ALLAN GRAY

GRAY ISSUE
1 February 2018 Issue 197

INVESTMENT LESSONS FROM 2017: BE PATIENT AND TRUST YOUR ANALYSIS

Separating oneself from the noise is tricky. There is an enormous amount of information out there; you can listen to experts on television, read newspapers, unit trust annual reports, stockbroker research or take in what the pundits have to say on social media. But are these content generators trying to inform you or serve their own agendas? In a world of ever-more noise, it is important to make a conscious effort to focus on what matters and adds value to your life, while at the same time thinking about what commentators are looking to achieve. This is increasingly important when quality, independent journalism is being squeezed out. 2017 reinforced this point for me, along with a few others.

Patience

Be patient and trust your analysis. Steinhoff is a great example. Constant disclosure changes, non-existent cash flow, equity issuance, very low tax charges and even lower cash tax payments, convertible bond issuance, strategic about-turns, annual reports that did not reconcile from year to year and management explanations that did not ring true struck us as extremely suspicious. We were patient for 10 years and avoided the share; but we were not patient enough. With the stock down 40% relative to the market over 18 months, having raised substantial equity to pay down debt and improved clarity on some of the operations, we began to buy a small position in October. Very frustrating that after ten years of work, only a little more patience would have seen us clear.

Short termism and the fear of missing out

Investing and accumulating wealth is a long-term business – as in more than 40 years. Many people are unwilling to invest consistently and significantly towards their retirement despite evidence that indicates a sensible strategy of compounding, executed over decades, will likely yield excellent results. But they will happily invest in something that has no intrinsic value or ability to work for them, on totally unregulated exchanges, with substantial transaction costs, in the hope of becoming wealthy overnight.

The long-term, valuation-based Allan Gray investment philosophy positions us well versus the short-term thinking, blind investing by passive funds and dearth of thoughtful, independent analysis that is the modern world.

The portfolios

Our long-term approach can be seen in the changes to the portfolios over the past year, which were fairly modest. Taking the Equity Fund as an example, only two of the top ten constituents changed. Rand Merchant Investment Holdings (RMI) and KAP Industrial Holdings were replaced by medical groups Life Healthcare and Netcare. Life Healthcare and Netcare were two of the Equity Fund's largest detractors from performance for the year, with their share prices falling by 18% and 21% respectively. However, as can be seen by their entry into the top ten holdings, we were buyers of both of these companies as the share prices fell below our assessment of fair value.

We increased the Equity Fund's exposure to internationally listed companies from 16% to 20% as we reduced our holdings in certain SA-listed companies like Standard Bank. The holding in Standard Bank fell from 7.3% of Fund to 5.7% as the share price rose 27% and the valuation became less compelling. The comparison is even more interesting when you consider that Standard Bank appreciated 41% over the year when measured in US dollars.

The equity allocation in the Balanced Fund increased slightly over the year to 62.5% from 61%. We were net sellers in 2017, particularly of international equities, where our exposure declined from 14.1% of Fund to 13.6% – despite strong price performance.

Asset allocation changes in the Stable Fund were even more pronounced. The Stable Fund's share exposure increased from the mid-teens in 2015, to a peak of just below 40% in July 2017, as we found more opportunities. The subsequent rally in domestic and global shares has led to fewer opportunities and we have started to reduce the Stable Fund's share exposure. It is currently sitting at 36%. Interestingly, for the first time in many years, we are beginning to find value in select South African property companies. These are still a small exposure in the Fund but it is a sector we are monitoring closely for opportunities.

Environmental and social

In 2017 we made changes to how we analyse and monitor environmental and social issues in the investment process. We hired a dedicated environmental and social analyst who works with the analyst team to assist in identifying and analysing any issues that arise.

Thank you for trusting us with your savings

We focus on managing the risk of capital loss and look to take advantage of opportunities as they arise by buying undervalued assets in an effort to generate real returns for our clients. This has proven to be a winning strategy over the past 44 years and we don't plan on changing it.

Commentary by Andrew Lapping, chief investment officer, Allan Gray

Adapted from the chief investment officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2017.