Was 2022 a secular turning point and if so, what does it mean for the years ahead?

In a complex environment of tight financial conditions, it is important to remember that successful investing involves not solely aiming to generate above-average returns, but also managing risk in a changing world. In his first investment update of 2023, Duncan Artus discusses the current investment context and how it differs from the past, shares a review of 2022 and describes how the portfolios are tilted to protect against risk and benefit from long-term trends. As we approach our 50th anniversary, he also explains how we can lean into our experience to navigate the current cycle. Watch the 11-minute video and read the commentary below.

My first investment update of 2022 began by referencing the pandemic and its effect on everyday life and asset prices. Just as we thought we were getting some respite, Russia invaded Ukraine, amplifying already-escalating geopolitical and fiscal risks. In a world where asset prices, many of which could politely be called speculative in nature, had been supported by expansion in central bank balance sheets, low interest rates and fiscal stimulus, what could possibly go wrong? A lot, it turned out.

Allan Gray will celebrate its 50th anniversary in 2023. We are proud of our long-term track record having managed our clients' assets and the firm through several geopolitical, financial and performance cycles. There are many ways to manage money. In my view, you must find a way that you believe in and trust because if there is one certainty in markets, it is that your belief in your philosophy and process will be tested – sometimes severely so. In turbulent times such as the last two years, we can look back over our history and draw confidence from the firm's ability to successfully navigate cycles for our clients.

Not only were markets extremely volatile in 2022, but the regulator also relaxed exchange controls for South African investors by increasing the maximum allowable amount to be invested offshore to 45%: another variable thrown into an already complex environment. This is a positive long-term outcome for local investors. I believe that, together with our offshore partner, Orbis, we are well placed to take advantage of the increased opportunities and risks in constructing appropriate portfolios and offer a compelling investment proposition.

A passive portfolio invested 60% in the MSCI World Index and 40% in the JPM World Bond Index would have lost 18% in dollars and 25% in real terms after accounting for US inflation of 7.1% – nearly the worst in 100 years. Against this backdrop, the South African equity market, as represented by the FTSE/JSE All Share Index (ALSI), returned 3.6% in 2022, underperforming both cash at 5.2% and inflation of 7.4%. The Capped SWIX All Share Index, which many funds use as a more representative equity benchmark, returned 4.4%. The resource index outperformed the financial and industrial index but is well off its relative peak. The FTSE/JSE All Bond Index returned 4.3%. Internationally, the FTSE World Index returned negative 12.1% and the FTSE World Government Bond Index negative 12.6% in rands, respectively. The rand weakened 6.6% against the US dollar, which was strong against most currencies. The US dollar traded below parity to the euro, almost reached parity with the pound and appreciated 30% at one stage against the yen.

The extent and speed of the rise in interest rates globally were not good news for long-duration and leveraged assets, such as growth equities, profitless companies, Australian house prices and liability-driven investment funds in the UK. Nowhere were the consequences of the end of free money highlighted more vividly than in the broader crypto universe. As with any bubble, all the malfeasance in crypto is being exposed as prices collapse. The Nasdaq fell 33% after many years of price leadership. Several speculative disruptor shares fell far more. What hurt many portfolios was not the collapse of the disruptor shares but the broad decline of the mega-cap tech companies, which dominate the makeup of most offshore portfolios. For example, Amazon halved, and Meta (Facebook) declined more than 60%. Tesla, which was mentioned in last year's commentary, lost 65% of its value. I believe there is a reasonable possibility that many mega-cap tech shares have made secular relative peaks.

We continue to be underweight large-cap US shares but are relooking at their valuations. For more detail, please refer to the Orbis President's letter and the factsheet commentaries of the underlying funds, available via our website. Orbis remains optimistic about the value gap between the shares they own and the market, which they believe has only partially been closed. We continue to find locally listed multinationals, such as British American Tobacco and Anheuser-Busch InBev (AB InBev), attractive both in absolute and relative terms.

Performance

Relative performance improved meaningfully across most of our funds with a strong contribution from the offshore portion, which has for some time looked very different from many of our peers. However, I often reflect on whether we could have made some different decisions during the sharp 2020 pandemic sell-off. Our portfolios tend to outperform when the market is falling, which was not the case in the first quarter of 2020.

The Balanced Fund returned 8.1% for the year, outperforming its benchmark by 8%. The Stable Fund returned 6.3%, in line with its absolute benchmark and ahead of its peer group. The Equity Fund returned 7.8% just ahead of its benchmark.

Within equities, detractors from alpha included being underweight Naspers and Absa. The largest contributors were being overweight Glencore and British American Tobacco. Other positive contributors included Woolworths and Nedbank.

The Orbis Global Equity Fund returned negative 10.3% in dollars for the year, outperforming the FTSE World Index by 7.2%. While pleasing, the three- and five-year numbers remain below the levels Orbis expects. The Orbis Global Balanced Fund returned 4.9%, outperforming its 60/40 benchmark by a significant 22.5%. The Orbis Optimal SA Fund, which hedges out equity market risk, had a strong year, producing double-digit positive absolute dollar returns of 16.6% in a year where fixed income provided little protection in asset allocation portfolios.

Positioning

While we are bottom-up investors, we want to be on the right side of long-term secular trends. This allows us to tilt the portfolio to protect against the risks of, and benefit from, these trends. We have for some time been highlighting four key trends, which we believe will endure for now:

- A higher inflationary and interest rate environment globally (especially in developed markets)
- An energy-short world caused by years of underinvestment and regulatory policy
- A world increasingly dividing along geopolitical lines, with a specific focus on China
- Longer-term risks in the South African economy that are compounding in the wrong direction

We continue to search for cheap and reasonably priced hedges against a broad sell-off in Chinese-related equities, commodities and technology stocks. This is not as simple as it sounds.

Conclusions

After a calendar year of historic losses across asset classes (around US$37 trillion, according to Bloomberg estimates), one would naturally expect a rebound from these oversold conditions in the short term. Inflation has probably peaked but I believe it will be structurally higher than in the past. The resultant tightening in financial conditions poses many potential risks. Handling these is part of successful portfolio management. Investing involves not solely looking to generate above-average returns, but also managing risk.

The Investment team is applying the same philosophy and process we have for the last 49 years in managing your hard-earned savings. We aim to make incremental improvements to our process every year that, when compounded over time, will enhance our ability to generate alpha in what is a very competitive industry. The increase in the foreign investment allowance provides more opportunity to diversify and I believe that, together with Orbis, we are well positioned to navigate this on your behalf.

As always, I encourage you to focus on your long-term financial plans and goals rather than worrying about the daily news cycle, as hard as that is these days. On behalf of the Investment team, I thank you for the trust you have placed in us.

Adapted from the chief investment officer's comments, which will appear in the Allan Gray Unit Trust Annual Report, 2022.

Commentary contributed by Duncan Artus, chief investment officer, Allan Gray

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