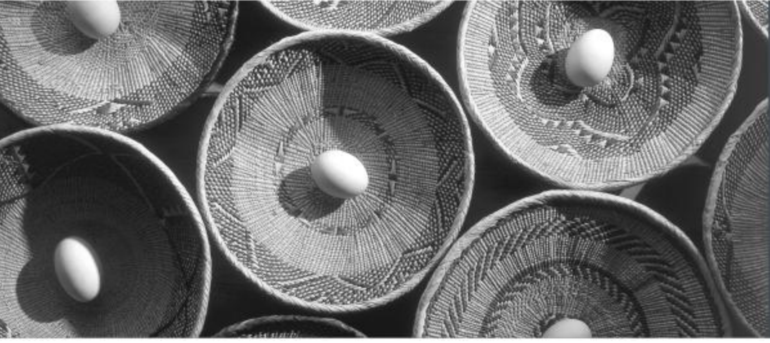

ORTHOGONAL
investments

Monthly Commentary – August 2009

At the time of writing, the JSE All Share Total Return Index was up 44% from the low point set on 20 Nov 2008 but still 21% below the all time high (22 May 2008). Let's put that into some context which may give pause for thought. The return of 44% can be decomposed as follows:

$$\text{Total return} = (1 + \text{Change in PE}) \times (1 + \text{Change in earnings}) + \text{dividends} - 1.$$

$$44\% \approx (1 + 73\%) \times (1 – 18\%) + 2.90\% - 1.$$

Our interpretation is that the market was demonstrably too cheap in November, when the PE was as low as 7.8. It is a fact that at no time in the past year was consensus expected earnings growth nearly as low as minus 18%, thus proving that the market, in a panic, was unwittingly priced for even worse outcomes. That kind of dislocation represented extremely good value. We have shown before that low PE multiples beget strong returns in spite of the awful sentiment and widespread outlook of doom that prevails at such times. In this case, earnings growth was substantially worse than expected and yet we have enjoyed a very strong market. Once again, the futility of forecasting earnings is highlighted, and is in strong contrast to the power of valuation.

It is now a little foreboding that the PE has rocketed in short order to 13.5. Fortunately, we can still demonstrate that the market continues to discount a bleak patch of corporate profitability and therefore remains marginally cheap. The fact that interest rates are about 5% lower than they were in November is unambiguously good for equities, but we now believe that it would be foolhardy to expect equities to appreciate at anything like the pace of the past six months. We try to compensate further by constructing a portfolio with a weighted average PE multiple substantially lower than that of the overall market (and with a higher dividend yield).

A common refrain against value managers like ourselves is that we tend to buy too early and to sell too early. Happily, that tendency turns out to be a rather minor nuisance in the context of our overall long-run investment performance, but we don't dispute it. Buying too early is fairly easy to understand: typically, when we can show that a share is cheap, invariably this also means that the underlying company is temporarily troubled or is an ex-growth company that has fallen rapidly out of favour (Imperial and Bidvest are good examples). Their newly disgusted ex-fans tend to sell rather indiscriminately. We can't measure or predict the sellers' levels of urgency, so we buy when we assess attractive valuation, and then remain stoic if prices fall further. Turning to the other side of the apparently flawed tendency, we think that once a share regains favour, it is right for us to sell it at full value; we have no business speculating whether full value will increase to frothy value. To do so would be to incur the risks of the children's game of "pass the parcel".

In the light of the "buy too early, sell too early" allegation, two topical shares are Old Mutual and Investec (both held). Each share price is up well over 100% in just the past few months, yet we continue to hold each on clients' behalves. The reason is simply that share price (or price appreciation) has nothing to do with our sell discipline. As always we defer to value. Old Mutual is still at a 35% discount to Embedded Value (which is not only cheap in an absolute sense, but is substantially below the long run average) and Investec trades at only about 1.6 times its tangible net asset value, which is again well below its long run average. If they return to their long run ratings, their share prices will have increased by another substantial amount, but we won't wait for them to become expensive; we'll be scouting for the new hard-luck story.

When we assess fair value for RSA bonds, we do so in the context of US government bond yields, SA's sovereign risk spread and inferred inflation differentials. We do not impose our or anyone's forecasts on the model. Further, we invariably take the 10 year US government bond yield as given and make no statements as to its price versus value, deferring to the fact that it is the world's most liquid security. And yet, now we can't stop ourselves from scratching our heads. Despite a fairly savage sell-off in prices this year (by bond standards anyway), these Treasuries currently yield just 3.30%. The problem is that politicians, in deciding to try to spare their careers, have done so by indebting generations of American taxpayers (the situation is the same in many other countries, but that is not particularly relevant here). The chart below is alarming. US debt as a percentage of GDP has been higher only once since records began in 1792, and that was in the aftermath of WWII. Given the scale of munificence promised, the trend is set to worsen. What is completely unclear is a very simple issue: who will buy all these bonds?

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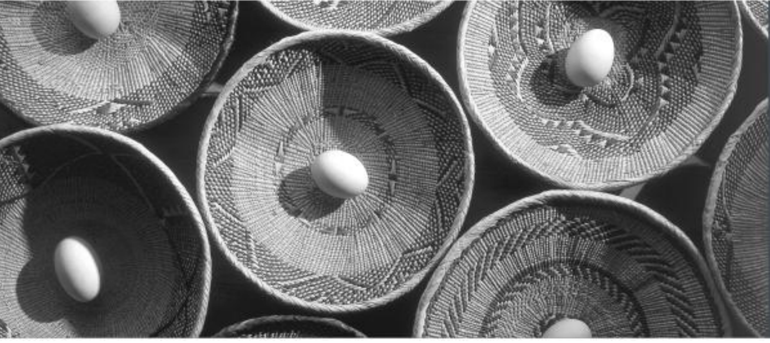

US gross federal debt as % of GDP

Source: Historical Statistics of the United States, EH.net, Congressional Budget Office

Domestically the sell-off in bonds, which we correctly anticipated in these monthly commentaries, has rendered bonds much less expensive than a few months ago, if not drippingly cheap. Also, the fact that money market rates are a desultory 6.60% and we can earn a yield of 10.50% on a long-dated Transnet bond has led us to modestly increasing duration.

Some company news during August that is of relevance to our clients' portfolios:

Imperial Holdings (held) reported results that were generally in line with the market's expectations. The positive impact of the significant restructuring done during the past two years was clearly evident and appears to position the group well to benefit from an improvement in local economic activity, when that eventually occurs.

MTN Group (not held) reported interim results that were somewhat difficult to interpret. The group's Nigerian operations performed well, but its South African business disappointed. Profits were also significantly negatively impacted by a weakening of the Nigerian naira relative to the South African rand. No comment was made regarding the proposed tie-up with Bharti, but the period of exclusivity was extended for a second time.

BHP Billiton (held) reported a 30% decline in earnings per share, which was in line with market expectations and commendable considering what had happened to commodity prices during the period. The company distinguished itself from its peers by maintaining its progressive dividend policy, sustaining its healthy operating margin, cash flow and return on investment, as well as the strength of its balance sheet.

Standard Bank Group (held) reported interim results which clearly indicated that the banking sector is still taking some strain. Headline earnings per share were down 27%, as was the dividend, though the group maintained a dividend cover of 2.5x. Of concern was a hefty 58% increase in impairments, resulting in an increase in the credit loss ratio (CLR) from 1.31% to 1.84%. This was partly driven by an increase in corporate non-performing loans, where the CLR increased from 0.3% to 1.15%. On a more positive note, Standard Bank remains well capitalised with a total capital adequacy ratio of 14.4%. Tier 1 Capital increased from 10.7% to 12%.

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