CONSEQUENCE
PRIVATE WEALTH

Talking Points
South African Investors Feeling Jaded

Morningstar Investment Management South Africa
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For Financial Advisors and their Clients

Feeling slightly jaded or disillusioned by your investment portfolio? You're not alone. For the best part of five years, investors could be excused for thinking that they've been trapped in a Groundhog Day of horrible market conditions. While global markets have rallied, especially in the US, South African investors have sadly missed out.

After prolonged periods of low returns, we often find ourselves being tempted to 'do something', to make a change and to fix what's not working. However, this can be precisely how wealth is destroyed over time.

We know equities deliver real returns to patient investors. If an investor had been exposed to the South African equity market from 1 January 1995 to 31 August 2018, they would have generated an annual return of 14.5%. This period includes tough market conditions, including the emerging market crisis in 1998, the tech bubble of the early 2000s and the global financial crisis in 2008/09 - plus the last five years during which the local equity market has been relatively flat. After inflation is accounted for, this is an annualised real return of close to 8% per annum for just less than 23 years.

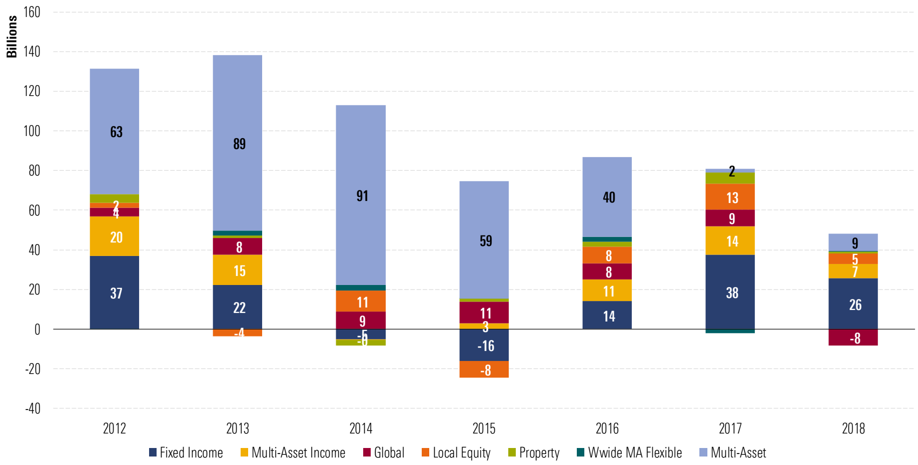
In spite of the evidence, the temptation exists to attempt to time the market – that is, pick entry and/or exit points. We believe that trying to time the market is a fruitless exercise. Often, the best time to invest it is when things feel most uncomfortable. If you had tried to time the market over the past 23 years and missed just the best 100 days of the total 5,782 trading days, your return would have been -2.4% per annum, instead of 14.5% per annum for the full period.

Risk of missing the best days in the market 1 January 1995 - 31 August 2018

Date as of 31 August 2018 Source: Morningstar Direct. The FTSE/JSE All Share TR was used as a proxy for the equity market.

The message is clear: staying the course works. Yet, despite the compelling evidence, there has been a material move by investors out of equities and into more conservative money market and fixed income products. Indeed, these asset classes provide a comfortable return profile with more predictable returns, and they have rewarded investors with positive returns over the past few years.

Has this been an appropriate course of action? Time will tell, of course, but we wouldn't rule out a comeback for the unit trust industry, especially given that the largest casualty has been the multi asset/balanced funds which used to take the lion's share of industry flows. Despite disappointing performance from local risk assets and balanced funds in the recent past, we believe that investors with a medium- to long-term horizon need exposure to these assets to generate inflation-beating returns. We also believe that investors run the risk of not achieving their financial goals if they move between different asset classes based on short-term performance.



Source: ASISA as at 31 October 2018. Excludes flows into Money Market.

Looking forward – the bigger picture

As we enter the final month of 2018, perhaps the core message is that beaten-up assets can do surprisingly well going forward. Many forget the important role that starting valuations play when judging the ability of assets to generate above-average future returns. So, where does that leave us? In the short term, it is anyone's guess (we've never claimed to have a crystal ball), although we can see some interesting opportunities presenting themselves when looking purely at valuations.

Value. The economy is not the market. What matters most is to not overpay for a stream of long-term cash flows. Many domestically-focused businesses remain out of favour due to the persistent gloomy economic outlook in South Africa. With the possibility of policy reform geared towards the goal of economic growth, we are aware (albeit with caution) of any unlock that could potentially materialize from purchasing these assets below fair value.

- **Risk**. Risk is the permanent loss of capital. In buoyant market conditions, we must not be distracted by any euphoric claims or the general feeling of calm. Similarly in difficult markets, we must not be tempted to react to noise and market volatility. Our process is aimed at unlocking value from unloved areas by focusing on what we can control – incorporating a disciplined long-term valuation-driven approach.

► **Diversification.** While value exists in certain areas of our market, we are conscious of staying true to our disciplined investment process, thereby minimizing the ill-effects that behavioural biases can have on investor outcomes. Our asset allocation framework provides a tried and tested method for building portfolios that is not reliant on one market outcome. Our view is that a diversified portfolio tilted towards asset classes with higher future expected returns, within appropriate risk constraints, provides the best chance of delivering outcomes in line with our investors' objectives.

There's no doubt that the current market conditions are unsettling for some. It is at these moments that we would discourage investors from making changes that could harm their ability to reach their financial goals. It is often during these difficult times that we have the greatest opportunity to add value for our clients, acting rationally when others struggle to do so.

Risk Warnings

This commentary does not constitute advice and is supplied for information purposes only. Morningstar Investment Management South Africa cannot guarantee positive results from our investment decisions, and we cannot guarantee that our portfolios will meet your objectives or that losses will be avoided in any of the portfolios. Any investment's future performance could differ greatly from its past results, and this difference includes a potential for losses, which may cause portfolio values to drop.

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