

Monthly Commentary – July 2009

“It is said an eastern monarch once charged his wise men to invent for him a sentence to be ever in view, and which should be true and appropriate in all times and in all situations. They presented him with the words “and this, too, shall pass away”. How much it expresses! How chastening in the hour of pride! How consoling in the depth of affliction!

Abraham Lincoln, in an address in Wisconsin, 30 September 1859.

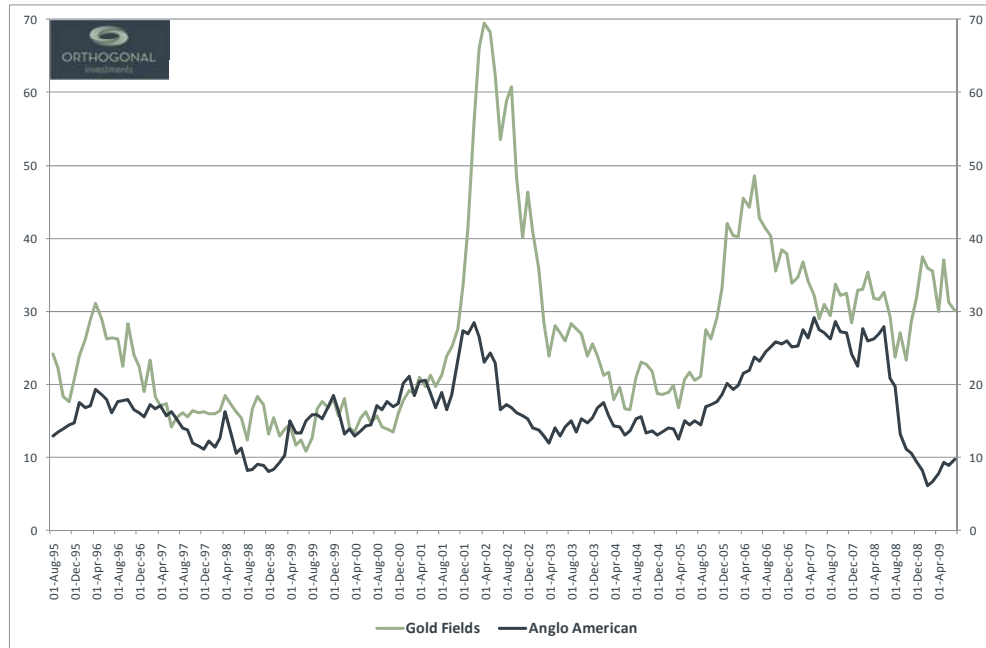
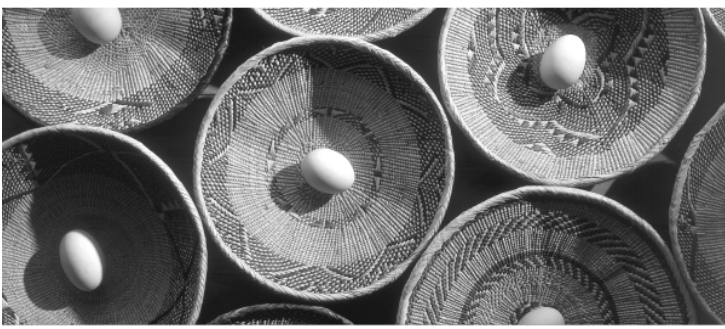
This wisdom certainly seems to already be true of the financial market calamities we have recently experienced, and in time it will also apply to the world’s economy, as it always has. July was a lollapalooza month for equities everywhere. In fact, even with an excellent total return of 10% in rand or 9.3% in dollars, the JSE was actually one of the world’s equity market laggards. And yet, most markets are still well below their recent high points. The extent of the recent bear market may be brought into perspective by looking at the amount by which markets still need to appreciate just to attain their previous high points. Here is a selection (all reported in dollars):

	Drawdown	Current Recovery	Still needed to reach all time high
World	-55%	39%	61%
Brazil	-70%	93%	70%
Russia	-79%	82%	162%
India	-70%	94%	73%
China	-71%	97%	75%
Japan	-49%	30%	50%
UK	-61%	41%	82%
USA	-53%	34%	57%
Australia	-66%	65%	76%
Ireland	-82%	47%	287%
South Africa	-57%	61%	44%

Source: Orthogonal Investments. Data since 2005, various index providers used.

Our proprietary indicators of value (which deliberately omit macro-economic factors but use current market metrics, the term structure of interest rates and consensus earnings expectations) suggest that South African equities remain very attractively priced, even though we allow for desultory earnings growth over the next two years. However, even if all goes well, it would be rash to expect the market to appreciate at the breakneck 84% annualised speed of the past six months. The simple reason is that the overshoot in terms of a mechanistic discounting process has partially unwound. Hard evidence of corporate delivery is now required.

The authors of the original great book on how to value shares, Graham and Dodd, proposed the use of a valuation tool that is not overly influenced by short term vicissitudes in companies’ profits. The idea was to calculate today’s price divided by a re-inflated ten year average of the company’s earnings (into today’s prices, using a CPI index). Considering all the new large cap listings in South Africa in the past ten years, we modify the methodology to run over 5 years, in the belief that it will still help stop us from being too influenced by short term developments in earnings (not in valuations – keeping an eye on those is our job as active asset managers). Plotted below is an example of this method. It shows these valuations for Anglo American and Gold Fields. In both cases, earnings and price data from 1990 is used, so the charts can be plotted from 1995. This is yet another reason (see previous editions of our monthly commentary) why we currently hold no gold shares on clients’ behalves, but do hold diversified miners.

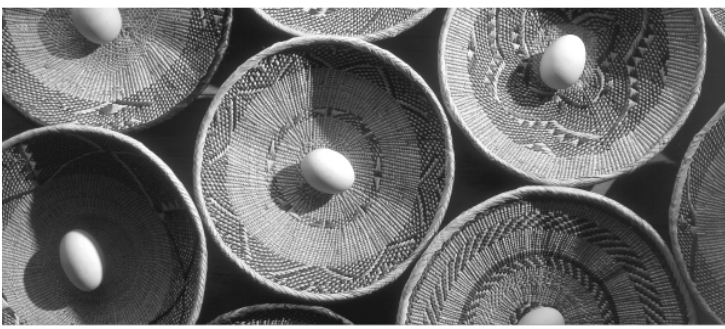


The All Share index (not shown) looks very attractive on this basis; just not quite as attractive as six months ago, understandably enough.

For a few months the bond market has benefited from, among others, a flattening of the yield curve, a strong rand and a remarkable recovery in South Africa's sovereign risk spread over US Treasuries. The latter blew out to 8% in late 2008, and is currently at just 2%. One has to wonder if there is any scope for further narrowing, especially now that South Africa enjoys a much lower spread than most emerging markets. Just six months ago, it was in the middle of the pack, alongside Russia. Even if we don't forecast a wider spread though, the onus is again on inflation to vindicate current bond yields. We reckon that inflation has to average below 5% over the next decade to make prevailing bond yields ultimately appear sensible, and that that is an unlikely level. Still, the burden on bond yields is much less than it was during the December madness when the panicked statement "Flight to quality" was dominating rational pricing. In these commentaries, we have frequently mocked rating agencies' assessments. We were pleased to learn that we are not alone, nor even as serious about this as some. Calpers is the biggest private pension fund in America, and news from July was that it has sued Standard & Poor's, Moody's and Fitch for "wildly inaccurate risk assessments" that were "seriously flawed in conception and incompetently applied". The lawsuit was filed in San Francisco on 9th July 2009. Our best wishes go out to Calpers.

As always, some selected company news:

Old Mutual: Paul Hanratty's successor as CEO of OMSA is to be Kuseni Dlamini, who comes to the assurer with a good business pedigree but no experience of the life assurance industry at all. We wonder if this appointment might demotivate veteran senior managers at Old Mutual. Hanratty has been elevated to the head office in London in the capacity of Chief Executive of the global long term savings division. We trust that he will avert the sort of less successful escapades that have hampered the group in recent years.



Anglo American appointed Sir John Parker to replace Mark Moody-Stewart as chairman. Apparently this ruffled the feathers of some politicians who felt entitled to influence the appointment. Perhaps they ought to relish the tax garnered from Anglo, which is a better lot in life than the dividends earned by shareholders. These have been conspicuous by their absence of late.

Mondi: Considerable excitement was generated when National Treasury permitted the JSE to reclassify Mondi plc in such a way that it can be traded locally just as easily as Mondi Ltd which is to say without foreign exchange restrictions. The valuation gap between the two promptly narrowed from 22% to 4%. We would be more than a bit pleased if the listing of British American Tobacco were to be afforded the same favourable treatment.

A slew of financial companies had grim things to tell shareholders, but the good news is that in most cases these were actually not as bad as had been expected so some crass extrapolators may have once again been caught short. This category of July news flow included Nedbank (headline eps down, bad debts up, margins down, asset growth slower), Investec (year-on-year earnings down but quarter-on-quarter earnings up), ABSA (earnings down (ho-hum), bad debts up, margins down substantially and the matter of a R1bn write-down) and Liberty Holdings (a loss of between R1bn and R1.3bn is on the cards, partly due to forex and hedging losses (the company appears to have timed its deleterious equity hedge almost immaculately incorrectly), very bad policy lapse experiences of late).

We have repeatedly drawn attention to the frequent differences between corporate news and share price behaviour. These differences materialise for a host of reasons, which we won't repeat. Instead, compare the month's share price performances against those dire news announcements: Nedbank (+9%), Investec (+32%), ABSA (+7%) and Liberty (+1%). Old Mutual, in which the management news was received with mixed feelings, was up 22%.

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