Discovery Invest

September 2010

Chris Freund
Portfolio Manager

Stock-picking dominant in this grind phase of the equity market

By Chris Freund, portfolio manager of the Investec Balanced Fund
September 2010

Markets have been very volatile over the last few months, which is typical of the grind phase of the equity market. This phase is now well established and it could take between 12 and 18 months before we enter the optimism phase of the market, which usually offers better equity market returns for investors.

For now, we need to remain patient, waiting for company profits to 'catch up' with share prices. Equities have already risen in anticipation of better company earnings in the future as the economy showed signs of a recovery. Now companies have to deliver on earnings to justify their ratings. The market also needs more certainty that the recovery is sustainable: job creation, income growth, the financial well-being of consumers and private sector capital expenditure are all key barometers to gauge the health of the economy.

At this stage, the recovery remains anaemic; consumers have had to tighten their belts and are paying off debt, and companies are not investing much. The only 'spenders' at this stage are governments, and they are running out of firepower. Interest rates are likely to stay lower for longer to help consumers, companies and the government to regain their economic strength.

We're not a bear in a market

Lower interest rates are generally good for stock markets and even though the global growth cycle is likely to be slow and subdued in the developed world, it should still be positive. We are probably closer to the beginning of this economic growth cycle than the end of it. Although we are not in a bear market, we don't expect runaway returns. Therefore, the Investec Balanced portfolio's equity weighting is slightly underweight – at around 60%. We usually follow a top-down and bottom-up approach to stock selection, but depending on market conditions, one approach could be more dominant than the other. During this grind phase of the market, bottom-up stock-picking (evaluating a stock on an individual basis) should continue to drive the portfolio's returns, rather than broad themes or sector picks. Our core investment philosophy is to buy companies with improving profit forecasts at a reasonable valuation.

Sasol is biggest share in portfolio

This is the first time that Sasol is our biggest equity position. The company is in great operational shape, thanks to the management that has addressed production issues.

Out of the Ordinary®
Investec
Asset Management

Management now seems to be performing well, which should help to improve the market's perceptions about Sasol's leadership team. We are also positive about the oil price; energy demands from China should provide a boost.

The second biggest stock we have is MTN and this is a very significant move because we had a very underweight position in this counter for many years. Management has now acknowledged that MTN is no longer on a high growth path and that the company has entered a more mature phase in its life cycle.MTN's growth rate will probably settle down to between 10% and 15%. This mature phase is likely to have some positive spinoffs in respect of capital expenditure. For instance, the company should need to spend less on new masts and base stations. MTN's cash flow is therefore expected to increase materially, putting the company in a position to declare higher dividends. This should be good for shareholders.

Old Mutual remains a relatively big holding in our portfolio. The company still has some issues that need resolving, but we think these are more than reflected in the current share price. The sale of Old Mutual's US life company should unlock significant value. If HSBC's bid to buy a 70% stake in Nedbank is successful, this should also add value.

Banks feeling the squeeze

The banking sector remains under pressure. Economic growth is still weak and the consumer recovery is expected to take time. With the exception of FirstRand, the earnings outlook for banks is disappointing. Banks are lending out less money than anticipated to consumers and companies, so their profits are not growing as fast as expected. We have materially reduced our exposure to this sector. FirstRand, which has the best earnings outlook, is the only bank which forms part of our top ten equity holdings.

The portfolio benefited significantly from the take-out of Dimension Data by Nippon Telecoms in July.

Our decision to build a position in Dimension Data wasn't based on a possible take-over bid, but on the company's earnings prospects. We anticipated that we would reap attractive returns on the stock over a one-to-two-year period, given expectations of good earnings growth. The Nippon telecoms transaction meant that we essentially realised this value over a month as the stock went up by 20% in one day.

On the retail front, we have a large holding in Clicks. The retailer's in-store pharmacies have boosted trading densities, helping to drive up profits. Clicks is a good growth story; the company will continue to add pharmacies to its stores. Woolworths, in which we also have a holding, seems to be managing its clothing offering better. The company's results have been pleasing and the business is gaining market share.

Macro conditions favourable for gold

Gold Fields is the major gold share in the portfolio. We don't normally have a big weighting in gold, as the direction of the gold price is hard to predict. However, the macro conditions at present seem to be favourable for gold. Many debt-laden countries are attempting to devalue their currencies to try and export their way out of trouble. Gold is attractive as an alternative currency as it cannot be devalued. Interest rates are also low around the world, so the opportunity cost for holding gold is minimal. Our long-term view on platinum is positive. Four South African companies control approximately 75% of the world's global platinum supply. Healthy demand and tight supply conditions should continue to boost the metal. We have a material holding in Impala Platinum. With regard to our offshore exposure, we hold the view that global equities are more attractive than global bonds. Consequently, we have an overweight offshore equity position. The portfolio has a full weighting in offshore assets (20%).

Government bonds are starting to look expensive

Central bankers in developed markets continue to signal that short-term interest rates are likely to stay at the current emergency low levels for an extended period, as inflation shows no signs of picking up and economic growth is still very fragile. There has been a huge demand by foreigners for emerging market bonds because they can earn a much higher yield than in developed bond markets.

Our bond market has also seen massive foreign inflows and has enjoyed strong gains. We anticipated the search for yield many months ago, increasing the portfolio's weighting in SA bonds to 25% in the first quarter. At that stage, most of our peers still had a bond exposure in the region of 10%-12%. This move paid off, significantly contributing to the portfolio's performance. We have made capital profits in bonds well in excess of cash. Government bond yields have now fallen to levels that don't offer much protection to investors should negative news hit the market. Consequently, we are reducing our government bond exposure, selling bonds into strength. The yields offered by corporate bonds are still attractive and we will maintain our exposure to credit.