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## PSG TANZANITE FLEXBLE FUND

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Paul Bosman completed his B.Comm in Institutional Investments at the University of Stellenbosch in 2001. He then did his honours in Financial Risk Management in 2002.

Paul commenced his investment career at PSG Capital in 2004 where he assisted the hedge fund manager. Paul started at PSG Tanzanite in November 2004 as an equity analyst. He is responsible for analysing local and offshore listed companies. Paul is also a CFA charter holder.

In this week's Funds on Friday we discuss the various asset classes within the PSG Tanzanite Flexible fund and highlight the risks related to each of the asset classes. As an introduction we discuss our approach to asset class allocation and the benefits of our mandate in this regard. The fund has to date only invested in equities (both locally and offshore) and cash and we will therefore explore these two asset classes in detail. In managing the PSG Tanzanite Flexible Fund we follow the so called bottom up approach. This means that the asset allocation in the fund is a result of stock picking. The opposing strategy is a top down approach, according to which asset class exposure is decided upon before selecting individual shares.

### Why do we follow a bottom up approach?

We believe that investing in exceptional companies when their share prices are below their intrinsic value offers a favourable payoff on a risk return basis. The risk is lower due to it being a high quality company and also because the investment is made at a discounted price. The possible return is above average because we expect a recovery to intrinsic value and because high quality companies are able to grow their earnings in excess of inflation. To fully harvest the returns of this strategy one needs to remain invested for the long term.

What do we mean by a high quality company? In our view this is a company with some form of sustainable competitive advantage which is managed by individuals with a proven track record.

### Why is our flexible mandate so important?

Our mandate allows us to invest up to 100% of the fund in equities, but we are also able to invest 100% in cash or bonds. There are two very simple reasons why this flexibility is so important to us.

Firstly, we don't want our clients to be trapped in equities when shares are overpriced. Secondly we don't want our clients to miss out on opportunities when shares are irrationally cheap.

Our mandate therefore allows us to be very defensive, i.e. radically reduce risk, when shares are expensive but also to be aggressive when shares are cheap. We believe that this approach enhances return and significantly reduces risk, i.e. an optimal asset allocation.

### Asset classes held in the fund

Consider the annual returns obtained by South African equities, cash and bonds between January 1966 and January 2010.

Asset class	Annual return	Volatility
Equities	Inflation + 7.7%	22.2%
Cash	Inflation + 1.8%	0.0%
Bonds	Inflation + 1.1%	8.0%

Table 1

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## Equities

As per the above table equities delivered an annual return of inflation + 7.7% over the last 44 years. This is significantly in excess of the returns obtained from cash and bonds. The volatility of equities however was way in excess of that of the other two asset classes, indicating that it is a riskier asset class.

Let us first consider equity returns. Why are equities able to grow significantly in excess of inflation?

There are essentially two drivers of share prices, the first one being company profits and the second being a share's rating in the market.

In the long term share prices are driven higher by rising company profits. What enables companies to grow their profits in excess of inflation for long periods of time? Companies are generally able to put up the asking price for their goods or services by at least inflation. If they are able to contain the growth in costs to below the increase in their asking prices profits will grow in excess of inflation. Another driver of profit growth is the fact that companies reinvest a portion of their profits resulting in a growing capital base. This characteristic of growing profits over long periods of time applies to equities in general, by no means to all companies. This is why stock picking is so important; we like to understand how a company makes its profits and what the likelihood is of earnings growing for many years into the future.

The second driver of share prices is the share's rating by the market. This is the multiple of profits at which a share trades. For example if a share's price earnings ratio (PE ratio) increases from 8 times earnings to 10 times earnings the share price increases by 25% - without any change in company profits.

Profit is the long term driver of equity prices; market rating is the short to medium term driver of share prices. To maximise our return from equities we would therefore look for companies which we believe will be able to grow their profits for many years to come *and* which are currently out of favour with the market. We then hope to benefit from both growing profits and a rerating of the share.

Let us consider equity risk. Equity return and risk run hand in hand, there are essentially two factors which can drive share prices down: declining profits and a weaker market rating. So to avoid equity market risk we avoid companies for which we believe the current profits are not sustainable. We also avoid companies which we believe have an overly optimistic rating by the market, i.e. we want to avoid companies which are on very high price earnings ratios (we use normalised earnings). If you are buying a diversified portfolio of quality companies the second factor is probably the most significant risk. It is unlikely that all the companies will have poor earnings performance, but it can easily happen that all the companies are overpriced. This is because asset prices go through cycles of being overly optimistically and overly pessimistically priced. The worst equity investments are made when companies' profits are at high levels and the market prices shares at a high multiple of such earnings. This would typically happen towards the end of a long boom period when market players are extrapolating current conditions too far into the future.

In such circumstances you could be buying shares which are in bubble territory, have ridiculously high PEs or high profits. Consider the below charts of equity bubbles.

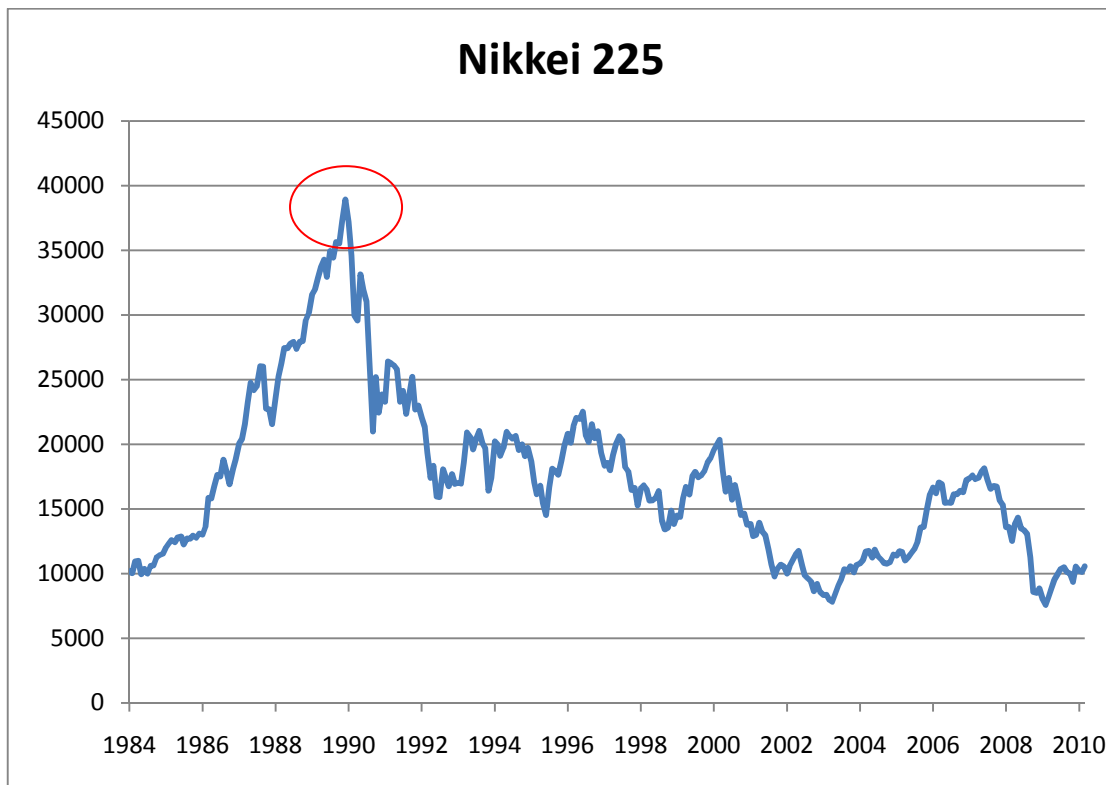


Chart 1

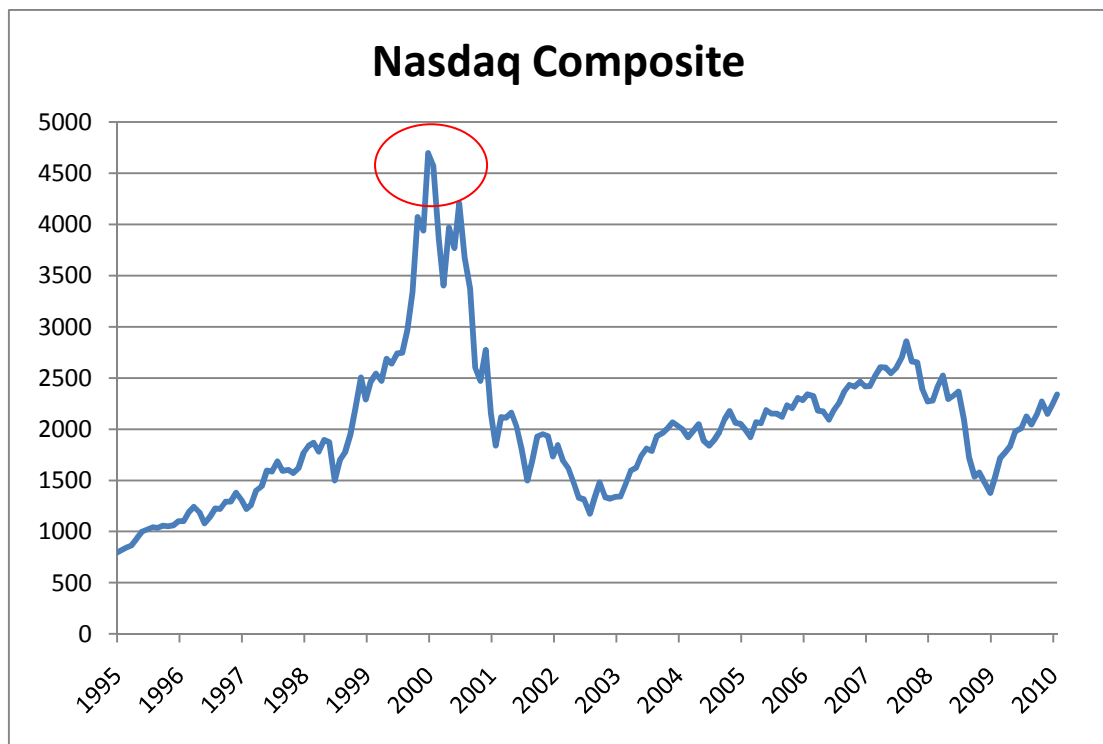


Chart 2

After a bubble bursts it could take a very long time to recover your losses, if ever.

In our fund we invest in both local and offshore equities. This introduces exposure to currency movements; you are exposed to the risk of a strengthening rand but will benefit from a weakening rand. We believe that diversifying equity exposure across currencies and geographical regions drastically reduces risk. We don't

try to make short term calls on the rand but rather invest in attractively priced quality offshore companies, i.e. we make equity not currency investments.

### Cash

From table 1 we can see that cash marginally outperformed inflation over the last 44 years. It is interesting to note that cash outperformed bonds, despite bonds exposing investors to far more volatility. To date we have not used bonds in our portfolio and will not dwell on this asset class, save to say that we do monitor bond yields and will pounce if we believe there is an opportunity.

Cash exposes investors to only one risk, inflation. If you are not willing or able to take on the volatility of equities you will not be able to grow your wealth in real terms.

Although cash is a very poor long term investment it is probably the most powerful investment tool available. If you have cash when other buyers have empty pockets you are generally able to buy assets at rock bottom prices. The recent credit crunch is a very good example of such conditions. In our fund we use cash for this purpose and were able to continue buying shares as the markets declined and were fully invested when share prices bottomed.

### How has the PSG Tanzanite Flexible Fund's asset allocation varied over time?

The below graph is a summary of the PSG Tanzanite Flexible Fund's asset allocation over time. It clearly indicates that our cash holding dipped to zero during March 2009 – shares became irresistibly cheap. We have subsequently reduced our equity holding as the prices of many of the shares held in the fund have drastically improved.

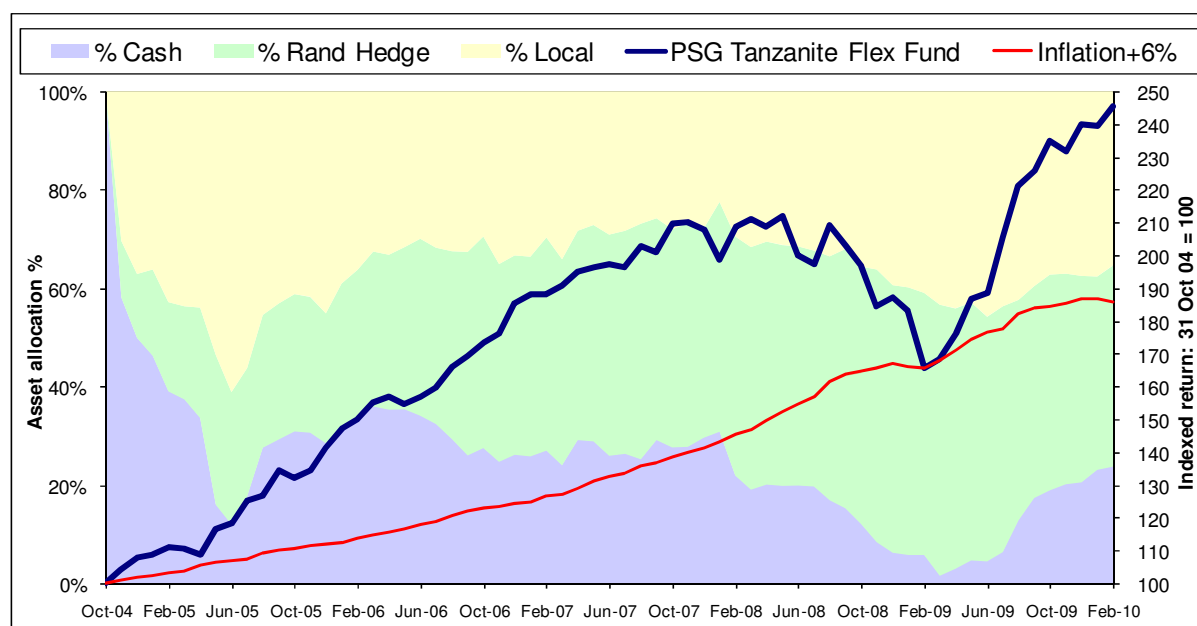


Chart 3

### Our view on the current relative valuation of local equities, offshore equities and cash

The Financial Times calculates a P/E ratio for a number of countries which represents at least 75% of the market capitalisation of each market. The current P/E ratios of 5 different markets appear in the second column of the below table. If you divide the earnings by the price instead of price by earnings the result is the yield offered by these markets. The table also provides the yields at which the long bonds of these countries currently trade. These yields are often used to represent the long term risk free rates in a country. We subtract the bonds yields from the earnings yields to obtain the reward for taking equity risk offered by the various markets.

Country	Price earnings ratio	Earnings yield	Ten year gov. bond yield	Reward for equity risk
South Africa	16.5	6.1%	8.8%	-2.7%
Germany	20.1	5.0%	3.1%	1.8%
France	18.7	5.3%	3.4%	1.9%
USA	20.2	5.0%	3.7%	1.3%
UK	12.1	8.3%	4.1%	4.2%

On a simple yield comparison basis South African equities currently look expensive. In our view SA equity yields also do not offer enough reward for the emerging market risk which SA investors are exposed to. The counter argument to the above is that SA companies will be able to grow their earnings faster than first world more mature companies. We have however found plenty of companies which have very good earnings growth potential which are listed in the developed markets.

The above reasoning serves as motivation for the fund currently using its full 20% offshore allowance.

As per chart 3 our cash exposure has gradually increased from 0% a year ago to over 20% at present. In our view cash has become more attractive as the market rating of equities improved, it reduces risk and enables us to buy if the market pulls back.

Despite the relative attraction of offshore equities and the protection offer by cash, we still find plenty of attractively priced local companies. Careful stock picking is however now far more important than a year ago.

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*Glacier Research wishes to thank Paul Bosman for his contribution to this week's Funds on Friday.*