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Fourth Quarter 2012

**Surprise, surprise...the economy in 2012 remained stagnant
but the equity market flourished**



By Daniel R Wessels

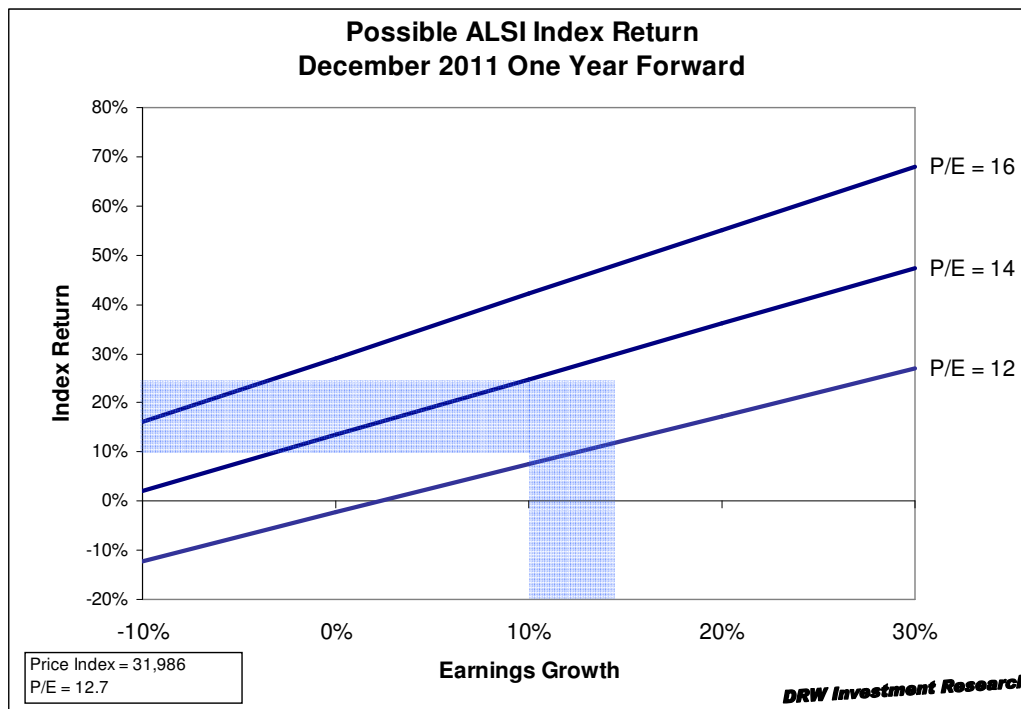
I've said it many times before – little evidence actually exist that there is a strong linear relationship between economic growth and stock market returns. Yet, when we read media reports and market comments, one invariably will find that the predictions for stock market returns is closely linked to forecasts how the economy will perform in the next period. The reality is that stock market returns are only somewhat related to economic growth, but the latter is not a very accurate predictor of the returns the stock market will yield.

A much better way, but not infallible, of looking at possible stock market returns for a next period is to consider the three components of equity return, namely dividends, earnings (or dividend) growth and possible changes in market rating (price/earnings multiple or dividend yield). The payout of dividends, more specifically the dividend cover is somewhat constant or reliable over time – companies do not easily lower their dividend payout ratio unless very good reasons exist and are communicated in advance to their shareholders. Companies' earnings growth is less reliable – quite often we find surprises to the upside or downside – yet it is possible to use a reliable range of expected earnings growth, especially if one is aware of the specific business cycle at the time. The real tricky part is to predict the market rating going forward – in fact, it is near impossible to guess market sentiment, say, one year from now – at best one can use historical ratios as a benchmark. Unfortunately, the changes in market rating often have the largest influence on total returns, especially over shorter term horizons (In the long run, however, these changes in market rating have a subdued influence only).

For example, let me briefly explain how I assessed the stock market one year ago. At the time the All Share Index (ALSI) was just below 32,000 with a P/E rating of 12.7 times. In my model looking 12-months ahead I used a baseline earnings growth of 10% to 15% for the next twelve months. I expected the market P/E rating to end between 12 and 14 times, which was in line with the long-term average P/E rating of the stock market.

The graph below shows that a reasonable return expectation for the next twelve months was anything between 10% and 25% - indeed, a wide possible

range of returns, but nonetheless not projecting any negative returns which incidentally many investors (perhaps unfoundedly) feared at the time.



Source: DRW Investment Research

What transpired over the next twelve months (ending 31 December 2012)? The ALSI delivered a total return (capital gains plus dividends) of 26% – earnings growth came in at a modest 6% for the year while the lion share of the gains was attributed to the change in market rating – up from 12.7 to 14.8 times earnings.

On both accounts (earnings growth and market rating) I had my predictions slightly wrong (as one can expect when making projections), but overall I came close enough. The point is: While stock market returns are in essence unpredictable, yet with the “right tools” at one’s disposal one does not have to succumb to a feeling that one is solely dependent on Lady Luck, or if you like, there is a “method in the madness”.

Next, when considering the different sectors of the market, it is noteworthy that industrial stocks were the star performers and on average delivered more than 40% for the past year. Resources stocks, however, were a distinct underperformer and only yielded a mere 3% on average.

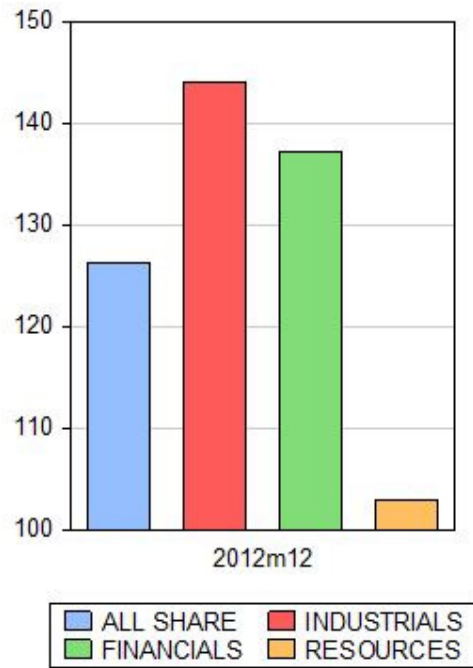
Performance	J200T	J210T	J212T	J211T	J253T
over	Top40	Resi 20	Fini	Indi	Property
1 Month	2.8%	2.9%	6.6%	1.9%	0.3%
3 Months	10.9%	7.1%	11.2%	13.2%	2.8%
6 Months	19.3%	10.4%	17.1%	26.6%	14.0%
12 Months	26.1%	3.1%	37.8%	44.5%	35.9%

Source: DRW Investment Research

I quote from a recent *Investec Wealth & Investment* bulletin¹: “Clearly, investing in the right sectors (as well as the right stocks) is very important. As we show in the chart below, such differences in performances are not unusual. The JSE Industrial Index realised 40% more than the Resources Index in 2004 and 2009; while resources rather than industrials were the right stocks to hold in mid 2006 and 2008. Over the past 10 years industrials delivered much higher returns than resources: R100 invested in the Industrial Index (with dividends reinvested in the index) would have been worth R915 by 31 December 2012. The same R100 invested in the JSE Financial Index would have grown to R522, while the R100 invested in the Resources Index would have grown to a mere R370.”

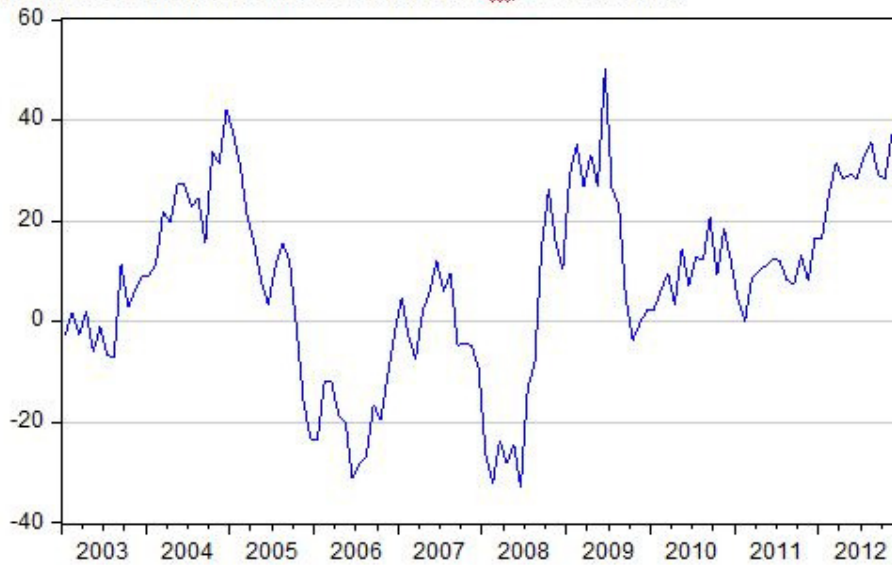
¹ Brian Kantor, 2013. *Investec Wealth & Investment Daily View*, January 9.

Total returns in 2012: R100 invested in the JSE All Share, Industrial Financial or Resource Indexes



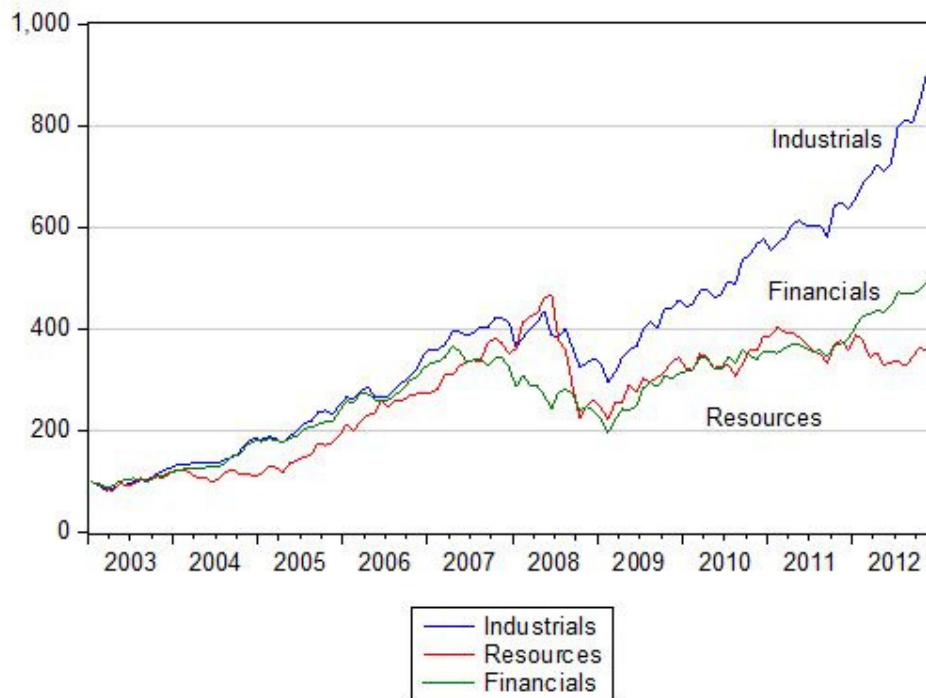
Source: I-Net Bridge and Investec Wealth & Investment

Difference in annual returns: JSE Industrials vs JSE Resources



Source: I-Net Bridge and Investec Wealth & Investment

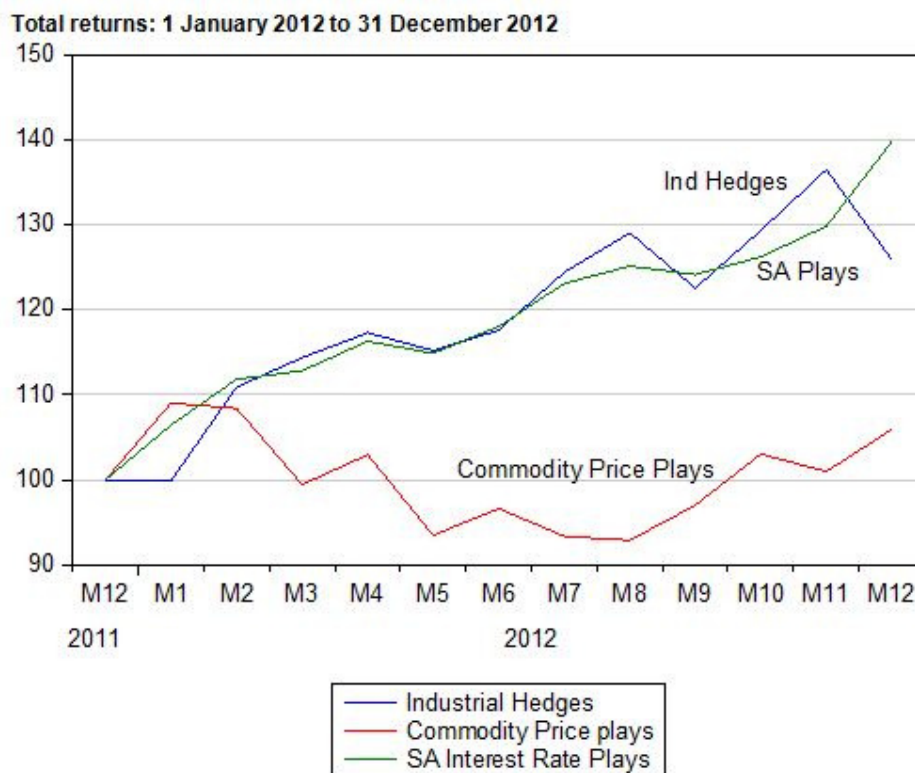
Total returns 2003- 2012: R100 invested in the JSE All Share, Industrial Financial or Resource Indexes on 1 January 2003.



Source: I-Net Bridge and Investec Wealth & Investment

“The Industrial Index is something of a mixed bag. It includes companies that depend very little on the SA economy for their sales and profits. British American Tobacco (BTI), Richemont (CFR), Naspers (NPN) and even SABMiller (SAB), MTN and Aspen (APN) among others fall increasingly into this category of companies much more dependent on global than SA economic growth. We call these companies industrial hedges.

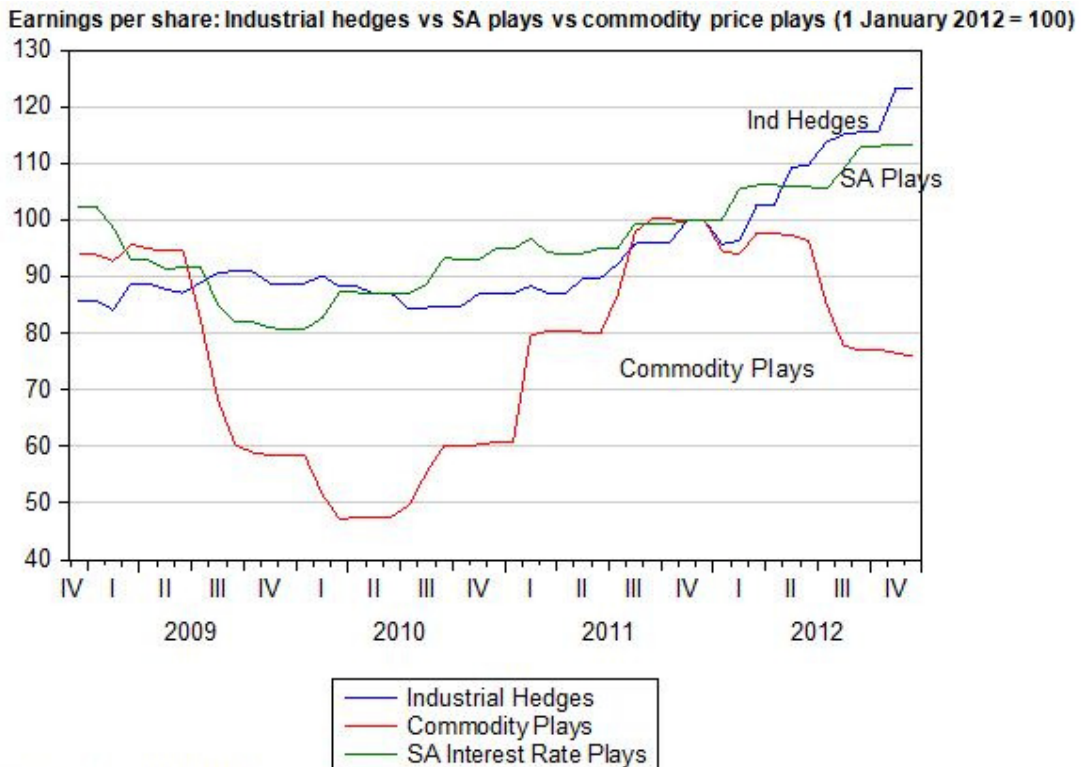
The other industrial companies listed on the JSE we regard as distinctly SA economy plays. SA interest rates have an important influence on their performance. The banks, retailers and listed property companies fall distinctly into this camp. As we show below, the SA plays performed in line with the industrial hedges in 2012 despite a degree of rand weakness. They were greatly assisted by stable and low interest rates.”



Source: Investec Securities and Investec Wealth & Investment

“The superior performance of the industrial hedges and the SA plays in 2012 is explained by the economic fundamentals. The industrial companies delivered consistently strong growth in earnings and dividends while the commodity price plays – resource companies excluding the gold miners –

performed very poorly by comparison, as we show below. The SA plays competed very well on the earnings front, demonstrating consistent and impressive growth in earnings, while the commodity price plays performed poorly and displayed their highly cyclical character.”



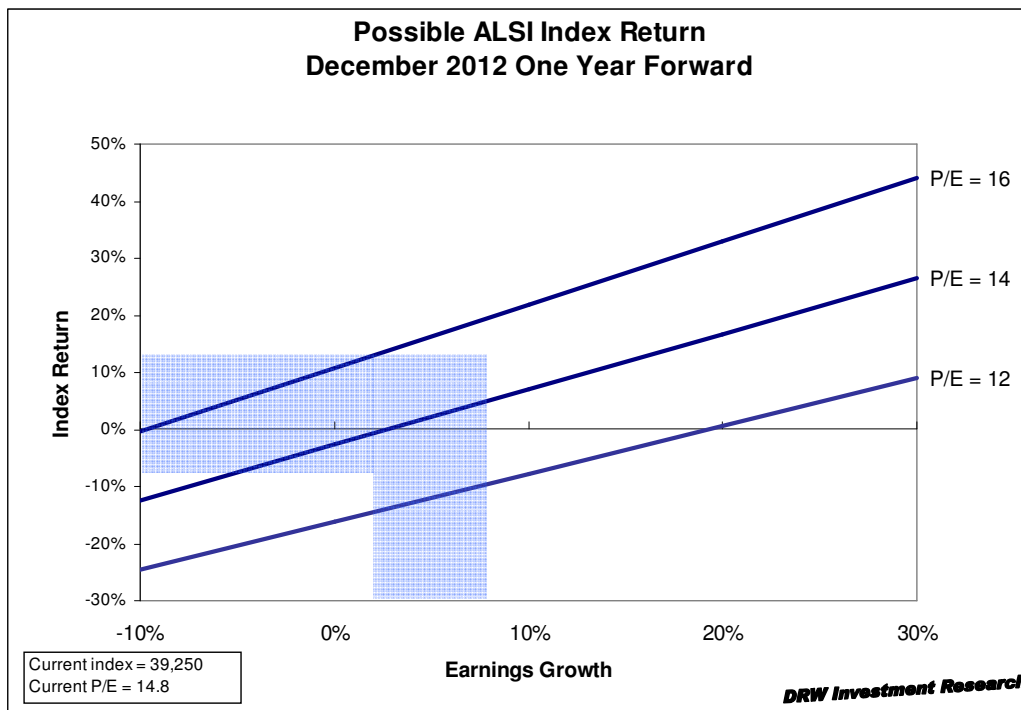
Source: Investec Securities and Investec Wealth & Investment

“It is not flows of funds from SA sources that drive performance on the JSE. The investors that move the market are global investors. They are not comparing value in JSE Industrials to presumed value in Resources. Their frame of reference is to compare SA Industrials with industrial shares listed elsewhere, especially on emerging markets. By this comparison, JSE listed companies offered them value; hence the impressive share price gains. Again, overseas investors will compare JSE-listed resource companies with equivalent counters listed elsewhere.”

What can one expect for 2013?

Investec Wealth & Investment lists, for example, the following considerations: “The case for investing in resource companies has to be made in the form of unexpected strength in underlying commodity prices. The case for industrials has to be made on the basis of sustained good earnings growth, accompanied by persistently low interest rates. A strong global economy, which is necessary to drive commodity prices higher, will also be good for industrial companies. This includes those SA economy plays that would benefit from a stronger rand (likely to accompany global economic strength) and lower interest rates and inflation associated with a stronger rand.”

The *Investec* article concludes: “What the market is not entitled to expect is for stock markets to perform as well as in 2013 as they did in 2012. That indeed would be a very pleasant surprise.” Let us compare this statement with the stock market prediction model I discussed earlier – see graph below.



Source: DRW Investment Research

Clearly, it shows a less optimistic picture than the year before; that is if earnings growth for the market index remains flat over the next twelve months and market ratings will end somewhere between a multiple of 13 and 15 times earnings. Then the market index may deliver total returns of about 12% (high-end of expectations), but note at the low-end of expectations there is still a possibility that the returns will end in negative territory – but less than 10% negative – over the next twelve months.

Finally, on a less serious note, I remind the reader in the following paragraphs to some of those weird and perhaps absurd phenomena observed in 2012 – just to show we do not live in an absolute rational world. I based it on an article written by Max King, strategist and portfolio manager at *Investec Asset Management (UK)*, published recently.

“When the market really loves you (or hates you)...”

- The share price of *Apple* reached \$700 in September which made it the largest company in the world (by market value). At the time its market value was greater than that of all the listed companies in Portugal, Ireland, Greece and Spain added together! An exemplary example of what happens when you are the market’s hot favourite! Subsequently, in recent times the share price of *Apple* dropped below \$500.
- *Facebook* made its long-awaited listing in 2012 and attracted a lot of investors’ hype at the time. But what did the listing really meant for those lucky pre-listing shareholders of Facebook? It is probably best reflected by the story of David Choe, a graffiti artist, who did some artwork for the *Facebook* headquarters back in 2005 and instead of receiving his remuneration in cash decided to accept Facebook shares. Well, seven years later Choe’s shares were worth a neat \$200 million at listing! Even as *Facebook* subsequently lost half of its listing market

value, I'm sure Choe, if he held on to his holdings, has not regret his original decision one single day.

- The Eurozone debt crisis is well-documented and discussed. In fact, since 2010 a total of 20 crisis meetings (summits) have been held. Two remarks summarise most observers' beliefs: "We have invented a machine from hell that we cannot turn off" – an anonymous German official – and "second marriages are surely a triumph of hope over experience" – Samuel Johnson – illustrating that a feasible solution to the crisis will not be reached easily.

"Treat your customers fairly..."

- Greg Smith, a (former South African) *Goldman Sachs* employee caused some major stirrings in the marketplace when he criticised his employer in his resignation letter of a business culture geared only to benefit the short-term profitability of the firm at the expense of the long-term interests of clients. But it is nothing new really. More than seven decades ago Fred Schwed – a former Wall Street stockbroker – wrote a book titled: "Where Are the Customers Yachts?" in which he explained how investors are often exposed to the less prosperous side of the trade.
- The architect of the Securities and Investment Board in the UK, that later became known as the FSA (similar to our FSB), Professor Laurence Gower once said: "My role is to prevent people being made fools of, not to prevent them making fools of themselves". Since then regulatory practice has always assumed that financial products are always mis-sold, never mis-purchased. Well, it is always easier to shift the blame for poor decisions or regulations onto market players...

“The search for low, low yields...”

- In May Germany raised €4.6 billion by issuing two year debt with a zero coupon (interest rate) – the first time ever. With inflation above 2% investors in these instruments are guaranteed to lose money in real terms – hence one commentator noted that government bonds in many developed markets offer “return-free risk” (instead of risk-free returns)!

“An ode to human ingenuity”

A cardboard bicycle has been made with a frame that is stronger than carbon fibre, weighs only 20 lbs, supports riders up to 24 times its weight, is 100% made of recycled materials, a maintenance-free, belt-driven pedal system and will only cost between \$9 to \$12 per unit. Nothing was said, however, whether the cardboard bicycle is rain-proof...

“...Connectivity”

More Indians now have access to a mobile phone than to a toilet in their home. There are now estimated to be 6 billion mobile phones in the world and with 1.2 billion subscriptions it overtook the number of fixed telephone lines.

“...Lead by example”

Jose Mujica, President of Uruguay, has been labelled as the poorest political leader in the world. Apparently his personal estate is worth only \$1,800 – the value of his 1987 VW Beetle. He lives on a ramshackle farm, which belongs to his wife, and gives 90% of his earnings to charity.

“And extravagance...”

Italian parliamentarians are probably the highest paid politicians in the world. For example, they earn twice than their counterparts in France and three times that of Swedish officials. Furthermore, the official residence of the Italian President (the Quirinale Palace) costs four times as much as it does to maintain the Queen in Buckingham Palace. Well, all that but still not really much efficiency in government or the way they manage their finances (or maybe because of that).