

ClucasGray Asset Management

Quarterly Commentary

December 2018

"The pessimist sees difficulty in every opportunity; the optimist sees the opportunity in every difficulty", Winston Churchill.

We live in a news obsessed world, and sadly good news seldom sells. As a consequence it seems optimism has indeed become a rare commodity. The investment industry in South Africa has for some time taken a dim view on the prospects for both the local economy, and companies that operate therein. In certain (but not all) respects this view has proved to be correct, to date.

The Economist magazine recently wrote: **"Optimists can seem naïve – looking on the bright side does not have the same intellectual cachet as forecasting calamity. Prophets of doom know they will eventually be proved right – it is the nature of the business cycles that recessions do happen. Good news is just bad news postponed."**

The reality is that over the course of time, economies have grown in real terms and are likely to continue to do so, enabling good companies to increase nominal earnings and, assuming one is able to invest in these at reasonable multiples, to deliver decent returns to investors. Indeed South Africa remains in the midst of a protracted period of below trend growth – an operating environment which has proved difficult for many companies to grow earnings at rates required to justify what have in certain instances elevated ratings.

At ClucasGray Asset Management (CGAM) we adopt a disciplined investment process which we believe helps to eliminate emotions and sentiment, mitigate against a number of key investment risks, and to take advantage of opportunities as they present themselves. At its core, our Alpha Thesis strives to resolve the interplay between earnings growth and valuation in all our investment decisions, be they individual companies or asset classes.

We concede that regular readers of our (and others') commentary could be forgiven for feeling a sense of fatigue! Fatigue at reading a narrative that at times feels repetitive, fatigue that the prospects for an improving operating backdrop are slow to materialize, and fatigue at the promise of an opportunity set delivering strong nominal returns that as yet feel elusive. We recently read the following unattributed quote which neatly describes the emotional journey many investors are forced to travel: **"Returns can be a function of uncertainty, confusion, short term loss, surprise, stretches of boredom, regret, fears, anxiety and sometimes even ridicule."** In the quest for longer term returns, periods of fatigue may well be a prerequisite.

ClucasGray Equilibrium Fund

"If the highest aim of a captain were to preserve his ship, he would keep it in the port forever."
Thomas Aquinas

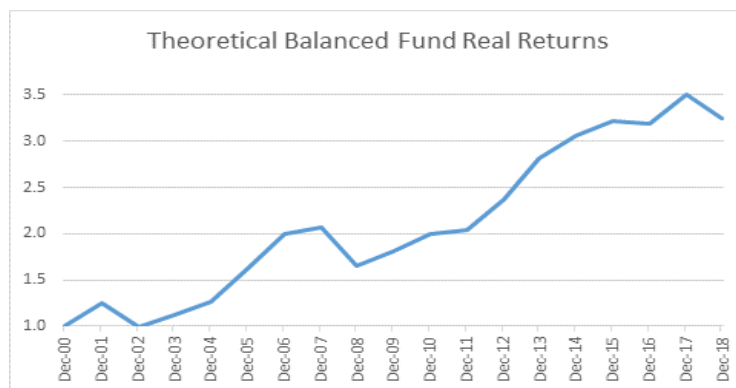
In the year that was characterised by weak equity markets, the ClucasGray Equilibrium Fund gained around 1% in 2018.

Whilst this return is below our objective of delivering inflation beating returns for investors, it is ahead of the peer group average returns of negative 3.8%. Over the last 3 years, the Equilibrium Fund has gained nearly 6% per annum, compared to the peer group of 2%, and since inception in January 2015, the fund has compounded at over 7% per annum versus 3.5% of the peer group. Whilst the Equilibrium Fund has delivered real returns over most periods, the average balanced fund has failed to keep up with inflation over nearly 4 years.

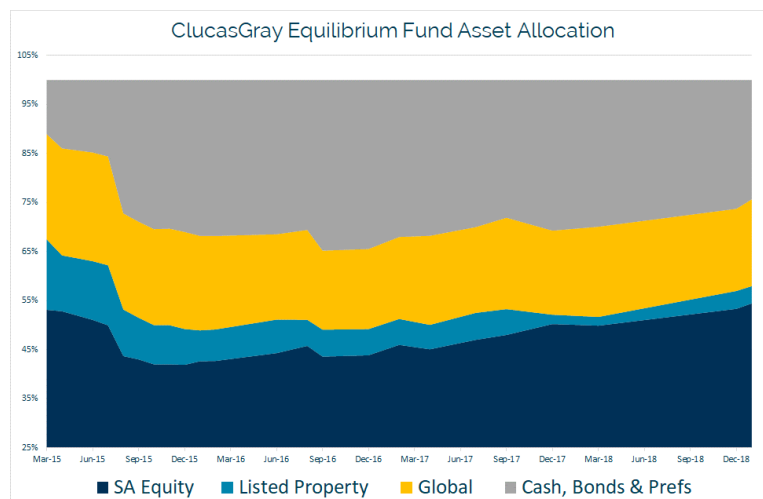
At ClucasGray Asset Management we remain firm believers in the ability of balanced funds to deliver attractive real returns for investors over sustained periods of time. With the ability to diversify the portfolio across individual companies, asset classes and geographies, balanced fund managers have numerous tools at their disposal to assist them in delivering inflation beating returns over time.

We have back tested the returns which a typical balanced fund should deliver, by calculating what a strategic allocation to Equities, Bonds, Cash, Property and Foreign would have returned over the last 18 years. It is by nature a theoretical exercise using index returns, but the results are indeed compelling, delivering an annualized real return of 7% over the last 18 years. As an aside, since the inception of the Equilibrium Fund in January 2015, the theoretical balanced fund would have returned more than inflation and the peer group, but less than the Equilibrium Fund's annualized return of over 7%.

The chart below shows that whilst there have been periods when real returns were negative like in 2018, over the course of time patience has been well rewarded.

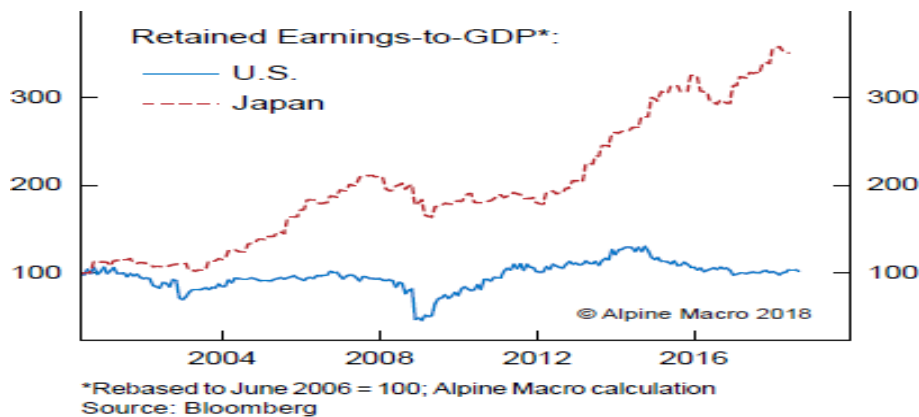


The most notable change we made to the asset allocation during the year was to increase the fund's exposure to local equities at the expense of local income assets, which have served the fund well over the last few years. Given the opportunity set which we believe exists in select South African equities, the fund has a higher weighting to SA Equities (excluding Preference shares) now than at any other period since its inception nearly 4 years ago. The chart below illustrates the dynamic approach we have taken to asset allocation since the fund's inception, and the current elevated exposure to SA equities.



Globally, we continuously strive to look for opportunities in specific regions and asset classes where the degree of pessimism reflected in current prices is not justified. Given the significant move in asset prices towards the end of 2018, major global equity indices have de-rated and have come back to more reasonable levels.

Notwithstanding the potential for a more austere earnings outcome, our observation is that the extent of the recent adjustment to market valuations is not universally justified. One such example is Japan, which now trades on a forward PE multiple of 11.4. In addition to the compelling valuation, Alpine Macro highlights in the chart below that corporates in Japan have been accumulating vast sums of retained earnings. They have not been investing or returning this cash to shareholders. The combination of valuation support and the state of corporate balance sheets makes this an interesting investment case. As a result we have initiated an investment into Japan in the ClucasGray Equilibrium Fund.



Our global equity allocations have changed over the course of 2018 to take advantage of what we deem to be select opportunities. Japan is a new entrant as outlined above, and we have increased weightings to both European and Emerging Market equities.

Asset Allocation is an output of the CGAM investment process – our starting point is which underlying assets will best be able to assist the fund deliver real returns to our investors. We are of the view that the current opportunity set within select local equities is extremely compelling – valuations remain subdued, and whilst the outlook for near term earnings growth is clouded by the low growth environment, we believe many have the potential to deliver reasonable earnings growth over the next few years.

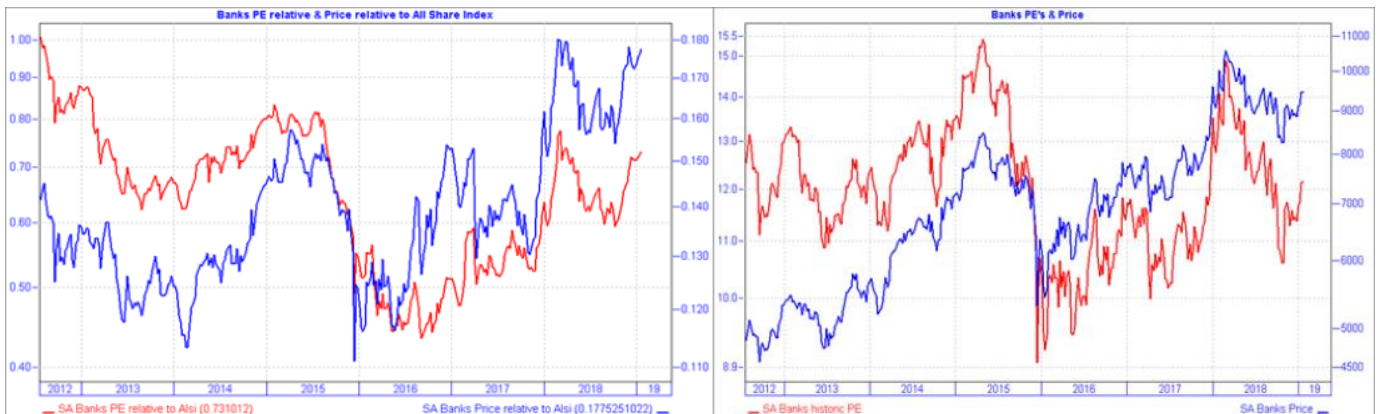
Coupled with the prospect of a re-rating off historically low ratings, barring unforeseen events, they should generate attractive returns. As ever, history will be the judge of these decisions, but given our objective to continue delivering long term real returns to investors, we believe it is appropriate to judiciously add weightings in these attractive assets, even if, like the captain of the ship referred to earlier, we need to leave the safety of the port.

ClucasGray Equity Fund

“When assets are priced for perfection, it doesn’t take much to generate disappointment.”
Jeremy Grantham

In what was a difficult year for equity investors, the ClucasGray Equity Fund declined by 5.2% in 2018. This compares to the JSE Swix which declined by 11.7% and the general equity peer group which declined 9%. Over the last 3 and 5 years the fund is up an annualized 6.6% and 5.9% respectively, which compares favourably to the JSE Swix (3.7% and 5.9%) and the peer group average (1.6% and 3.2%). Given the gyrations within the equity market that occurred during the year, the fund has been able to take advantage, where appropriate, of mispriced opportunities in the market.

The fund is well exposed to financials, where we believe valuations remain undemanding, and following a protracted period of benign economic activity, the prospect exists for reasonable earnings growth off subdued earnings bases. Aligned to some of our comments earlier in the quarterly, the environment was far from conducive for locally oriented companies like banks to perform well. Yet, as illustrated in the charts below, the sector was trading at a deeply discount valuation both relative to the market (left) and in absolute terms (right), and even with a low rate of earnings growth, has performed extremely well.



We remain underexposed to the large global industrial companies, but did take advantage of what we deemed to be an overreaction in the British American Tobacco (BTI) share price to adverse regulatory developments. BTI aside, where valuations and dividend yields look compelling, we are cautious around the ability of the others to deliver good relative returns. During the final quarter, Clover announced that they are the subject of a potential buy-out, resulting in a 20% move in the quarter. Clover has been a key holding in the portfolio, with numerous attributes we find attractive, coupled with an extremely undemanding valuation. We await the outcome of the cautionary with interest.

One set of companies which don't receive much coverage, are the investment holding companies. We own reasonable weightings in both Ethos Capital and Sabvest in the fund. Both companies have delivered very good returns over long periods of time, and current valuations look extremely attractive to us. On our estimates, both trade at over 30% discounts to their NAV – whilst their long term returns on NAV have been in excess of 20%, even a relatively modest 15% return on NAV would in effect equate to a much higher return on their current subdued share prices. In an environment where uncertainty abounds, we like the upside optionality that these companies provide, with what we deem to be limited downside.

The earlier quote resonates with us as investors – the last year has once again brought with it many lessons for all investors, not least of which is that high valuations provide little support when earnings start to slow. Equity investing is by nature risky in the shorter term, but we believe that by resolutely adhering to our process, taking advantages of opportunities where appropriate, and exercising patience, we will be able to continue to deliver on our long term investment promise to clients.

If there is any interest to engage further, please don't hesitate to get in touch with us.

Kind Regards

Andrew, Grant and Nikki

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