

Crisis brings opportunity

In conversation with Veritas, Orbis and Ranmore

**Morningstar Investment Management
South Africa**

November 2022



Debra Slabber
Director: Portfolio Specialist
Morningstar Investment Management
South Africa

What a fantastic time to be a fund manager! Yes, after many years of wonderful returns in global markets, this year posted some of its worst numbers in history. We currently find ourselves in a world filled with uncertainties and negative headlines - from geopolitical tension, an energy crisis in Europe, rising interest rates and slowing growth, just to name a few. As a result, we are witnessing huge dislocations in markets and huge dislocations in currencies.

A sell-off of this magnitude does not come around often. In fact, it only happened twice in the last 15 years – first with the Global Financial Crisis and second during the Covid-19 pandemic. When I think back to all the textbooks I have read and studied about investing, it taught me that it is more often than not during times like these that the best investment decisions are made.

Markets are on sale today and there are most certainly some great bargains available. It was my privilege to unpack some of these opportunities with some fantastic global equity managers at the Morningstar Investment Conference, held on 19 October in Cape Town.

Looking beyond the noise: finding global opportunities where fear and greed are driving sentiment

As the MSCI World Index posts some of its worst returns in history, many stock markets around the globe are also in bear territory. While offshore equities are still not exactly cheap, we are now in a correction phase with corporate earnings downgrades being the order of the day. Should you be catching the falling knives? Is “quality” still “quality”? What should your regional allocation look like at this point in the cycle?

Opportunities in the US – “Quality Cyclical”

U.S. stocks have had a difficult year, with the froth in the market coming off. In particular, we have observed an unwinding in the more speculative pockets of the equity market, with one of these categories being the “innovative” companies that often grab the financial headlines and garner attention from investors looking to own the next big winner.

Upon review of our conviction for the US equity market as a whole, Morningstar landed with a Medium overall conviction – the first time this has been the case in quite a while. The scores across two key “pillars” – absolute valuation and relative valuation—improved moderately, while scores for contrarian indicators and fundamental risk remained unchanged. The weak stock market backdrop, as characterized above, certainly played a role in improving the outlook in this market. This is not to say that we consider U.S. equities to be an outright bargain—we don’t. But our process tells us that the situation has moderately improved, which is reflected in our conviction upgrade.

For Financial Advisors and their Clients

According to Dan Brocklebank, Head of Orbis UK, Orbis Investments, he agrees that the US market certainly isn't cheap, but there are definitely pockets of opportunities. Particularly in certain 'buckets', sighting that they are currently overweight value stocks, in particular quality cyclicals. By this he means that they are positive about companies with long-term value, that they believe will beat the short-term cyclical movements of markets on a long-term basis.

Whilst markets are still pricing these companies down a lot, Obis believes these companies hold tremendous future value, although noting that they will be subject to short-term cyclicity. Examples include XPO, GXO and the payments companies, like Global payments.

Payment providers are generally paid a "take rate" (a percentage of each transaction processed) and the pandemic was a major blow to spending on many of the services and experiences provided by small and medium-sized businesses (SMBs). At the same time, "disruptive" new competitors like Square (public) and Stripe (private) caught the imagination of many investors, and the "legacy" payment companies like Global Payments, and its peers FIS and Fiserv, were left behind. As a result, Global Payments went from trading at a 30-50% premium to the S&P 500 before the pandemic to about a 30% discount today. There are valid reasons to be cautious.

Like any technology, the payments space evolves rapidly and the competitive threat is real. And while SMBs may have begun to recover from the pandemic, discretionary spending may suffer yet again on fresh consumer fears about recession and the cost of living. At less than 12 times their estimate of 2022 earnings per share, Global Payments offers exceptional value in Orbis's view. They believe that the business should be able to deliver earnings growth of 15-20% per annum over their investment horizon.

We also can't ignore the US dollar

Recently, the U.S. dollar has strengthened meaningfully, surpassing parity with the euro, which is a major development for currency markets.

Markets have turned their focus toward the trajectory of future earnings. In this regard, corporate profits appear high versus historical levels and potentially vulnerable, especially in an environment consisting of persistent inflation and moderating economic growth. This is a regime in which it could become more difficult to pass on cost increases through pricing, with aggregate earnings potentially falling from record highs at a point where the economy is at risk from recessionary pressures. That said, we note that financial conditions, by many observations, remain fairly robust.

Andrew Headley, Head of Research and Portfolio Manager, Veritas Asset Management notes that Veritas follows a bottom-up approach when it comes to selecting investments. Their large regional exposure to the US is a result of companies they invest in, not due to region, but due to their high quality. With this being said, even though these companies are domiciled in the US, they earn a lot of their revenue offshore from the US, such as Mastercard. Whilst he recognises

that these companies are suffering in the current environment due to the return and growth rates they are seeing from their offshore currency exposure, they believe this has been priced in largely. Veritas believes that the dollar will remain strong and therefore favour the currency.

An interesting point that Andy also raises is their belief that the type of recession that we could see ahead, would be very different from that experienced in 1991, 2001 and 2008. Whereas these recessions were deflationary based, the recession that could lie ahead will be of an inflationary nature. This is also evident in earnings today, where companies are pushing through pricing, meaning the earnings decline is likely to be less than we have seen in the last few recessions. We are also seeing US companies price this in.

At the moment, in his opinion, you should be keeping an eye on companies that you believe have the security of earnings but that is available in a cheap currency – which will ultimately pay off in the long term.

This of course raises the topic of Japan

Japanese stocks have had a unique experience, often moving out of lockstep with the rest of the global equity market. They continue to offer a diversified revenue source, especially for unhedged exposure, with the Japanese yen showing incredible value (near multi-decade deviations against other developed market currencies).

For the most part, Japan has seen change taking place at a corporate level. While much of this structural tailwind is now behind us, we still see scope for a continuation of improving shareholder interests, rising dividend payouts, and board independence. Japanese stocks also carry attractive diversifying properties that may help in broad market setbacks.

Sentiment toward Japanese financials had been hindered by the Bank of Japan's prolonged quantitative-easing program, making it difficult for banks to make money (and lowering investment income for insurers). While this is likely to remain a challenge, the upside is meaningful if and when normalization takes hold.

Ranmore notably has a 22% holding in Japan. According to Sean Peché, Portfolio Manager at Ranmore Fund Management, he remains excited by the opportunity Japanese companies offer, with a lot of change being implemented by the management of businesses in recent years.

One of their top 10 holdings is Mitsubishi UFJ, which owns 20% of Morgan Stanley, and has one of the best banking results in the market. This is important to note, as the dollar headwind that most US companies have, is actually a tailwind for European and Japanese companies. In his opinion, the trick is to find companies that have US assets or are US exporters (like Yamaha or Mizuno) that will benefit from these tailwinds. He further states that Japanese companies are on the front foot, they are well capitalized, focused on return on equity and management don't take all the profit for themselves.

And of course, no discussion would be complete without tackling the topic of emerging markets

The broad emerging-markets basket remains challenged by high inflation, higher funding costs, and volatile local currencies. As usual, investors in emerging markets must also price in regulatory and geopolitical risk.

We need to remember that emerging markets are heterogeneous. Investors tend to bucket emerging markets as one, but often the real opportunities present themselves at a country, sector, or regional level.

If 2022 has taught us anything, it is that we need to be cognizant of the differences that need to be considered when it comes to emerging markets and what these markets are driven by. For example, some are driven by commodities and others by tech, and at the end of the day, the jurisdiction of that country matters.

When I asked Dan Brocklebank how they balance country-specific risk, with company-specific risk as well as the currency risk when investing in emerging markets, he reminded us of how important the research process is. For Orbis, the focus remains on finding good quality investments and focusing less on the jurisdiction in which these companies are listed in. According to him, their principles remain rooted in the analysis and understanding of what has been priced in, and that investing remains an interaction between logic and psychology.

Commenting on their 6% holding in Petrobras (a state-owned Brazilian multinational corporation in the petroleum industry headquartered in Rio de Janeiro, Brazil) Sean Peche sighted the company's incredible value. According to Peche, it's one of the lowest-cost producers, that generate high earnings (more so than Shell), paying 60% of its free cash flow in dividends. This has earned them a 40% return on their original purchase price, in dividends. Indicating that you don't always have to search too far to find value.

Lastly, is there still energy left for the energy (and related) sectors?

At a sector level, we've seen significant divergence as inflation and high commodity prices influence investors. Perhaps the most notable is the stellar run for energy companies in 2022, which have significantly outpaced other sectors, albeit from a low base.

Defensive sectors have played an important role too, helping manage volatility and providing the characteristics that people seek in a market setback. Andrew Headley notes here the large holding Veritas has in BAE systems (a British multinational arms, security, and aerospace company).

In closing

There are a lot of very visible risks across the globe at the moment and potential further risks to earnings in the near term. Despite this, it is clear that global equity managers today are excited about the long-term prospects of opportunities presenting themselves today.

With so few places to hide, it's understandable that investors are feeling very nervous. However, for those still investing, the outlook is improving as lower prices could potentially imply higher returns. Valuations, on almost every measure, continue to improve. In such environments, it's helpful to think about investing as a little like farming, there are times when we are harvesting previous gains and times when we are sowing the seeds for future return potential. As prices fall, it can be prudent to move into the sowing season.

According to Andrew Headley, valuations are much cheaper, we're seeing earnings still coming through robustly (particularly in quality companies that are protected). We've seen deratings take place, and now is the time to set your portfolio up for a three, five and seven year horizon from here, and the results that you could get from the right companies, will be quite strong. ■■

Risk Warnings

This commentary does not constitute investment, legal, tax or other advice and is supplied for information purposes only. Past performance is not a guide to future returns. The value of investments may go down as well as up and an investor may not get back the amount invested. Reference to any specific security is not a recommendation to buy or sell that security. The information, data, analyses, and opinions presented herein are provided as of the date written and are subject to change without notice. Every effort has been made to ensure the accuracy of the information provided, but Morningstar Investment Management South Africa (Pty) Ltd makes no warranty, express or implied regarding such information. The information presented here in will be deemed to be superseded by any subsequent versions of this commentary. Except as otherwise required by law, Morningstar Investment Management South Africa (Pty) Ltd shall not be responsible for any trading decisions, damages or losses resulting from, or related to, the information, data, analyses or opinions or their use.

This document may contain certain forward-looking statements. We use words such as "expects", "anticipates", "believes", "estimates", "forecasts", and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially and/or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason.

Morningstar Investment Management South Africa Disclosure

The Morningstar Investment Management group comprises Morningstar Inc.'s registered entities worldwide, including South Africa. Morningstar Investment Management South Africa (Pty) Ltd is an authorised financial services provider (FSP 45679) regulated by the Financial Sector Conduct Authority and is the entity providing the advisory/discretionary management services.

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.