Is there still value in local equities?

Morningstar Investment Management South Africa

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After years of drought in the local equity market, some green shoots finally started to appear after the 2020 crash. Local investors are however facing a challenge - going forward, will local still be lekker or should investors be venturing more into offshore equities? Which equity markets are offering investors the most attractive returns at the moment? What are the key risks of allocating capital to those markets and how can equity portfolios be positioned to balance the trade-offs between risk and return?

At the 2021 Morningstar Investment Conference, I had the privilege to sit down with Chantelle Baptiste (Fairtree), Chris Freund (Ninety One) and Shaun Le Roux (PSG Asset Management) to discuss local and global equities. In this panel discussion, I was again reminded of how volatile and uncertain equity markets can be, and how the best opportunities can often be found in less popular and unloved parts of the market.

The past 20-months have been unprecedented. Markets bottomed out, only to recover to historic highs. Just when you think you know what will happen next, the ballgame changes. It's no wonder investors often don't know which way to turn to and sometimes seek safety in cash-like instruments.

Let's first unpack the views from these panellists on equity markets from a global perspective.

Growth is slowing down
Let's face it - it was mathematically impossible for growth to continue the way it did. It is clear that growth is slowing down, but Ninety One believes that equities are still very likely to outperform other asset classes. Periodic setbacks however are very likely to continue and keep on "testing your mettle", as Chris Freud put it.

Expect higher inflation and interest rates hikes (but it won't upset the applecart)
The question everyone has been grappling with - Is inflation transitory or more structural in nature? Only time will tell, but there continues to be upward pressure on wage inflation, especially in the US at the moment and the Fed will likely start to raise interest rates in the new year.

The consensus seems to be that as long as the Fed does this in a structured and sensible way, it is unlikely to upset the applecart.

Geopolitics remains an issue

The tension between the US and China continues, the tension in Afghanistan claimed its fair share of airtime and we continue to witness social unrest and riots across the globe.
Isolation and social media accentuated the status quo, social imbalances, and governments continue to be criticised for how they are handling the pandemic. People are fed up, tired and over rules and regulations that don't seem to be moving the needle.

Now, let's look at local equities.

It's as good as it gets for a differentiated stock picker in South Africa
In South Africa, every now and then a strange thing happens where everything goes on sale – as was seen in 2003, 2009, 2020 to name a few examples. PSG compare themselves to "kids in a candy store" when opportunities like this arise, and March 2020 was no different. On a forward-looking basis, PSG still believes that there are fantastic businesses in South Africa that will continue to do well and are trading well below their intrinsic worth.

Fairtree also believes there are some remarkable opportunities left on the local front in retailers, Naspers and Prosus and especially resources. Naspers is a share that has been deeply out of favour for some time now. Management has been under pressure to close the valuation gap, and recently you have had a lot of Chinese regulation noise in the mix. China is also our biggest trade partner and the largest consumer of commodities. Over the next 18 months, more volatility is expected due to these uncertainties coming from China.

For Ninety One, local banks are the standout opportunity from a valuation perspective. They are well capitalised, and the dividend yields on offer are especially attractive.

Plenty of global opportunities
Even though parts of the market are trading at extremely lofty valuations and in some cases near all-time highs, opportunities remain. Globally, we have witnessed a large divergence in the performance of equity markets, and this is even more visible between developed markets and developing markets. Financials, energy, and brewing companies are all opportunities that panellists were excited about.

What about risks?

Be aware of crowded trades: PSG warns against having too many long-duration assets that are very sensitive to interest rates in your portfolio. An example of this is owning US technology at all-time highs, especially with interest rates are at historic lows.

Focus on portfolio diversification. Fairtree unwrapped the merits of gold as a potential portfolio hedge. Gold has historically shown a low correlation to traditional asset classes and can provide downside protection in a scenario where inflation becomes more permanent.

In closing

The past two years have been extreme and equity markets took investors for a wild ride. Sticking to a repeatable philosophy, process, and plan is much harder to do when things get tough. Investing is about putting emotion aside, taking a long-term approach and realizing that with volatility comes opportunity. K

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