

Monthly Newsletter – March 2016

A Message from Theo and Warren

What now?

The world is in a major state of flux and we have not seen many optimistic forecasts from respected analysts about global growth prospects for 2016. As investors, we are becoming increasingly comfortable with the state of local and international equity markets.

Valuations of companies are becoming more reasonable and many investors are starting to forecast “the end of the world” scenarios again. This means that we are starting to see opportunities to buy quality assets at good prices. This was certainly not the case at the start of 2015 when markets were near their long-term highs while the global economic situation was rapidly deteriorating.

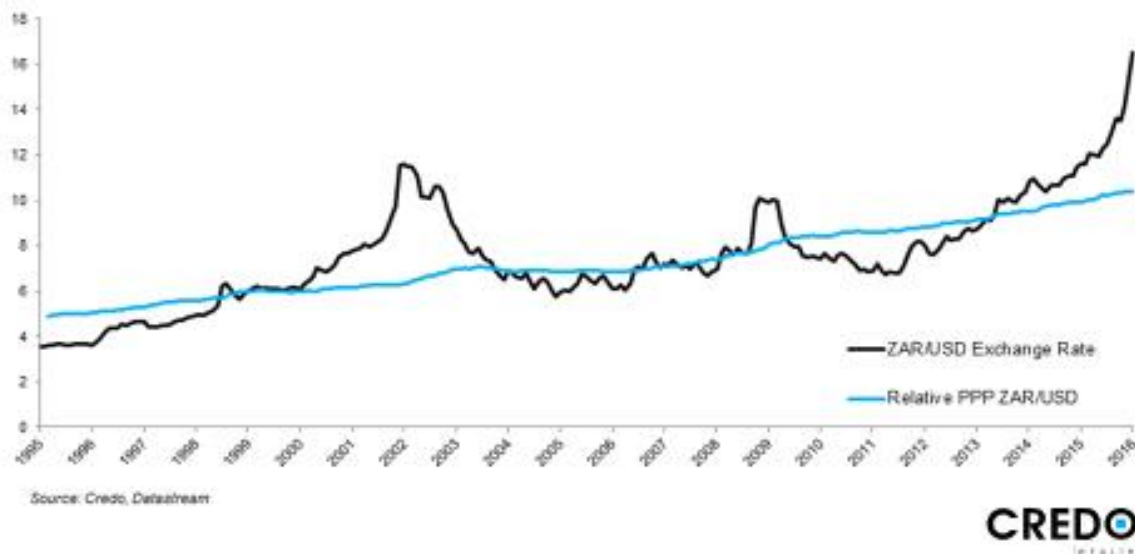
In times like these it is important to remember that the markets always look forward. Some investors will be in a perpetual state of gloom where they believe things are going to get continuously worse with little possibility of recovery. It is easy to see why they would feel this way and many such investors will have intelligent reasons for their predictions.

Similarly, those of us who believe in mean-reversion will be criticised as unrealistic optimists who are smoking some really good stuff. Naturally we will be similarly criticised when we start to become bearish in good times. In simple terms, believing in mean-reversion is a bit like believing in gravity – what goes up must come down. If something goes up for too long then the likelihood of a significant correction increases.

If you were to graph the rand/US dollar exchange rate since 2011, you would see that it has moved in a nearly straight line upwards. This means the potential for a reversal of this trend is increasing all the time. That is not to say that the rand will recover to R5/\$ but a significant recovery from R16 is likely.

You will note from the graph below (courtesy of Credo Wealth), that the rand is on a long term decline against the US dollar (blue line) but current levels are simply overdone (black line).

Relative Purchasing Power Parity – ZAR/USD



This does not mean that the rand will start recovering immediately, as there are still some significant events such as the municipal elections and potential ratings downgrades that might impact it in the short term. However, if the rand recovery is of the same size and duration as experienced in 2002, investors who sent all their money offshore at R15 or R16 to the US\$ could be in for a torrid time.

What drives the rand?

RMB Global Markets did some research on the factors affecting the rand. They found there are three broad categories: US\$ strength, commodity effects/global risk appetite and South African specific issues. Our interpretation of “South African specific issues” would be domestic politics, economic policies, corruption, etc.

RMB found that since July 2011, South African specific factors account for 41% of the rand’s move: ie. R3.45 of the current R16 level. Over longer periods, ie. since the year 2000, these factors have accounted for 42% of the rand moves. Commodity and risk issues account for 27% and US\$ moves account for the remaining 31%.

As RMB says, when we think about the rand, we should give a 60% weighting to international factors and 40% to local factors. At present, it would seem that many investors are allocating 80% or more to local factors, which could be detrimental in the long term.

If history repeats itself it is likely that the US\$ strength will decline and appetite for commodities will increase, which will drive the rand’s recovery. In the longer term, we believe that all our clients should use this potential rand strength to increase their offshore allocation significantly. This is a theme that we will discuss with you in our meetings, but we do believe that the Nene issue has increased our offshore focus substantially.

We would like to stress that the rebalancing of offshore exposure might take place over three years or longer and large changes should not be done in the short term.

Share update

Here are some brief comments on companies that feature in Galileo Asset Managers portfolios. We prefer to be positioned in businesses that hold some kind of advantage that will see the company (and the share price) through day-to-day noise.

Although we manage a portfolio as a composite entity we have produced this note to help our clients understand our thinking behind our share selections.

Anglo American

An iconic South African Company, Anglo American is a global and diversified mining business in iron ore, manganese, coal, copper, nickel, diamonds and platinum. Group mining operations and marketing activities extend across Africa, South America, Australia, North America and Europe.

Some poor CEO choices saw the company lose traction in recent years, but we believe current management is taking the right steps to re-orientate the company and unlock significant existing value to shareholders. Recent results certainly showed that times are tough, but they also showed that a combination of “high-grading” (going after the higher grade ores) and cost cuts (capex was massively reduced) should see them through.

Why invest in this sector when things are so tough? Well, on the Anglo share, one can buy \$21 of assets for \$6. That’s pretty cheap.

Standard Bank

Standard Bank (which also trades as Stanbic Bank across Africa) is a financial services group with a unique footprint and long history. Their African franchise is large and diverse, and only Barclays comes anywhere close.

Their strategic positioning enables them to connect Africa to other emerging markets and pools of capital in developed markets. The wide portfolio of businesses and skills provide many opportunities to grow. The world’s largest bank (China’s ICBC) is a 20% shareholder, enabling a strategic relationship that connects Standard Bank to the world's most important growth economy.

The recent sale of the troublesome UK business has also allowed the group an important opportunity to refocus. This is evident in the latest trading update, which notes that earnings to be announced soon will be up at least 25%. At current levels, the share is not far above book value – which, for bank shares, is very cheap indeed.

Insights from Warren Buffett’s annual letter

Longstanding clients will probably know that Theo and Warren are both Buffett groupies. Here are some great insights from Buffett’s latest letter to his shareholders, as summarised by SmartCompany in Australia.

Billionaire Warren Buffett has taken a veiled swipe at US presidential hopeful Donald Trump in his much-anticipated letter to shareholders this weekend.

The businessman and investor's annual letter to shareholders is always a highly anticipated event thanks to his frank observations about life, business and politics.

It also helps that Buffett is one of the richest people in the world, and has a wealth of business knowledge to share.

Here are four things to take away from Buffett's most recent letter to shareholders.

1. Politicians who say America is no longer great are "dead wrong"

In his letter to shareholders, Buffett points out it is an election year in the United States and candidates "can't stop speaking about our country's problems".

"That view is dead wrong," Buffett says.

"The babies being born in America today are the luckiest crop in history. American GDP per capita is now about \$56 000. As mentioned last year, that – in real terms – is a staggering six times the amount in 1930, the year I was born, a leap far beyond the wildest dreams of my parents or their contemporaries."

2. There are countless products and business out there just waiting to be invented

Buffett says America will continue to innovate, despite some presidential hopefuls talking about how the country has lost its way.

He says capitalism, more than ever, has proven itself to be the best system for producing products and services people want – or don't yet know they want.

"My parents, when young, could not envision a television set, nor did I, in my 50s, think I needed a personal computer," Buffett says.

"Both products, once people saw what they could do, quickly revolutionised their lives. I now spend 10 hours a week playing bridge online. And, as I write this letter, 'search' is invaluable to me. (I'm not ready for Tinder, however.)"

3. To be successful in business, you simply need to diversify your income streams and avoid unnecessary risks

In his shareholder address, Buffett points out his business – Berkshire – is far more conservative when it comes to avoiding risks than other insurance companies.

"For example, if the insurance industry should experience a \$250-billion loss from some mega-catastrophe – a loss about triple anything it has ever experienced – Berkshire as a whole would likely record a significant profit for the year because of its many streams of earnings," he says.

"Meanwhile, other major insurers and reinsurers would be swimming in red ink, if not facing insolvency."

4. Everyone makes mistakes – and that's okay

Buffet's letters are an entertaining read precisely because he is not afraid to criticise himself.

In the 2016 shareholders' letter, Buffett says his company has operations that sell everything from "lollipops to jet airplanes", but not all of them drive the same returns.

"A few ... and these are serious mistakes I made in my job of capital allocations – have very poor returns," Buffett says. "In most of these cases, I was wrong in my evaluations of the economic dynamics of the company or the industry in which it operates, and we are now paying the price for my misjudgements".

"I will commit more errors; you can count on that. If we luck out, they will occur at our smaller operations."

- Theo and Warren