Talking Points
Unpacking South African equity performance

Morningstar Investment Management South Africa
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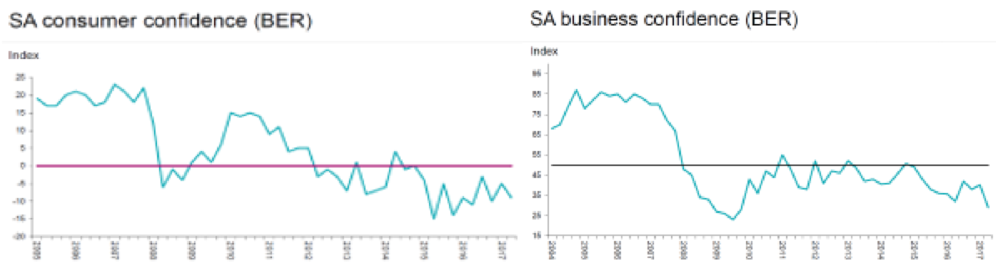
For Professional Investors only

On Tuesday the 7th of November 2017, the FTSE/JSE All Share Index closed at an all-time high of 60,183 points. This is the first time that the index has closed above 60,000 points and represents an interesting milestone for the South African equity market. Strong year-to-date returns from the local bourse have been welcomed by local investors after a 3-year period where the local equity market struggled to produce inflation beating returns. For the 3-year period from 1 July 2014 to 30 June 2017, the ALSI produced an annualised return (including dividends) of 3.4%, well below the annualised return of cash (using STeFI composite as a proxy) of 6.9% and the annualised return of the local bond market (using the All Bond Index as a proxy) of 7.1% over the same period. For the four-month period from 1 July 2017 to 31 October 2017, the ALSI has produced a return of 15.7%, catching many investors off guard after a period of disappointing returns from the local equity market.

With consumer and business confidence in South Africa near all-time lows, this sudden surge in local risk assets could be considered counterintuitive. The depressing state of the country's finances was highlighted in Minister Gigaba's latest Medium-Term Budget Policy Statement (MTBPS), and the IMF's expectations are for weak GDP growth for South Africa of 0.7% in 2017 and 1.1% in 2018. Ratings agencies are no doubt keeping a close eye on proceedings, with the possibility of further downgrades to South Africa's sovereign credit rating in the next 12 months (even the next month is a distinct possibility). Indeed, South Africa appears to be on a knife edge heading into the ANC policy conference in December 2017, where the ruling party will decide on its next leader.

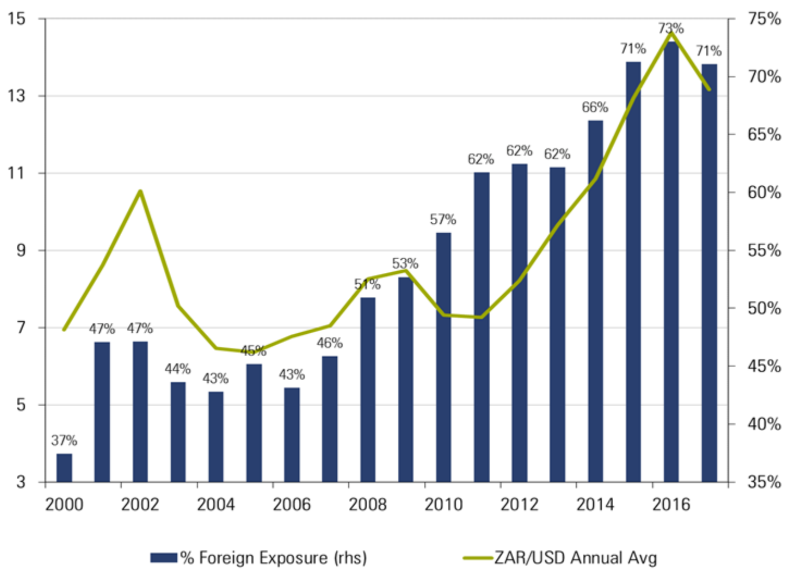


Source: STANLIB Asset Management, January 2004 to June 2017

So, what has driven this sudden surge in the performance of the ALSI in the second half of 2017? If economic growth is weak, the outlook is poor, confidence is low, and politics is front of mind, how can our market reach new highs? We believe the market strength is mainly due to two factors:

1) The large percentage of companies listed on our local stock exchange that generate their earnings outside of South Africa. These companies are more resilient to SA-specific problems, and in fact, benefit from a weakening rand. These companies are often referred to as rand hedge shares. Over 60% of the earnings of companies listed on the JSE are generated outside of South Africa's borders. This figure has steadily increased over time and means that the performance of the ALSI has increasingly become a function of global developments.

JSE Top 40 offshore exposure through time



Source: Investec Asset Management, 1 January 2000 to 31 October 2017

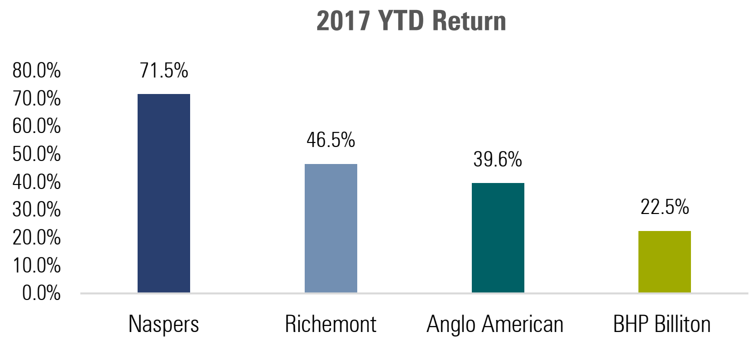
In this regard, the global economy has enjoyed an extended period of good health and consumer confidence is at a 10-year high. This positivity has influenced the performance of those rand hedge shares listed on the JSE which generate a significant amount of their earnings in foreign markets. The South African equity story is therefore characterised by a two-speed market, where the majority of South African oriented businesses have performed poorly (i.e. businesses that are dependent on the South African economy, often referred to as "SA Inc" shares), while a select few large rand hedge shares have excelled. Below is an illustration of the top 10 best and worst performing shares year-to-date of the large- and mid-cap shares, clearly demonstrating the disconnect between rand hedge shares and SA Inc shares.

	YTD Return	Rand Hedge		YTD Return	Rand Hedge
Kumba Iron Ore	86%	Yes	Brait	-39%	Yes
Naspers	72%	Yes	EOH	-36%	No
Exxarro	71%	Yes	Famous Brands	-35%	No
Richemont	47%	Yes	Tsogo Sun	-22%	No
Clicks	40%	No	Oceana	-22%	No
Anglo American	40%	Yes	Pioneer Foods	-21%	No
Assore	38%	Yes	Harmony	-21%	Yes
African Rainbow Minerals	34%	Yes	Omnia	-19%	No
Goldfields	32%	Yes	Netcare	-19%	No
Fortress B	30%	No	Lonmin	-17%	Yes

Rand returns: 1 January 2017 - 31 October 2017

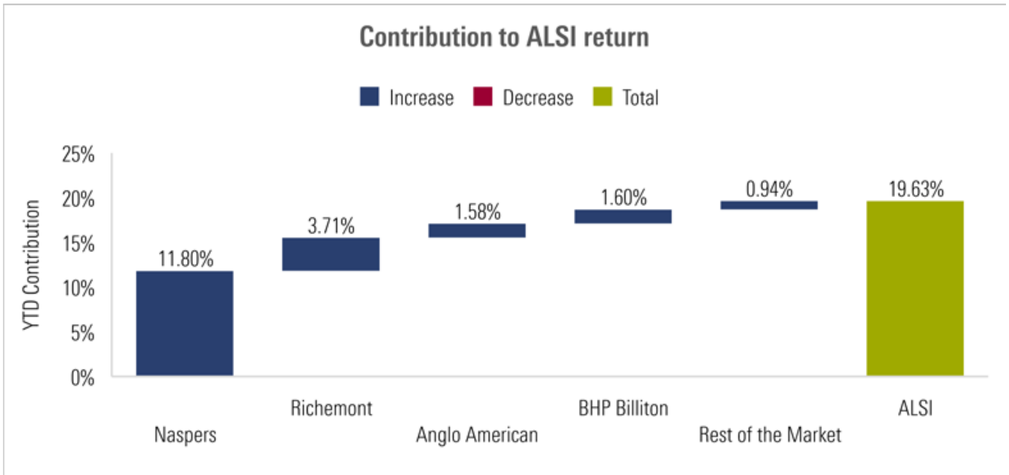
Source: JP Morgan. For illustration purposes only. Past performance is not a guide to future returns.

2) The Naspers effect on market performance. The fact that one share makes up over 19% of the JSE All Share Index demonstrates the concentration issues we experience. In fact, at the end of October 2017, the biggest four companies on the JSE by market capitalisation made up 39.2% of the index. This means that the performance of Naspers, Richemont, BHP Billiton and Anglo American currently account for almost 40% of the returns of the index! These companies generate significant earnings in offshore markets and are less reliant on the South African economy. All four of these shares have performed well in 2017 as can be seen from the graph below:



Source: Morningstar Direct, as at 31/10/2017. For illustration purposes only. Past performance is not a guide to future returns.

If we take the average weight in the index of these four shares from the end of 2016 to the end of October 2017, these companies contributed 18.7% of the total return from the index, which returned 19.6%. In other words, approximately 95% of the returns from the index were delivered by only four shares.



Source: Morningstar Direct, as at 31/10/2017. For illustration purposes only. Past performance is not a guide to future returns.

This highlights that returns from the local equity "market" have been anything but broad based. There have been a small number of shares that have performed very well (mostly large rand hedge industrials and resource counters), whereas local or South African focused businesses (mostly SA banks and retailers) have fared much worse.

So, how should an investor interpret these developments? At Morningstar Investment Management, we maintain defensive positioning with a high allocation to rand hedge shares and offshore assets.

Given the valuations of SA Inc shares, we have been building exposure to select counters and as a result our portfolios are well diversified. We are ready to deploy cash if market movements shift asset prices away from our assessment of intrinsic value. We advocate building portfolios holistically by understanding the different return drivers of each asset class. This means being valuation-driven in our approach and continually seeking to identify undervalued assets to include in our clients' portfolios. While South African oriented assets may currently be out of favour, we caution investors against extrapolating recent market trends into the future. Much of this is unknowable, and although the next few months could easily provide a significant number of South African talking points, it is important to focus on corporate fundamentals and apply sound logic to remove emotion when making investment decisions.

Risk Warnings

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