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What we know for sure

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At Allan Gray we prefer not to opine over reasons for short-term movements in stock markets and share prices and we shy away from predicting changes in the market in the near term. The reason for this approach is we are firmly of the view that in the short term, the market is mostly – exactly as legendary value investor Benjamin Graham described it – a voting machine. What Graham meant is that in the short term share prices are determined by investors whose decisions to buy or sell those shares are largely driven by emotion. They decide at any point in time that they either like or dislike a share(s), and this emotional response is usually motivated by their interpretation of news flow and the impact this has on near-term expectations and sentiment.

The remarkable volatility in stock prices around the world, and indeed in South Africa, over this past month provides a good example of this investor behaviour phenomenon. For example, in the US stock market, the volatility has been unprecedented. The Standard & Poor's 500 stock index (S&P 500) – which is the index of the largest 500 actively traded shares in the US – swung alternately up and down by more than 4% each day for four consecutive days in August. It is believed that this is the first time this has occurred in the S&P 500's history, which goes back to the 1920s.

Investor behaviour: the market's wildcard

Interestingly, the combination of reasons that appears to be driving current investor uncertainty is not based on new 'breaking news'. The patchy and often dubious recovery in major developed economies post the 2008 global credit crisis; the quantum of US government debt and associated fiscal concerns; the ongoing European sovereign debt crisis and the question mark over the ability of China to continue to consume certain commodities at a voracious rate have all been known realities for some time. What triggers have caused investors to suddenly place a greater or lesser emphasis on these realities over recent weeks is something that is impossible to fathom. Why the pendulum swings so wildly in extremes from optimism to fear and panic, and then incredulously back to hopefulness just as quickly, is simply irrational.

In the face of this heightened market volatility and uncertainty, and given how powerful the emotional influences of the market (behaving as a herd) can sometimes be, as investment managers we are very mindful to remain calm and thoughtful and to maintain an even keel, as we would through steady bull or steadfast bear markets. The reason for this is that we invest on the basis of what we know; what we can develop a true insight into and what we can reasonably control, as opposed to speculating about where share prices might go in the short term.

Key investing truths

So especially in this current investment environment where uncertainty appears to be the only certainty, what are some key investing truths that we know for sure?

We know for sure that the best determinant of returns from shares is the price you pay in relation to the true worth of each respective share.

We know for sure that the true worth of a business doesn't fluctuate wildly on a daily, weekly or monthly basis though the share price can.

We know for sure that we don't know where the South African stock market might move to in the short term. At around the 30 000 level, and despite delivering weak returns this year, we believe the stock market as a whole is still not outstandingly cheap – the P/E on the FTSE/JSE All Share Index is currently above its long-term average of 11.8x; the dividend yield is below the historic average of around 4%; and most importantly the underlying current earnings level for the market is well above its long-term trend.

The positioning of our portfolios both in terms of the level of equity exposure and the shares we actually own has been driven, as always, by our bottom-up views of fundamental value on a case-by-case basis and where the risk of permanently losing money is the lowest. Margins of safety have been insufficient in several instances to compensate for our estimates of the full spectrum of risk, so it is not surprising that our portfolios have been cautiously positioned for some time. We still don't know exactly where the global macroeconomic environment will settle in the foreseeable future and what this will mean for investor psychology. However, we know for sure that – as investor Howard Marks said – you simply cannot create investment opportunities when they are not there, and that patient opportunism, i.e. waiting for bargains, is often the best strategy.

Commentary by Delphine Govender, portfolio manager, Allan Gray

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