Should one hold or sell equities currently considering the market volatility?

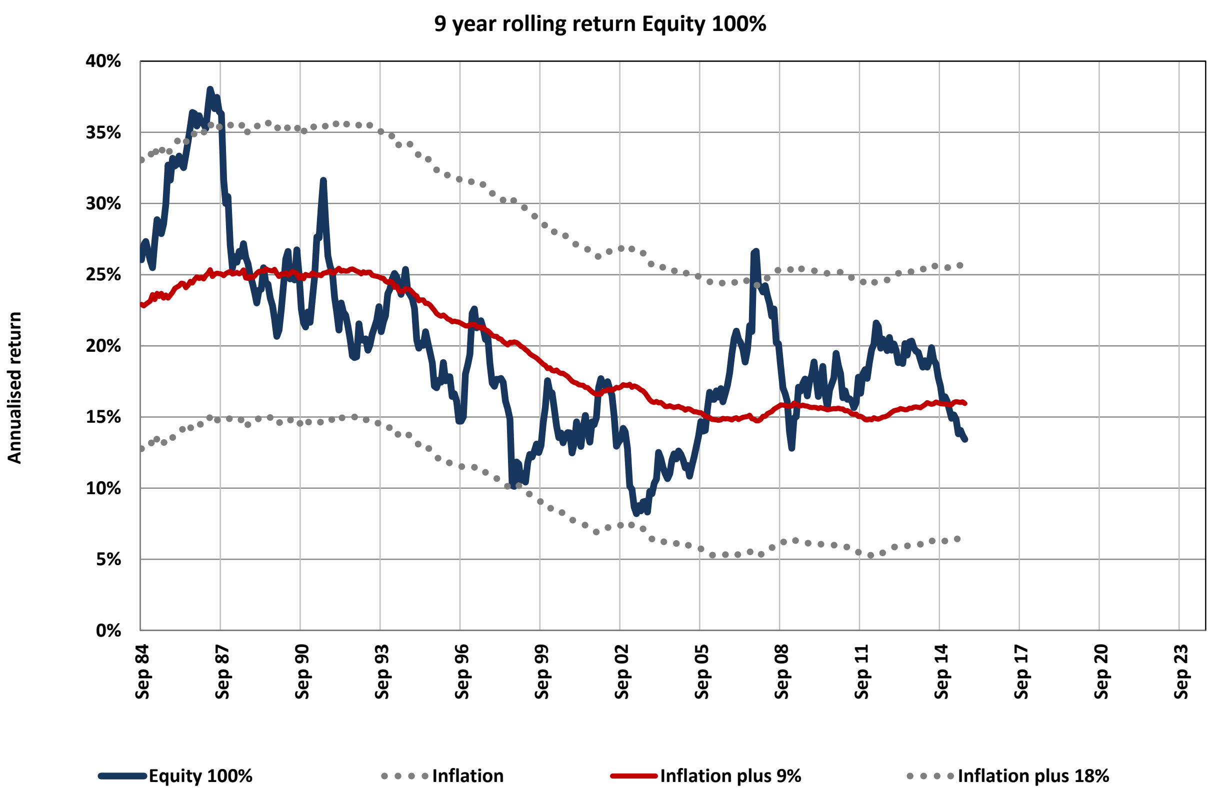
Two concepts are important when addressing this question.

- Time and expected returns – what period of time is reasonable when deciding on investing in equities and what returns should be expected?
- Value versus price – how are stocks priced currently versus what they are really worth?

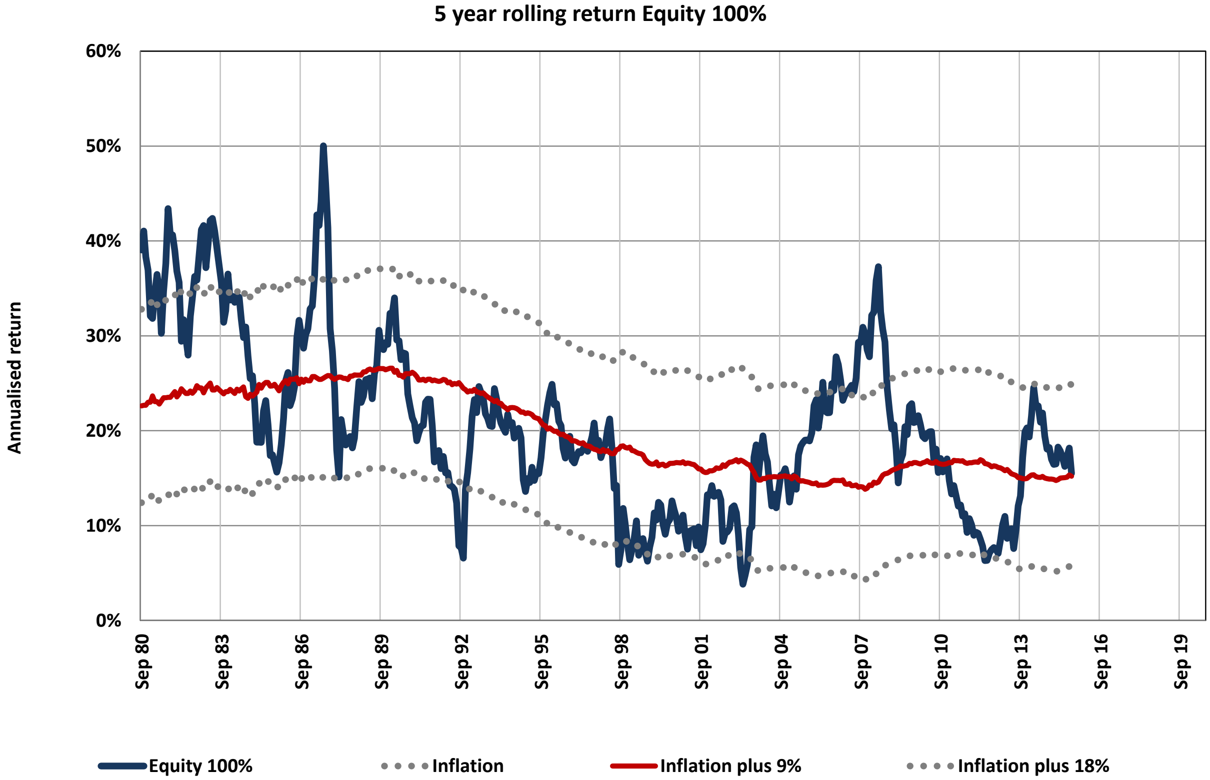
<u>Time – what is a reasonable period of time when making an equity decision and what returns do equities normally deliver</u>?

How long should your time frame be?

From all the analysis Northstar Asset Management has undertaken to assess how long an investor should be prepared to stay invested when equities are the asset class of choice, it is clear that periods less than 9 years heighten the risk of disappointment when real returns are the target.



In the attached graph, we show that all 5 year rolling periods over the last 4 decades has resulted in the JSE producing positive nominal returns (not taking inflation into account).



Whilst long term investing is definitely the correct approach when looking at shares, nothing could be further from the truth if your time span is a short one. Equity returns are effectively random over short time periods as markets reflect animal spirits – the human emotions of fear and greed dominate price movement. In the long-term, share prices reflect the net present value of future cash flows which are expected to emerge from companies. Thus, over the long-term, the market is a more rational value calculator, whilst in the short term it is Rolette wheel operating on randomness.

What returns do equities provide over time?

Over the long-term, equities on the JSE have provided annualized returns of inflation plus 9% (the red line in the attached graphs). This far outweighs returns from all competing asset classes, in South Africa, as an example, cash has provided long-term returns (4 decades) of inflation plus 2% and bonds about 3%. For the past decade, property has also been a winner, but over the very long-term, little stands-up against stocks. In the last decade, cash has only beaten inflation by 1% annualized and bonds 2%. For the decade until May 2013, the JSE delivered real returns above 16%. The last time such incredible returns on a 10-year rolling basis were experienced was leading up to the two crashes – 2008 and 1987.

Historical returns are important to understand for the following reason. Over extended time periods, markets are relatively predictable. So it makes sense deploying cash into equities if your period is multi-year and in the immediate past, on a decent rolling period, markets have underperformed their long-term average real returns. Equally, if on an extended rolling period, equity returns are way higher than their long-term average, some caution should be applied to aggressively entering equity markets.

Taking this into account, if one took 3, 5 and 9 year rolling periods at present, the JSE is currently at its long-term average real return in all instances of 9% - this is looking at the last 40 years of data. It should be noted that our market can go through long periods of delivering returns below the long-term average – so again, patience is the key factor when investing.

<u>The second critical discussion point is how are equities priced at the moment? Are they worth less or more than the price you see on the screen?</u>

At Northstar, on average it takes us about 100 hours to assess a company in detail, which includes an in-depth focus on valuing the business. Our goal is to determine whether the market is pricing the business higher or lower than we deem it to be worth. When we do this work, we assume that we have infinite amounts of capital and that we intend buying out the entire business, plan to delist it and remain invested indefinitely.

With this mindset, we act like real shareholders as against traders that want to turn a quick buck. This approach demands buying into solid businesses, that compete actively within their specific industries and with Management teams that have shown deftness in allocating capital appropriately as they build their firms. We cannot afford to make too many mistakes when the stakes are this high. Part of this work is detailed valuation work and we do not want to own companies where we feel the margin of safety is lacking – as custodians of capital we seek ownership of businesses that trade at a discount to what we have calculated them to be worth.

With this in mind, throughout the second half of 2014 and deep into 2015, stock after stock that we undertook this detailed work on, had share prices above what we calculated the company to be worth. Very few South African companies looked fairly priced and if an investor sought a real 'margin of safety', this was sorely missing. Much of our market was floating on helium.

To an extent, this changed for various companies on the JSE since the market started selling-off midway through 2015. Our Northstar Buy List (the companies which we have made it through our research process and onto our list of stocks which we intend owning) now shows annualized returns in the high teens over a three-year view – more value has crept into the market. It is however very stock specific as against being broad-based value or applicable to any specific sector. We are still finding the majority of dual listed SA stocks, most consumer stocks and the many industrial companies trading above what we deem to be fair value. A number of financials, particularly the banks, are trading below fair value and offer opportunities.

So from the perspective of whether an investor should 'sell now' taking account of what companies are really worth, we have to say that the answer to this depends completely on what companies the investor owns. There are segments and companies on the JSE that we feel will come under severe pressure in the months and years ahead, whilst others should do rather well. The key here is an ability to undertake proper research and to get to grips with the value on offer versus the price you pay on the market – these are not one and the same!

So in conclusion, what should an investor do right now?

If your approach is to assess long-term returns and to gauge where the market is on this basis, then the attached graphs show clearly that the JSE is neither well below nor well above its long-term real return average. From the perspective of whether it is an obvious time to sell and head for the hills, selling would have been much more appropriate in 2013/2014!

If your approach is to understand each and every company and be invested in those where the value of the company is higher than the current share price, then your decision to buy or sell depends on what you have in your portfolio. At Northstar, we feel the stocks on our 'Buy List' are worth substantially more than what they are currently being priced at by the market. Contrary to this, the many stocks that have not made it onto our 'Buy List' have not done so because we deem them to be overpriced.