ASSET MANAGEMENT

Recent Market Turmoil
11 August 2011

Investors are right to feel nervous. As at 11 August 2011, the US S&P500 Index has fallen some 18% from its most recent high earlier this year and the JSE All Share has slipped by 13%. The 2008/9 sell-off of equity markets is too recent and - by implication - too fresh in the minds of investors and most are asking: will we see a repeat? In 2008/9, the US market fell by 56% peak-to-trough and the JSE by 44%. Since then, the S&P500 clawed back 100% and the JSE 82%, with the latter peaking a few points shy of its previous all-time high, whereas the former was still well short of its all-time pinnacle. The 2008/9 shakeout was driven by the sub-prime crisis, which at its heart had the failure of lending institutions to effectively limit and manage the amount of property-linked debt assumed by the private sector. The equity market downside accelerated with the demise of Lehman Bros and the bleeding was only staunched once the poorer quality debt burden of the banks was taken over by the public sector.

This step then attracted the focus of investors on other highly geared public sectors, with Europe the target because it contained a group of the most profligate government departments who were weak on revenue collection and strong on spending. Suddenly, government debt in certain countries – previously viewed as gilt-edged – was reclassified as junk. Contributing to the uncertainty was the inability of those economies to adjust to their new found status via a debasement of their currency, because they were part of the unified Euro and which perversely strengthened as the bulk of its direction is determined by one country – namely, a highly productive and efficient Germany. Couple these macro economic distortions to the inability of the world's political and financial authorities to provide a macro framework that results in investor confidence and you have the seeds of the current selloff. Instead of a long-term, believable plan, investors are offered one stop-gap after another, building layer upon layer of patches. Eventually though, the hard issues will have to be faced: indiscriminate spending on social security, health and other government handouts will have to be trimmed; the retirement age might have to be lifted and new ways of ensuring employment will have to be found.

In the meantime, should one avoid equities? We don't think so and would like to raise a few issues defending our standpoint:

- Whereas individuals and governments have been slow to react to the rising debt burden, corporates (excluding some well-known banks) haven't. In general, most companies have used the cycle in their favour and have limited gearing. They are well placed to institute buy-backs and increase dividend payouts, or both;

- We would look to those markets where the fiscal and monetary levers still have traction and at quality companies. Emerging economies (and those companies doing business there) have been far more adept at managing the cycle than have their bloated Emerged counterparts. Growth in China and most of the southern hemisphere countries has slowed as rates have risen in response to inflationary pressures, but are well placed to perform once the cycle turns. Although a fall in demand from the larger nations will have a negative impact on the growth rates of the Emerging universe, the latter are less reliant on the former than a decade ago;

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- Certainly, there are vast differences between the 2008/9 selloff and the most recent one. The most compelling is the fact that the markets are considerably cheaper now than previously. So, for example, the JSE stood on a Price:Earnings (PE) ratio of 15.7 in October 2007, when the earlier selloff started. It is currently on a PE rating of 10.6. Earnings growth has risen by over 60% over the intervening period. Similarly, the current dividend yield of 3.4% is significantly higher than the 2.6% dividend yield on offer in 2007. So the value of the market is supportive, with cyclical counters such as Anglos and Billiton especially offering great value.

Equities are risky investments, but this is compensated for by their potential return characteristics. Exactly how this return profile will play out over the next few weeks, months or years is anyone's guess. The macro and micro permutations are almost infinite. That we are in a period of high volatility is however a given. A cardinal rule to investing is diversification and all our equity portfolios have that principle inherent in their structure.

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Portfolio Manager

Cadiz Asset Management is the recipient of the 2011 Morningstar Best Specialist Fund House award. This award recognises our ability to provide superior risk-adjusted returns to investors in all our funds.