Talking Points

Is now really a good time to invest?

Morningstar Investment Management South Africa
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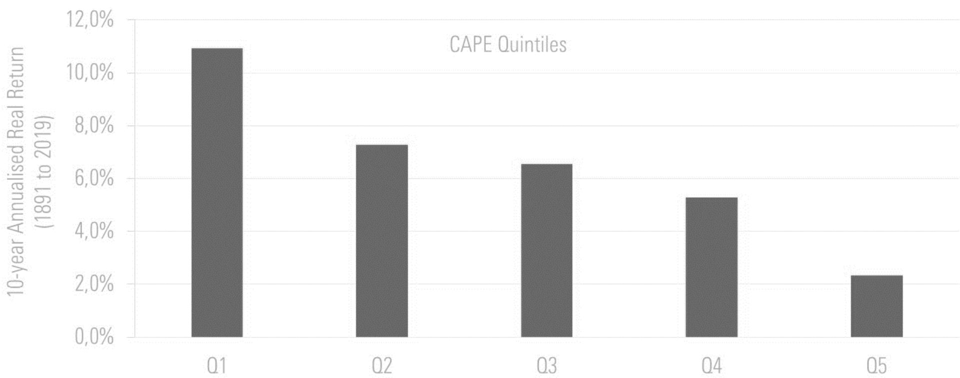
For Financial Advisors and their Clients

The fear of an impending recession, low interest rates, U.S. strength, South Africa's weak economy, and the negative implications of the ongoing trade war (to name but a few), have left quite a few investors at an impasse. Many investors are battling with the question "is now really a good time to invest?". Despite all these concerns, we believe that now is a great time to invest – provided you follow a tried and tested investment process.

At Morningstar Investment Management, we follow a valuation driven investment approach. This investment philosophy aims to identify cheap asset classes to invest in and limits exposure to expensive asset classes. Many factors are considered in understanding the valuation of asset classes. Evidence points, such as longer-term valuation, is evaluated as a key determinant of future returns. To avoid value traps, fundamental risk is also considered to ensure that we do not invest our client's capital into asset classes that are cheap for the wrong reasons (as these assets will likely remain cheap).

If we consider the CAPE ratio (Cyclically Adjusted Price to Earnings ratio) think of it as an inflation-adjusted measure of how much you are paying for each unit of future earnings. Therefore, the higher the value, the more you are paying for further earnings. Currently, assets with a high CAPE value include US large-cap tech stocks such as Apple, Alphabet and Amazon, to name but a few. In this instance, investors are assuming that the growth achieved by these companies over the last couple of years will remain intact for the foreseeable future. They are also therefore willing to pay more for the future earnings of the asset.

As illustrated in the graph below, and if history is anything to go by, expensive asset classes tend to underperform their cheaper peers. If we were to rank all asset classes into expensive (Q5) and cheap (Q1) and measure the returns over the next 10 years, we can see that cheaper asset classes tend to outperform their more expensive peers.



By creating a portfolio of asset classes that have lower CAPE ratio's, it creates the possibility of such a portfolio to outperform in the foreseeable future. But what happens if there is a market sell-off and all asset classes decline in value? If we consider what happens to these assets in the event of a significant risk-off trade (in other words, the large sell-off of equities), the more expensive asset classes (Q5) sell-off more than their cheaper peers (Q1). The cheaper asset classes will inevitably lose some value as well but a portfolio with a 10% drawdown will recover meaningfully faster than a portfolio that lost more than 50% of its value.

So, where are we seeing opportunities and how are the Morningstar portfolios positioned currently? In global markets, U.S. large caps are relatively expensive when compared to other asset classes (Q5). Areas such as the UK, Japan and Emerging Markets (Q1) are presenting better opportunities.

Locally, we're seeing opportunity in S.A. bonds and the S.A. industrial sector. Our analysis indicates that S.A listed properties are still facing significant headwinds due to an oversupply of both retail and office space.

What does this mean for clients and ultimately their investment goals? Thankfully, lower interest rates have supported most asset classes in recent years. Going forward, it would be advisable to place more focus on expected future returns and risk management. It is no secret that risk has increased of late, but we remain confident that our investment approach will deliver positive outcomes for your clients - irrespective of market outcomes.

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