



# Platform

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Independent Insight in an Uncertain World

# PLEXUS

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## MYSTERIOUS MR MARKET

I have been avoiding adding to the already uncountable amount of column space dedicated to fund managers giving their views on the recent market correction and importantly the prospects lying ahead. But like the proverbial moth, circling the flame, I have found the attraction irresistible.

Of course we are all entitled to our opinions, which make for good radio and television. The market has known about US and European sovereign debt loads, the housing crisis, debt deleveraging, the frailties of the European banking system and weak consumer demand for a long time. I am motivated to remind investors that while it's comforting for an "expert" to offer a rational explanation of why markets tanked (and recovered somewhat), the fact remains that no single person truly understands Mr Market's moods in an absolute sense.

While market outcomes are easy to measure, the great mystery lies in why markets suddenly decide to react to one data point and not another. Mr Market is deceptive and cunning, his underlying trend moves imperceptibly slowly like the minute hand on a watch, until a tipping point is reached and then he suddenly lurches savagely in his chosen direction.

No matter how many times the pattern repeats itself, it unsettles professional and amateur investors alike. Too much equity, too little equity! We are again reminded that while capital investing is necessary, it's inherently risky. As is forecasting.

Let me be upfront. I am a terrible forecaster – whether it's the Durban July, Super 15 or Billiton's 12-month forward earnings. I am far more comfortable interpreting historical contexts and then measuring those contexts relative to where we are today. Let me offer, based on these historical contexts, a medium-term expectation for the broad asset classes in which we invest.

Presently, JSE equities appear fairly priced, not bargain-basement cheap or seriously overpriced in our view. Based upon 12-month historical price to earnings (PE) multiples, the ALSI PE of 13,9 is marginally below the 15-year average of 14,4. On a smoothed out and longer data series the rolling seven-year normalised price to earnings multiples of the ALSI at 18,1 are slightly above its long-term average of 17,2.

On a three-year view, SA equities are likely to deliver around 11% to 12% per annum. The assumptions I have used to make this rough calculation include the current dividend yield of 2,7%, the addition of 5% inflation (mid-point of the SARB inflation target) and the assumption that real earnings growth will be more or less the same as expected real GDP growth of 4%. Assuming no change in the market rating (PE) from these levels, the expected return will therefore be 11,7%.

Now that we know US short rates are fixed until 2013, SA cash yields may rise a little or fall a little in the next 12 months, but either way the shift should not be meaningful. Yields will remain low. Similarly, bonds yields may rise (my view) or fall a little, but it's hard to make a case for a large and surprising shift either way, given global conditions.

So while it may be tempting to rush for the cover of cash in these uncertain times (and we have indeed adjusted our portfolios a fraction in the past two weeks), it is probably unwarranted if you still have a longer-term orientation.

Looking at three years out, and based on current valuation and relative to cash and bonds yields, SA equity still seems relatively attractive – but it will be volatile.