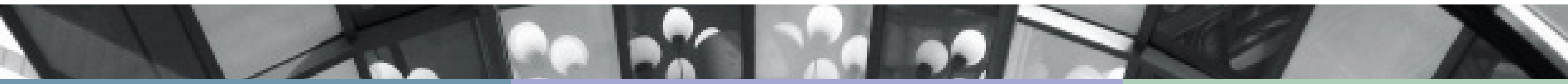
Investment Solutions

WITH CONFIDENCE



Disciplined investing against our basic instincts

AUGUST 2015

"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions under control from corroding that framework." – Warren Buffet

Equity markets simply shrugged off the worst financial crisis since the great depression in 2008, delivering extraordinary returns over the last decade. Investors have become accustomed to double-digit real returns that have framed their future expectations, catching many in a success trap. A success trap occurs when investors become so used to success that they develop a false sense of security, blissfully ignoring those risks taken to achieve the success.

So what do investors need to know to ensure they meet their objectives?

The first thing to understand is that our behavioural biases influence the way we invest. Despite the many warnings on the dangers of investing our money based on past performance, this information still drives most investment decisions as it enables us to rationalise the decisions we make to invest in the midst of an uncertain future.

Over the long term, you have been rewarded for taking on investment risk

A key assumption we make when we invest is that we will be rewarded in the long term for taking on investment risk.

The JSE (considered to be a risky place to invest) has rewarded investors handsomely. The average return over the past 10 years has been about 18% a year, compared with inflation over the same period of about 6%. This means you would have more than quadrupled the value of your money and outperformed inflation by 2.6 times over this period.

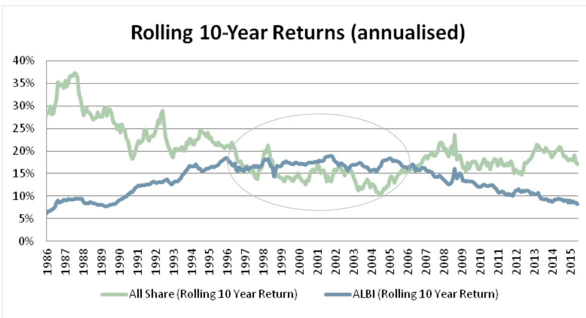
If you look back over the past 40 years, the JSE delivered a return of about 19% a year compared with inflation of around 10% a year. An investment of R100 40 years ago would have grown to over R88 000 compared with inflationary growth to around R4 100. You would have outperformed the inflation rate by more than 20 times.

But, risk and reward do not always have a linear relationship

A long period is made up of a number of interconnected or "mini" periods that show the path to success over the last 40 years has not all been smooth sailing. Investors experience through some of these mini periods (which can be quite extended) would have been very different from what they had expected.

Consider the mini period in the late 1990s to early 2000s. For most of the time during this period, the 10-year return on South African bonds was actually much higher than the return on equities. In fact, when you looked back over 20 years in April 2003, equities had not been able to deliver better returns than bonds. During this time, investors could have been tempted to throw in the towel on their long-term investment strategy. Warren Buffet's advice in times like these is to keep "your emotions under control".

Chart 1: Compares the rolling 10-year share performance against bonds, as measured by the All Share Index and the All Bond Index respectively



Avoiding the success trap by acknowledging the risks in the system

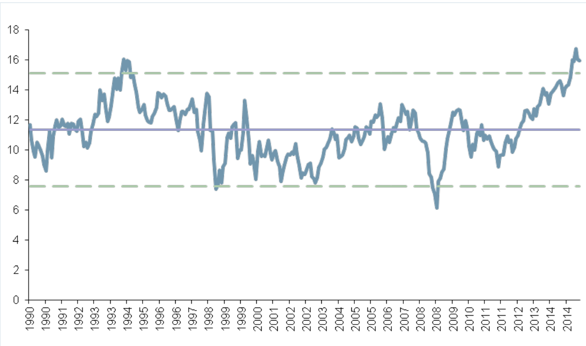
If the JSE achieves a positive return in 2015, it will be the seventh year in a row of positive returns. More importantly, 12 of the last 13 years would have been positive. The longest previous winning streaks were from 1961 to 1968 (eight years) and 1977 to 1986 (10 years).

Long winning streaks can be viewed as mini periods and tend to be followed by periods of disappointing returns from equity markets as they revert to more realistic valuation levels. It is impossible to predict when a winning streak will come to an end, but a sensible investor will be very wary about taking on additional investment risk right now. There are some big macro-economic issues that should caution us to moderate our investment-return expectations over the next decade.

1. Share valuations

There is increasing evidence that the price of shares in general, as a multiple of historic and projected earnings around the world, is very much on the high side of expensive and in some countries (such as South Africa) leaning towards very expensive. The price/earnings (P/E) ratio is often used to determine whether a share is expensive. It compares a company's current share price with its per-share earnings. The current 12-month forward P/E for the All Share Index of 2016 shows that shares are expensive relative to their long-term average. History teaches us to moderate our expectations on future returns when shares are expensive.

Chart 2: 12-month forward P/E of the All Share Index



2. Bond valuations

Although the bond market has recently sold off, valuations around the world are stretched. The bond market has adapted to a low interest-rate environment. It is widely expected that it will now deliver muted (and even negative) returns when interest rates start to increase.

3. Stock markets have been driven by quantitative easing and a depressed interest-rate policy

Quantitative easing and low (in some cases, zero) interest rates have been a key driver of good returns in stock markets over the past seven years. A reversal of this easy monetary policy is likely to mean the extraordinary returns we have seen from equity markets since 2009 have come to an end.

4. Governments are highly indebted

The developed-world governments have taken on massive debt to boost their economies following the 2008 global financial crisis. Public debt as a percentage of GDP is at highs last seen in the late 1800s. At some stage, these debts will need to be brought under control. This means the ability of governments to implement stimulatory economic policies is limited as they focus on balancing their budgets. It is also possible that some countries (e.g. Greece) will not be able to meet their loan obligations and could default. The current state of global debt does not bode well for the outlook on equities over the next decade.

Chart 3: Public debt/GDP ratio for advanced economies, average for 22 countries (%)

Moderate your expectations and stick to the plan

Our base-case outlook on equities over the next 12 to 18 months is that a market crash or significant correction is unlikely for now, but the risk of poor (and even slightly negative) short-term equity returns has heightened significantly. Investors need to moderate their expectation on longer-term investments. A portfolio that has historically achieved a real return of 10% a year is more likely to achieve a more moderate real return of around 5% a year over the next 10 years, and this return is unlikely to come in a straight line.

As is always the case, long-term investing requires a "*sound intellectual framework for making decisions and the ability to keep emotions under control from corroding that framework*". In other words, stick to your long-term strategy and don't be tempted to chase last year's top-performing manager or asset class.

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