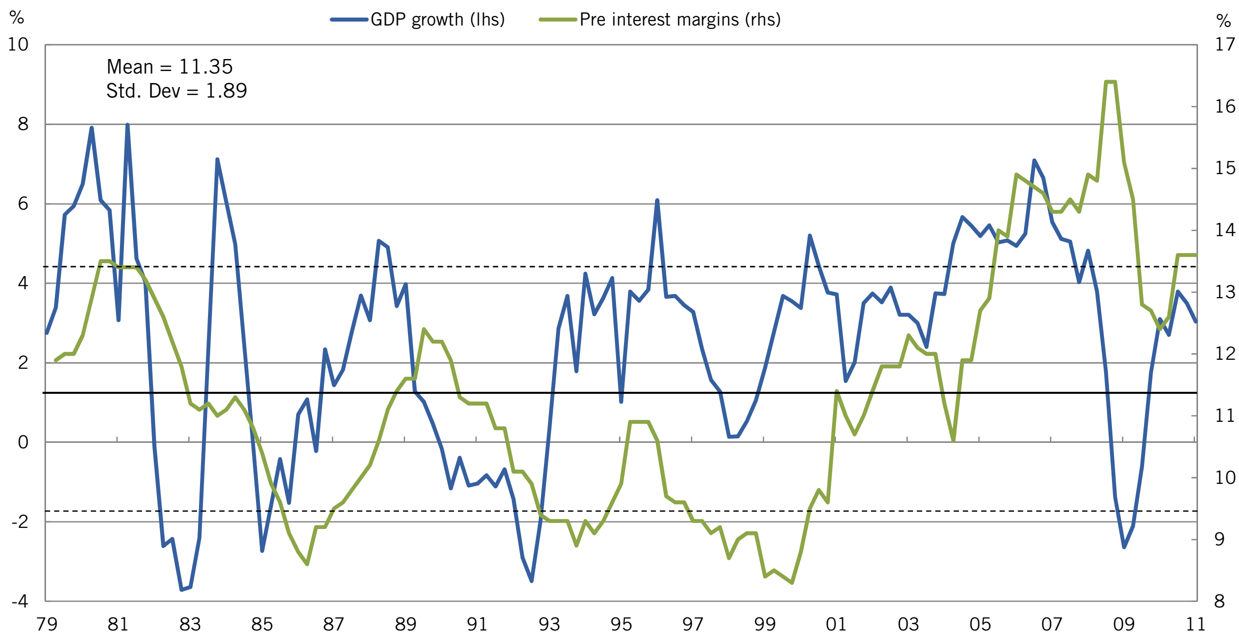
Growth in earnings

In range-bound markets, earnings growth tends to be a meaningful contributor to total returns. This is not dissimilar to the experience we have seen so far in 2011, with the biggest outperformance coming from stocks exhibiting above-average short term profit growth, with little or no regard for valuation.

Growth in earnings is a function of revenue growth and changes in operating margins. In an environment where many companies are struggling to grow revenue (due to slowing GDP growth), any surprise in corporate profit growth will have to come from margin expansion. This is concerning given that in aggregate the margin for SA Inc industrial stocks is already over one standard deviation away from the long-term average (refer chart 2). We would therefore be very cautious buying companies whose margins are at unsustainably high levels[2].

[2] Of course we love companies with high margins which are due to sustainable competitive advantage and not short term cyclical factors which are likely to disappear.

Chart 2: Pre interest margins and GDP growth



Source: I-Net

A core part of our investment philosophy is seeking out mispriced opportunities. These could be due to a company's profitability that is well below its long-term potential. One instance in which this may occur is when a company's operating margins are at very depressed levels. On the basis that the company has not lost its competitive advantage, operating margins generally revert to their mean over time.

Included in our clients' portfolio are several businesses where a recovery in profits is less dependent on revenue growth in the short term and more reliant on a recovery in operating margins. These would include, for example, our investments in British American Tobacco, Pick n Pay, Lewis, Iliad to mention a few.

Good returns are also earned from companies trading at a fair price with an above-average ability to create value for shareholders. As Warren Buffet pointed out, if a business does well, the stock eventually follows. As we highlighted earlier, the ability to create value for shareholders is a function of the ROIC and the number of opportunities available to invest each rand of cash flow (in other words profitable growth).

This would include companies in the portfolio such as Distell, Advtech and Discovery.

Dividends

As we highlighted above, dividends (together with growth in earnings) contribute a greater proportion to total returns in range-bound markets. Dividend yields are a function of the starting earnings yield and the payout ratio. Again this points to stocks that have a low PE ratio and the ability to sustain or increase the payout ratio[3].

Companies we are invested in with attractive dividend yields and sustainable payout ratios include Lewis, Abil and Astral.

In conclusion, there will always be opportunities to pick stocks that have a greater probability of outperforming the market and other asset classes, even in range-bound markets. A greater margin of safety, rising growth rates and dividend yields should offset the impact of declining PE multiples at these times.

To rely on only one metric of the total return (either PE multiple expansion, growth in profits or dividends) is an oversimplification of the many factors that should be taken into account in an investment decision.

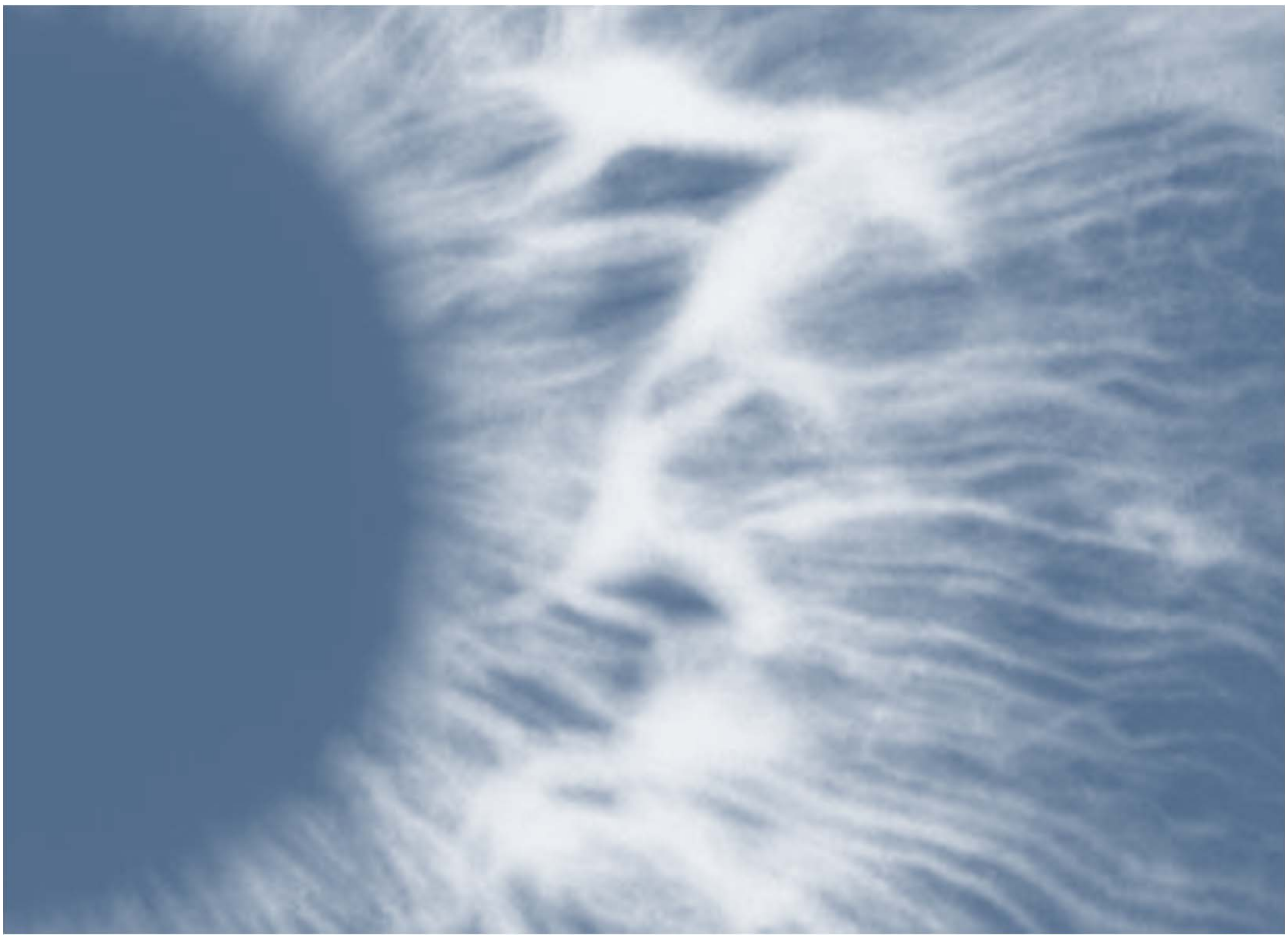
An investment approach that successfully combines these elements of investing into the decision-making process will have a better chance of ensuring clients are adequately rewarded for the inherent risks that come from investing in equities, irrespective of the stock market cycle.

[3]We went into some detail on this topic in an article entitled, "When do dividends matter?", August 2010. If you would like a copy of this please email us on francoiskr@sim.sanlam.com

contact details

Name	Email
Claude van Cuyck	claudevc@sim.sanlam.com
Ricco Friedrich	riccof@sim.sanlam.com
Jan Meintjes	janm@sim.sanlam.com
Francois Krüger	francoiskr@sim.sanlam.com

Disclaimer



SIM Unconstrained Capital Partners

55 Willie van Schoor Avenue
Bellville | 7530 | South Africa
Private Bag X8 | Tyger Valley | 7536
South Africa

A DIVISION OF SANLAM INVESTMENT MANAGEMENT (SIM) | LICENCED FINANCIAL SERVICES PROVIDER