Market Synopsis – September 2017

We take a step back from our regular economic and market synopses to provide insight into our chosen investment philosophy. Clients and our supporters will know that we follow a value investment philosophy. We formally define our investment philosophy as follows:

"Benjamin Graham ("Graham") is often referred to as the 'Father of Value Investing'.

His works 'The Intelligent Investor' and 'Security Analysis' provide the intellectual foundation of this concept. According to Graham, 'an investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.' According to Graham investors should thus spend time and effort to analyse the financial state of companies. When a company is available on the market at a price which is at a discount to its intrinsic value, a 'margin of safety' exists, which makes it suitable for investment."

Amongst other, markets are driven by the constant battle between fear and greed, different time horizons (short-term traders versus long-term investors), news flow and "expert" opinions continuously being bandied about in the media. As such, share prices are volatile and often not linked to the relevant company's intrinsic (or fair) value over the short-term. A company's fair value does not change from second to second as its shares trade in the market – this is the market price or market capitalisation. On the contrary, fair value is a relatively stable figure which grows over time should the business have competitive advantages and competent management.

Investors often understand a property analogy much better: If an investor buys a property that is worth R1 million for R2 million, it will take a long time, if ever, to generate growth on the initial investment. It is thus imperative to buy property (or any asset, for that matter!) at the appropriate initial value. Hence in most instances, once buys one's profit.

This sounds relatively straightforward and simple to apply. The contrary is however true – value investing often tests investors' patience and process integrity to the extreme. This can be seen in Figure 1 below: Long periods of relative underperformance are followed by sharp and significant rallies (some examples are indicated by green arrows).

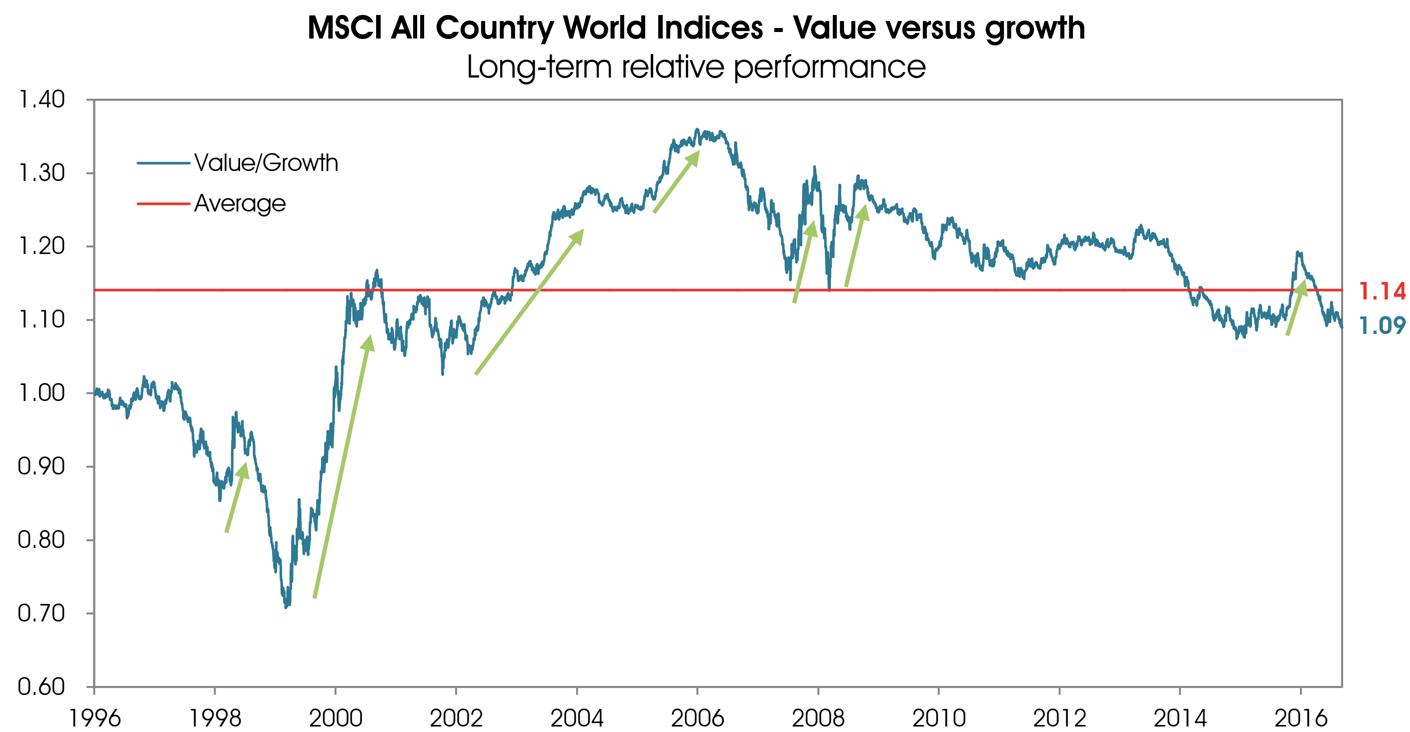

Figure 1: Value versus growth – Relative performance **Source: Integrity AM, Bloomberg**

To time the periods of value style outperformance is unfortunately impossible. If one cannot time these rallies, then why bother? Well, because value investing works. Figure 2 illustrates the long-term outperformance of value versus growth. Over the long-term, value investing has outperformed growth investing by a significant margin – in excess of 30% cumulatively or close to 1.5% per annum.

The only way to capitalise on value outperformance is to invest according to a well-defined investment process which rigorously and consistently applies the principles of value investing. Over time temptations to waiver from value investing will come knocking at your door. Eventually only softly, but over time, as other investment styles outperform, the knocking will become deafening. Then, suddenly and without warning, the next best thing will not be that good anymore, the market will realise that they have overpaid for evaporating growth expectations and value corrects to the long-term trend. Some investors try to blend philosophies, by tilting towards growth strategies and then towards value strategies. There is however no bell that rings when value starts outperforming and, as mentioned above, the outperformance rallies are short and significant. It is often not possible to get in quick enough and the opportunity is foregone.

Most other investment strategies are easier to apply. The composition of market indices, which mostly are market capitalisation weighted, reinforces the perception that growth and momentum strategies work. As the growth/ momentum companies outperform, their weights in indices increases. This leads to more buying interest from index tracking solutions (exchange traded funds), which pushes prices even higher, reinforcing investors' belief that the current market darlings are the "next best thing".

The fact that these companies often do not warrant the resultant dizzying market multiples do not concern investors. Market maxims like "this time is different" and "value investing is dead" then surface… again. As the share prices continue rising, investors' confidence in their own abilities increase, since their views are being vindicated day in and day out. This often continues until frenzy in a certain theme, company or sector is created and the last fool buys in at the peak. At this point some event, which is not pre-announced or publicised, occurs and the market realises that fundamentals and the "new reality" are so far apart, that the frenzy stalls and later evaporates. This event can be an earnings release, an economic announcement or geopolitical event – any event that alters the *status quo* really…

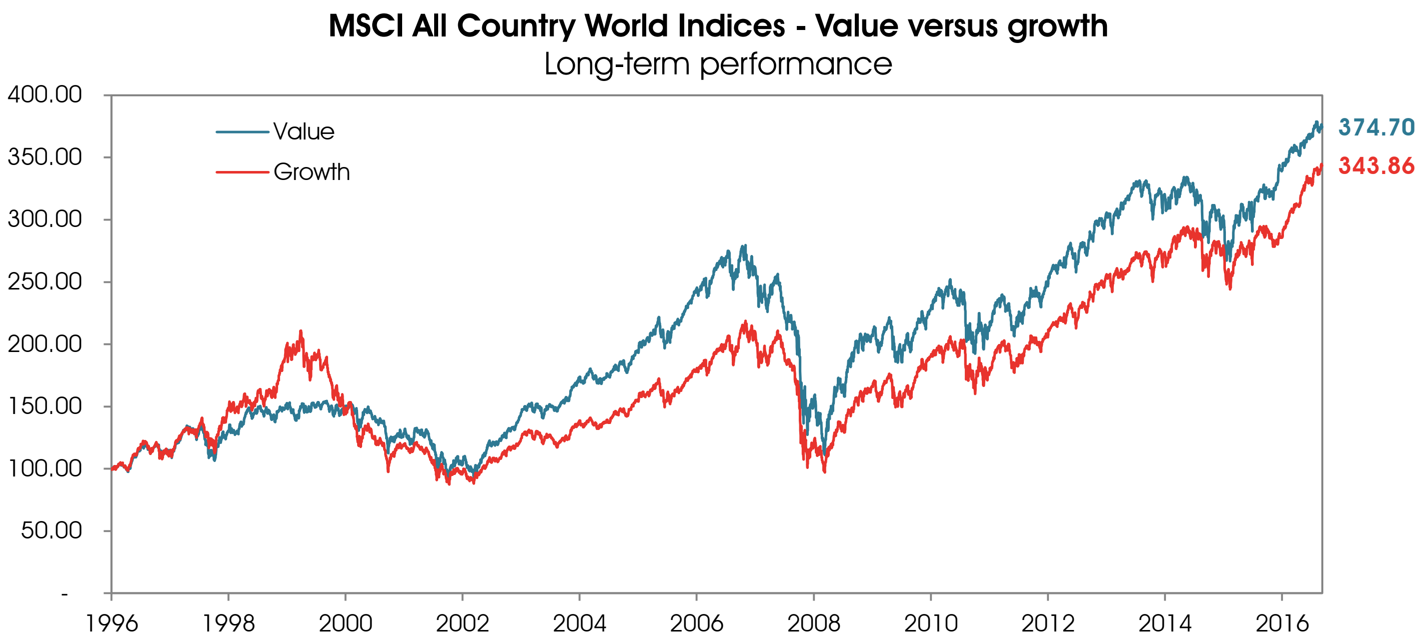

Figure 2: Value versus growth – Long-term performance **Source: Integrity AM, Bloomberg**

This creates permanent capital loss since the applied market multiples rerates down to realistic levels. It is the same as the R1 million property bought for R2 million mentioned above.

We have seen this happen time and time again. As a student, this writer learned a about value investing the hard way after buying into Dimension Data in the late 1990s and selling it years later at an almost 100% loss.

How does one avoid this permanent loss of capital? By rigorously and consistently applying the principles of value investing.

The same should apply to your investment manager. How have we faired in this regard? Below we provide a summary of Integrity's local equity and global equity strategies' performance relative to the relevant value indices:

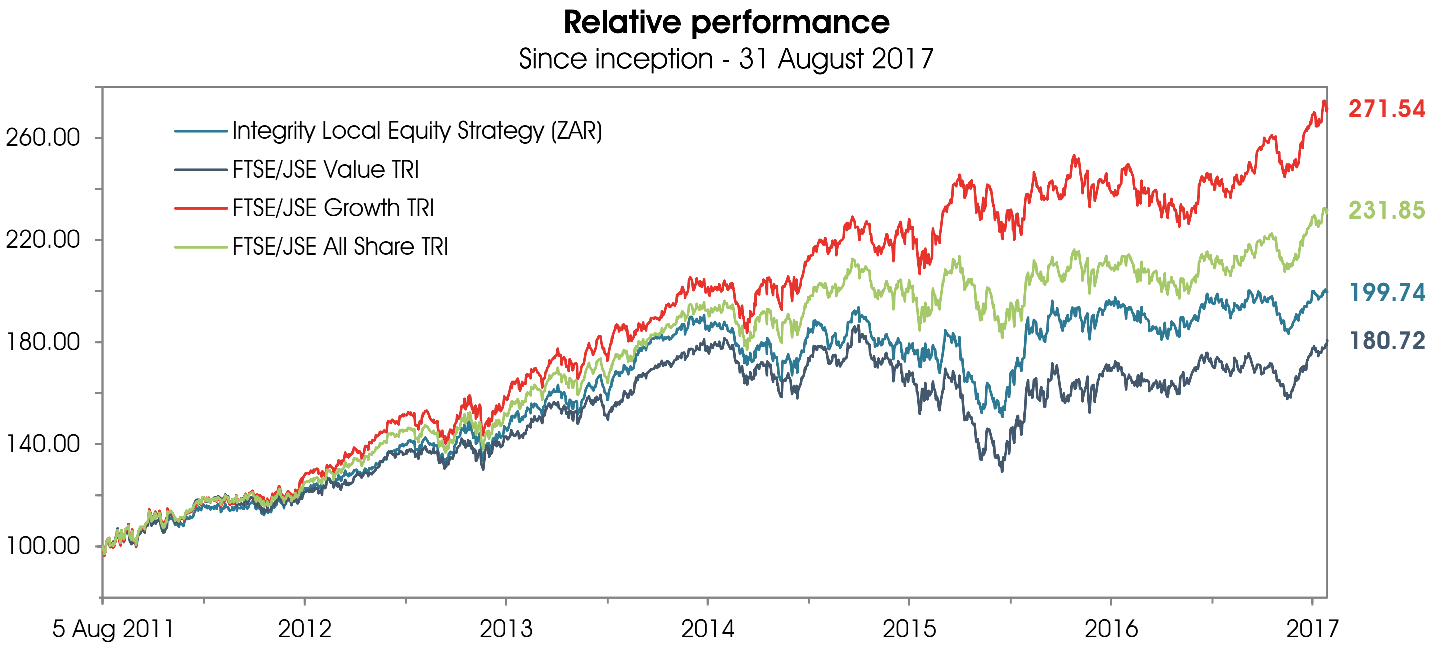

Figure 3: Relative performance – Local equities **Source: Integrity AM, Bloomberg**

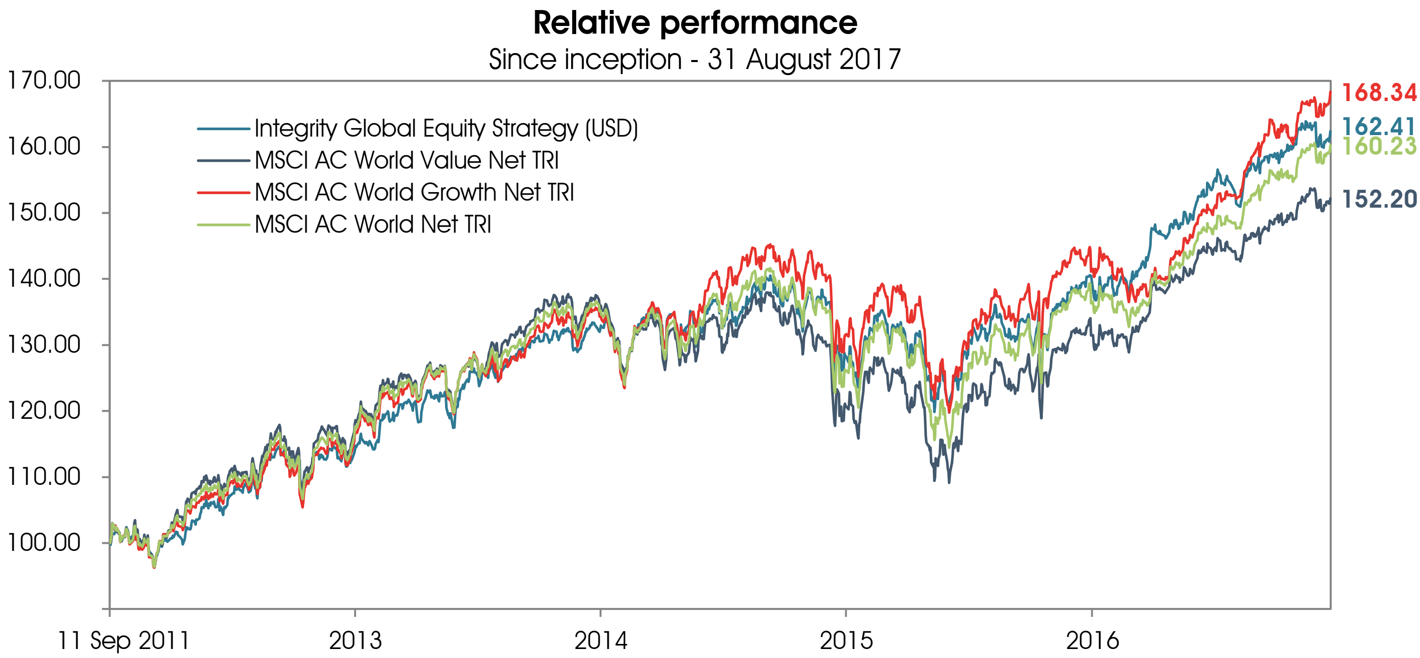

Figure 4: Relative performance – Global equities **Source: Integrity AM, Bloomberg**

Over the more than 6 year period since the inception of the local equity strategy, Integrity has outperformed the FTSE/JSE All Share Value Total Return Index ("TRI") by 2.91% per annum whilst maintaining a 95.16% correlation with this index. Looking at the global equity strategy, the same message applies. Over the more than 5 year period since the inception of this strategy, Integrity has outperformed the MSCI All Country World Value Net TRI by 1.98% per annum whilst maintaining a 97.61% correlation with this index.

Integrity's stock picking abilities have thus added value (after all costs) when compared to our investment philosophy's style indices. Unfortunately both these value indices underperformed the general market indices due to significant growth strategy outperformance. In the local context the performance disparity between the value and growth indices was a whopping 90.82%, whilst in a global context the performance disparity was a more sedate 16.14% over the respective investment horizons. It has thus been impossible to outperform the local market, whilst rigorously and consistently applying a value investment philosophy. If your "value" investment manager has achieved this, one should ask whether they truly are value managers. As mentioned above, the temptation to change one's strategy is ever present, but one does so at ones own peril...

In conclusion, we have stuck to our value investing knitting and will continue to do so – we do not believe in managing equity portfolios in any other way. History has shown that when the market corrects the current relative underperforming trend of value versus growth, value investors are sure to be richly rewarded for their patience.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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integrity asset management

Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 287.33	-1.6%	11.7%	-2.2%
Brent Crude	57.41	12.9%	1.0%	17.0%
USDZAR	13.52	3.9%	-1.6%	-1.5%
EURZAR	15.93	2.9%	10.2%	3.2%
GBPZAR	18.16	8.0%	7.2%	2.0%
JSE All Share TRI	7 782.03	-1.3%	11.4%	9.1%
JSE Resources TRI	2 185.05	-0.8%	11.6%	10.4%
JSE Industrials TRI	14 254.63	-0.8%	18.3%	11.9%
JSE Financials TRI	8 089.52	-2.8%	3.7%	7.0%
JSE Listed Property TRI	2 279.60	1.8%	8.4%	9.8%
S&P 500	2 510.06	2.1%	12.1%	15.8%
Euro STOXX 50	7 152.15	4.8%	10.8%	21.8%
FTSE 100	6 165.87	-0.5%	5.9%	10.4%
Nikkei 225	31 618.39	5.1%	8.3%	26.1%
Hang Seng	73 827.18	-1.8%	29.2%	22.4%

Source: Bloomberg, as at 28 September 2017