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Talking Points
The year ahead | Will hindsight be 20/20? Or will 2020 surprise us all?

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For Financial Advisors and their Clients

As the expression goes, hindsight is 20/20, meaning it's easy to know the right thing to do after something has happened, but it's hard to predict the future. Enter the year 2020, and it's interesting that the saying has never been truer in the area of investments.

It's no secret that the past few years have been hard on South African investors. Looking ahead into 2020, there are some noticeable dark clouds looming on the horizon and many are wary of what it may bring. Should investors be preparing for a light drizzle or a full-on hurricane? 2019 was yet again a relatively bumpy year for equities but the asset class still managed to deliver solid inflation-beating returns for the year. Unfortunately, the rand remains weak and a Moody's downgrade remains likely. On the global front, the trade war between the world's two largest economies continues and the US will soon start to gear up for its next presidential election.

What are the key hindsight "20/20" lessons to take into 2020?

Separate bad news and emotions from investing

Every year holds bad news, dramatic headlines and things to worry about. It is safe to assume that 2020 will be no different. When investors are faced with negative or sensationalist news, it's hard not to worry and/or not to react. Even though acting on these calls to action may give investors a sense of control in the short-term, it is the surest way to destroy wealth in the long-term. It would serve investors well to remember that concerns and uncertainties surrounding the future, is most likely already priced into any associated assets.

Steer clear of regret and envy

There have been many quick win strategies and "hot tips" over the years and this will likely continue. As long-term investors, Morningstar tends to steer away from "hot tips" and rather remain focused on fundamentals. Although that might mean missing out on the occasional quick win, we prefer to stick to our knitting and stay true to our long-term view.

There will always be someone, some fund, some share or some investment strategy that did a lot better than yours (whether it be through luck or skill) and you may regret missing out. Fear and panic can force investors into making mistakes with their money, with envy being even more destructive.

Let's look at some of the possible 2020 events that are worrying investors and what the impact could be on portfolios:

What would a downgrade mean for South Africa?

A downgrade to sub-investment grade from Moody's would result in South Africa losing its place in the Citigroup World Government Bond Index (WGBI). This could translate to a forced selling of South African

bonds by international investors that are mandated to only hold investment-grade bonds. The rand could potentially weaken against the US dollar due to foreigners selling local bonds.

With that said, the WGBI is not the only government bond index. Should South Africa fall out of the WGBI, it would be included in several other global indices that only include countries that are sub-investment grade. In other words, as some investors would be selling South African bonds, there would be a host of foreign investors that would be buying local bonds. At a portfolio level, there may be a short-term movement in the currency and bond yields might spike but over the medium-term this would settle, and the current yields would have more than priced in this risk. In so doing, investors would be compensated for an overly pessimistic outcome.

If the downgrade will have such a big impact on government bonds, should I remain invested?

Market pricing suggests that a downgrade has already been priced into South Africa bonds (given that they are offering investors a real yield of close to 4%). It is possible that yields creep higher on the day of the downgrade, along with a weaker rand. Remember, if bond yields rise, it results in capital losses for bond holders, however, investors are being paid roughly 9% a year in yield to compensate for this potential risk. Rising yields could also create buying opportunities for investors. Times of panic and stress often present golden opportunities to enhance returns if one can price risk appropriately.

Moreover, once South Africa is downgraded, investors that invest in sub-investment grade options will start allocating to South African bonds. This, combined with the fact that nearly 60% of European debt is yielding negative returns, would be a great opportunity for foreign investors.

Morningstar is seeing good value in South African government bonds as well as select South African equities, which appear to have the pessimism and bad news priced into it already.

I've been told for the past three years not to move to cash, where you could have gotten 7% a year. Why should I remain invested and not move to cash now?

Having a portion of your investments allocated to a cash component is part of a well-diversified portfolio. During turbulent times, people tend to seek safety and surety, which is something that cash investments offer. Investors should consider the cost they would be paying to switch their investments to cash and the risk associated with holding too much thereof.

Historically, over the long-term, equities continue to outperform cash. Cash may provide security in the short-term, but one must remember that it also has its risks. Cash is subject to inflation risk, and if the value of your investments does not keep up with inflation, you will lose value and purchasing power.

Conservative investors in a cash plus or a cautious portfolio still have to manage growth assets and ensure that the yield of the total portfolio is in line with that of a money market. If an investor has a longer than a 12-month time horizon, he/she is likely to get capital growth from the underlying assets.

The bellow graph illustrates the rolling five year return of the JSE relative to the rolling five year return of cash and highlights how unique the last few years have been, with cash outperforming equities for a sustained period. However, it is clear that equities deliver substantial returns over cash over the long-term.

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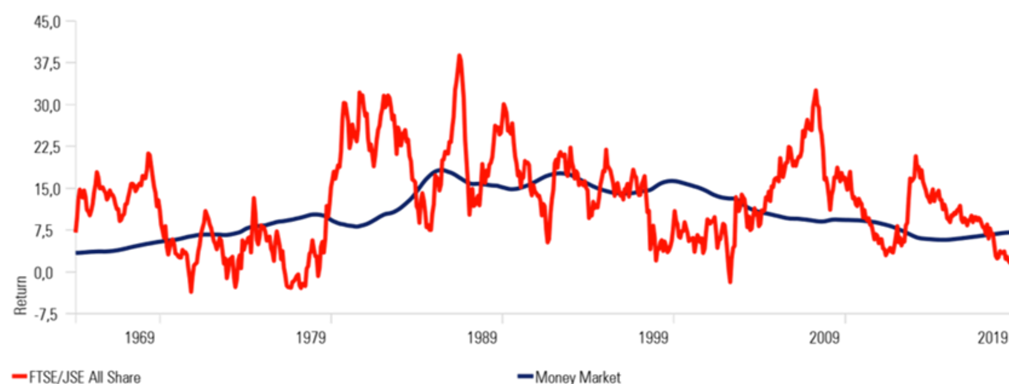

Source: Morningstar Direct, FTSE/JSE All Share PR and Alexander Forbes Money Market

What will 2020 hold for equities?

While no one can predict the outcome of what will transpire in the year to come, the best thing investors can do is to remain disciplined, focused on valuations and identify opportunities in unloved, well-priced asset classes. In this context, volatility in market prices should be welcomed. A drop in price can create opportunities for managers who hold cash to buy assets that are significantly underpriced relative to their long-term fair values, thereby sowing the seeds for future returns.

With that said, the biggest worry at the moment is the impact that trade wars are having on global growth. This remains a severe area of concern as global world trade accounts for roughly a third of the global GDP. A slow-down in world trade will impact global growth, which will affect all countries and economies.

Currently, in the global landscape, large cap US equities are looking expensive (earnings have not been able to keep up with the prices these equities are currently trading at), so Morningstar has been building exposure to unloved areas of the market such as UK equities, Japan and US cash.

A tried and tested philosophy of not overpaying for assets that people have fallen in love with (as a result of some form of sensationalism) has rewarded investors handsomely in the past. Keep an eye on the fundamentals - often bad news is in the price, offering an attractive entry point for long term investors. This is, however, easier said than done. It is much easier to buy something that makes you feel good - even if it's expensive and unlikely to repeat its recent return run.

When thinking about the valuation opportunity in select South African equities that have been battered over the past five years, it is impossible to predict when unloved areas of the market will turn around and deliver returns – nobody rang a bell on the 9th of March 2009 and said the crisis is over, let's go markets!

Looking at the next decade

President Cyril Ramaphosa's investment drive to raise $100 billion worth of investments into South Africa, continues to be keenly watched by South African market participants and businesses. At the 2019 Africa Investment Forum, 56 deals worth $67.6 billion made it to the boardroom discussions at the forum.

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According to the Africa Investment Forum statement, this is an increase of 44% compared to last year. Of the 56, 52 made it to approval. The deals secured investor interest worth $40.1 billion. Rectifying the economic decay and low confidence that has built up over the past decade will take time. Make no mistake, this will be a multi-year process, but it has started.

Portfolio construction and/or investments should always be approached keeping an investor's time horizon and risk tolerance in mind. Morningstar's portfolios have exposure to areas of the market where we have high conviction, but we also remain diversified. While diversification may feel silly in the short-term, the reality is that it does pay off in the long-term.

Morningstar's asset allocation framework provides a tried and tested method for building portfolios that are not reliant on individual market outcomes. In our view, a diversified portfolio tilted towards asset classes with higher expected returns - within appropriate risk constraints - provides the best chance of reaching our investor's return objectives. We do not try and predict the future and rather focus on finding asset classes/opportunities that are undervalued.

While market conditions are both challenging and uncomfortable, it is exactly times like this that investors should be encouraged to stop, pause, and use evidence and perspective as their guide.

As counterintuitive as it may feel, sitting on one's hands and doing nothing really is the best action one can take at the moment. Achieving positive portfolio outcomes continue to be Morningstar's long-term focus, which is driven by a willingness to be different from others and applying a disciplined investment approach.

The above factors once again emphasise the need for investors to remain patient, stay the course and avoid making investment decisions in a panic. It is during these challenging investment times that investors should remove emotions from the investment decision-making process and focus on the fundamentals. M

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