March 2024

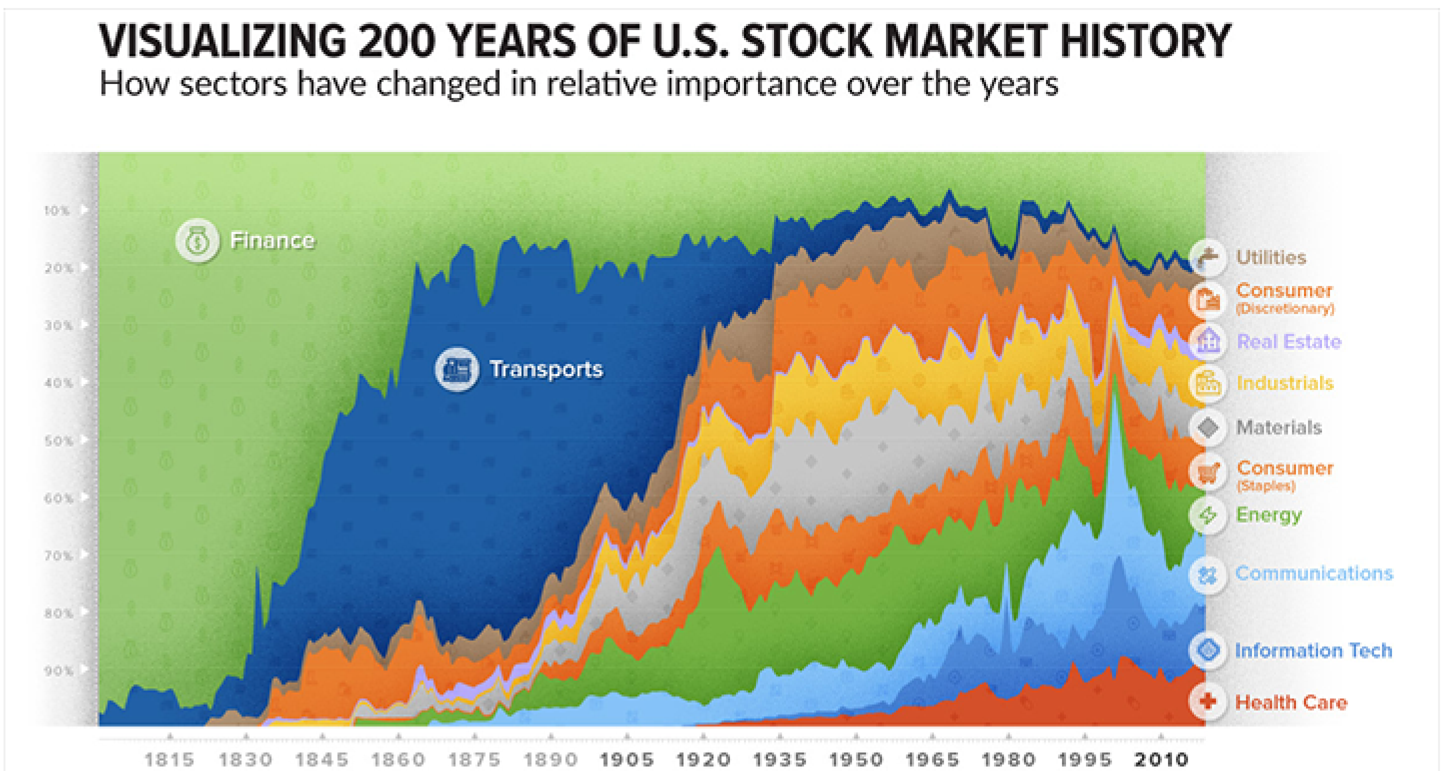
Reconnecting to Reality

At times share prices and even broad stock markets can appear unhinged. Wild swings both positive and negative stir investor appetite to invest more, or to run for the hills. For instance, NVIDIA, a very large company making computer processors, has risen 72% so far this year, while Boeing has lost a third of its value. Have the prospects and valuations of these two long established companies really changed so much in just 70-odd trading days? What have investors figured out in this short space of time which indicate such a dramatic change in fortunes?

In this article we reconnect with the concept of value and the real drivers of investment returns. We aim to understand why the price of an investment can fluctuate significantly, even when there are minimal changes to the underlying organisation and its value.

Price is not the same as value

Let's start by considering the chart below. It details in a simple format, the historical make-up of the US stock market for the past 200 years, since 1800. Back then, as an investor you could buy the shares in a bank or a railroad company. More likely you were spending your time and money on tack supplies from the local market, with the more fortunate able to invest in real estate and into private businesses. Yet you could have done quite nicely in railroads and banks, for a time.



Source: The Visual Capitalist

But even in these simpler times, the share price of Northern Pacific Railways shot up from $100 to $1000 in just a few days in 1901[1]. Over this short period, investors were willing to pay ten times the price for a company consisting of steel tracks and locomotives. It so happens there was a short squeeze[2] on. Yet a short squeeze has absolutely nothing to do with the operations of the railroad, and you would think, its business profits, prospects and value. Yet the price, for a brief period, had increased tenfold.

This example illustrates the divide between the real world of steel and locomotives, and the financial world, which can often appear as distant relatives to one another. This disconnected nature of financial assets from real assets can create wide distortions in share

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prices in the short term.

In 2024 you will notice that the market is not quite so simple. The number of investments listed on the stock market gathered pace after the Great Depression, to the point where the depth and breadth of financial assets today is vastly more than any one person can consider. And in this great, complex mass of investment opportunities, we get many 'Northern Pacific' examples each day. Wild share price movements, seemingly disconnected from reality. *What do the 'others' know that I don't? Is it speculation or the new reality?*

The reality is that it is too hard to make sense of all the noise created within this complexity to draw definitive conclusions. Moreover, the reasons for such departures between price and value may be devoid of any common sense or rational support to begin with, rendering it a fool's errand to try and understand. Wild share price moves can have both valid and invalid reasons. Here are some examples:

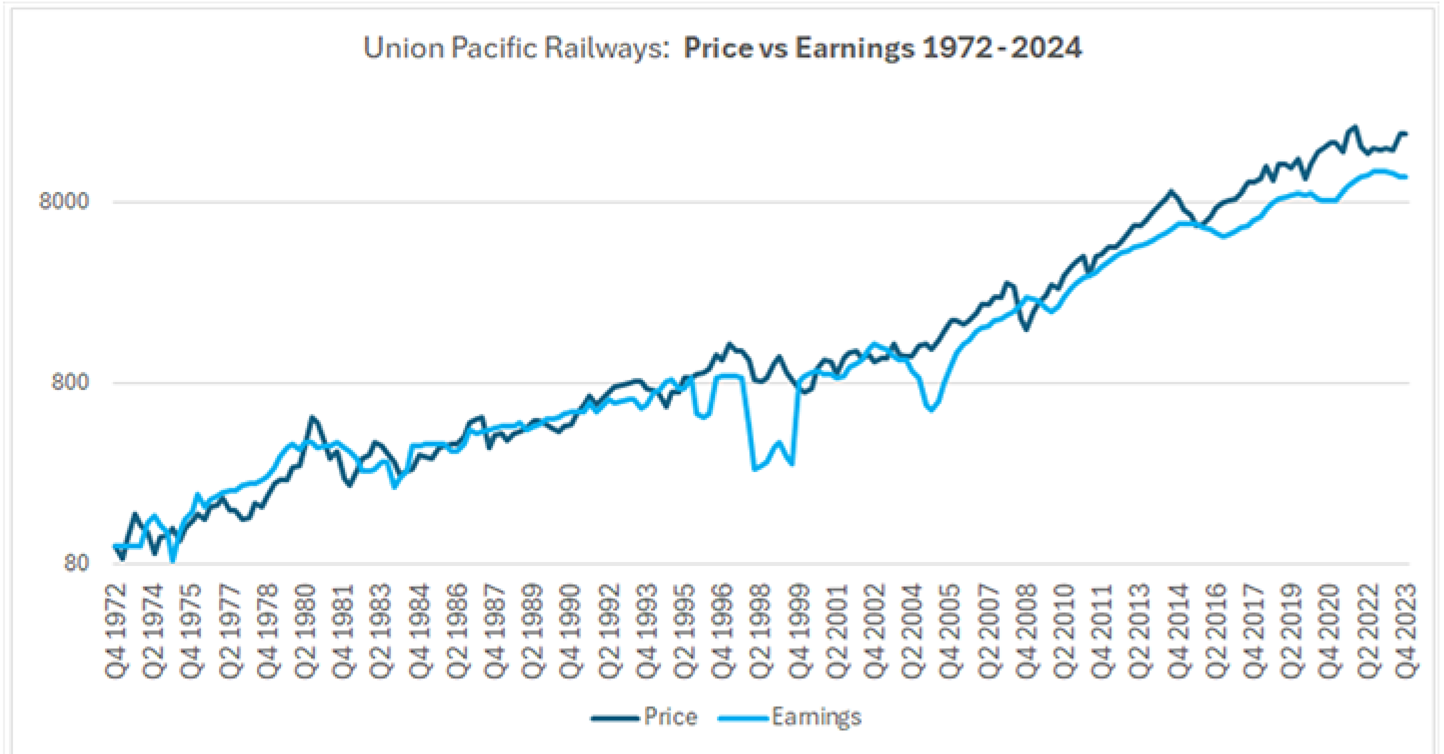
- 'New' news – such as the approval of a new drug which can be sold to the public;
- As in Boeing's case, the perception that all their planes have faults creates something of a panic amongst equity holders;
- Chinese and South African equities being uniformly sold off by foreign investors on political concerns;
- ChatGPT giving rise to the new era of Artificial Intelligence, spurring demand for NVIDIA's chips;
- Consensus that the US Fed will change its interest rate policy at the next meeting.

Are you able to foresee which of these has merit and will impact earnings, and to what extent?

Frequently, multiple events happen simultaneously and over various time spans, making it challenging to pinpoint accurately which one influences the price and to what degree! Does this mean investing is mere guesswork? Not at all. Let's delve into why and how we can anchor our investment strategies on value rather than price to better navigate through the noise.

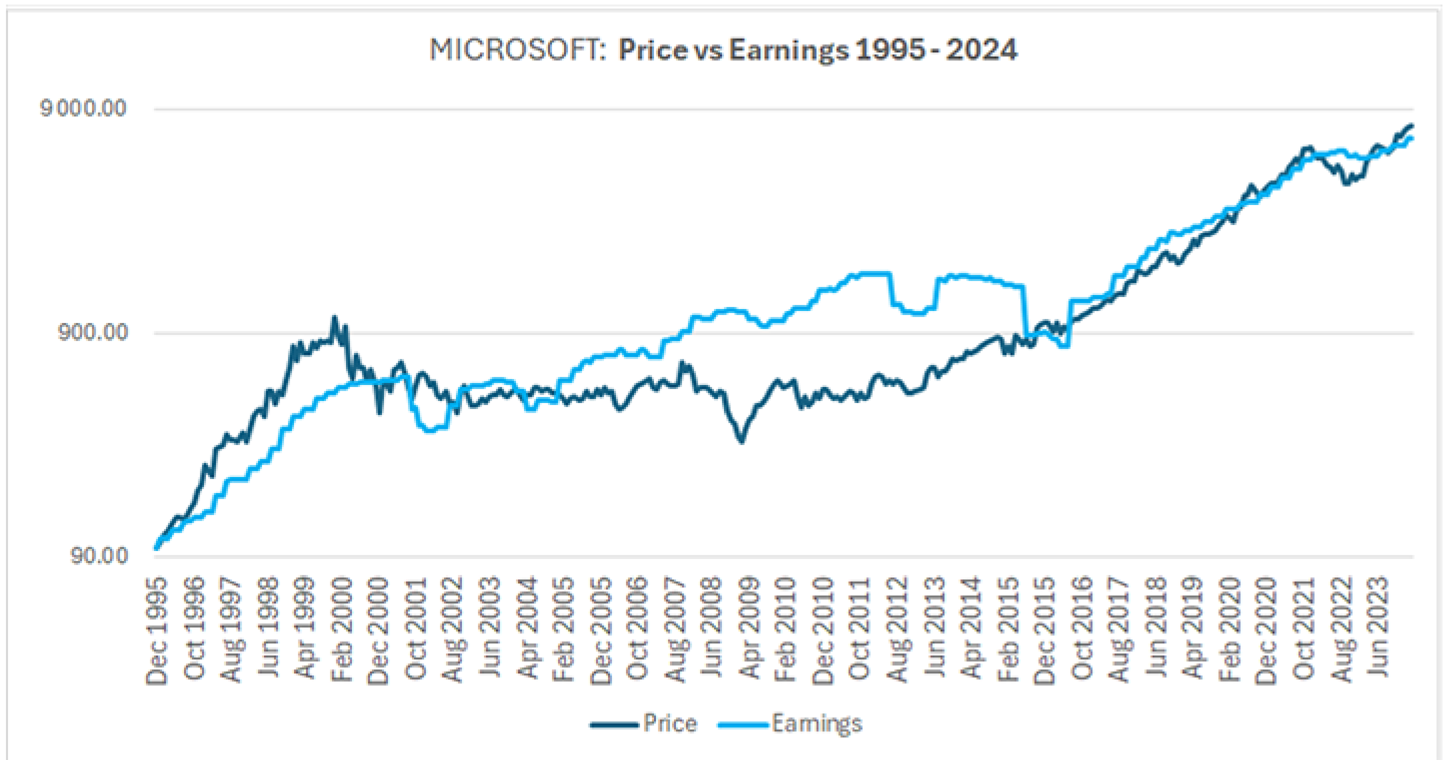
Earnings Matter in the Long Run

As the chart below attests, the price of Union Pacific Railways - a close competitor to Northern Pacific and part of the reason behind the price swing in 1901 – has grown steadily in line with its growth in realised earnings. Apart from a dip in 1998 (a logjam!), investors in the share will have benefitted from a steady rise in price and earnings, at around 10% per year for 50 years. Not a bad outcome! This steady growth in earnings delivered a nice annual dividend of around 2.6% per year, leaving a fair amount for capital reinvestment which you would imagine is easily spent on trains. So in this case, it's clear: price follows earnings, which are mostly predictable. Value is therefore quite easy to ascertain. The business does not 'pivot'.



Source: Refinitiv; Fundhouse

But take Microsoft as an example. While it is currently the darling of many investors, it was a few steps down the ladder back in the mid-2010's when it was still selling software bundles and trying to outcompete the iPad with its Netbooks (remember those?). Additionally, it made a significant investment in Nokia, and was in the process of writing it off in 2015 when investors started paying up for the share. The share price rallied by 25% in the last quarter of 2015 alone, in a company whose prospects were flagging, and various missteps had weakened confidence in leadership. The chart below shows how wide this gap between price and earnings was from 2009 until 2015 – at which point even the value funds were willing buyers of the share. In this instance, the wild moves in share price at the end of 2015 were justified, as it is the inflection point when the conversion to cloud services and the software subscription model started paying off for Microsoft. In this case, where companies are in the business of innovation and disruption and are prone to 'pivot', as Microsoft was, value is much harder to ascertain and can appear more speculative. Remember the Metaverse? That was the blip on the chart in 2020. Knowing how earnings will play out is what sets good fund managers apart.



Source: Refinitiv; Fundhouse

We can observe that price eventually converges to earnings, even if it can deviate at times, for months or even years. And we can also observe that there are companies which are easy to assess from an earnings perspective (railways), and companies which are more difficult (technology for example).

The sector in which a company operates influences its predictability, and therefore the shares sensitivity to news flow, and its propensity to have large deviations between price and earnings. The country in which a company operates also plays a big role in how predictable earnings (and therefore value) are. Take Alibaba in China for example: with the political noise, trade wars, property crisis and debt levels it is hard to determine which one of these is causing Alibaba to trade at price lows currently. Perhaps it is due to the CEO who was AWOL for a few months. Perhaps not. But it does scream “opportunity!!” Let's examine whether price and earnings converge in this case. (Will earnings meet price, or will price meet earnings?)

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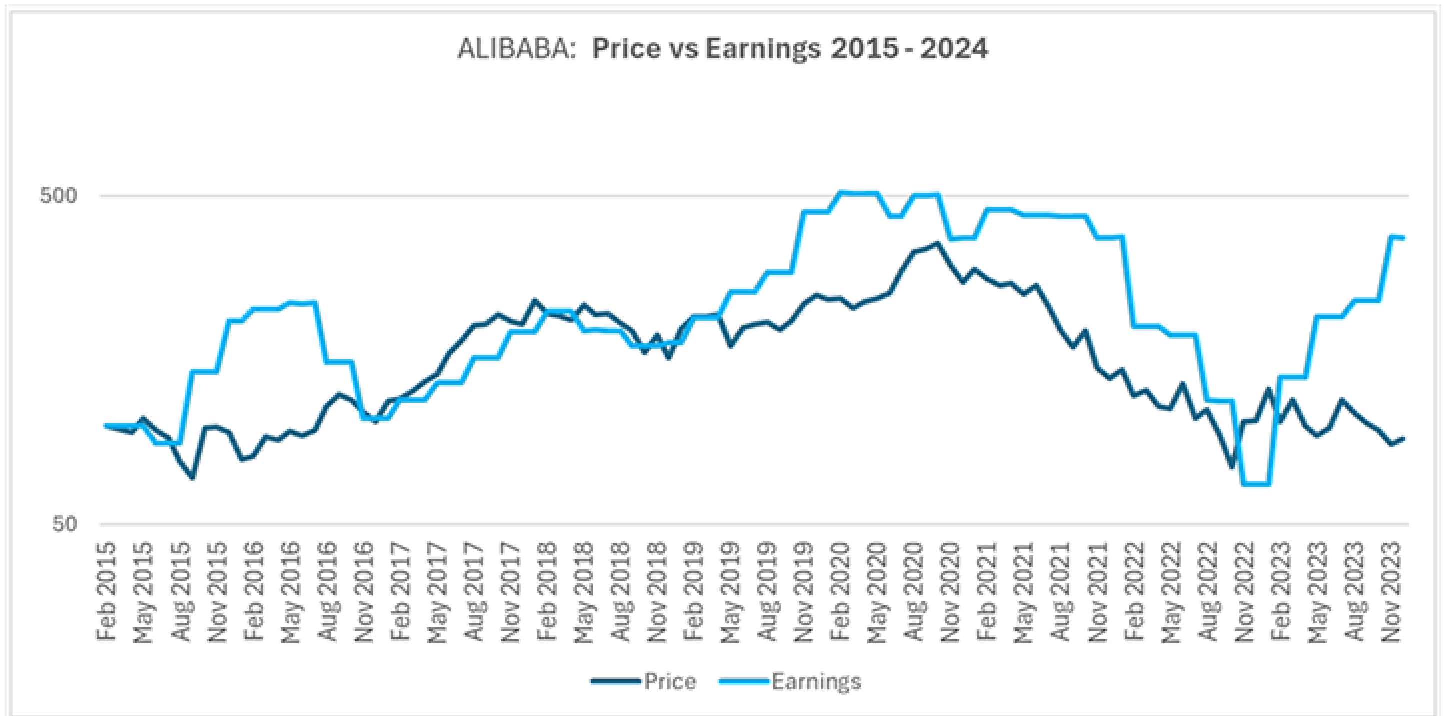

Source: Refinitiv; Fundhouse

Earning a Return

So price follows earnings over time, and earnings can be hard to predict. From earnings we get dividends. Dividends are easier to predict (CEO's don't like to rock the boat with dividends). The more reliable the earnings base, the higher the dividend yield can be. But, there is a price to pay here: companies which are perceived as safer or more reliable tend to attract a premium valuation. There are no free lunches.

How else can we earn returns as investors? Well, the company can change its prospects and increase its earnings base beyond what was previously considered (e.g. Microsoft in 2015), or it can attract a higher rating[3] where investors are prepared to pay a higher price for the company even if earnings stay the same. This could be due to better governance, investor friendly policies or debt reduction. A company trading at an average 15x earnings which rerates upwards to a 20x earnings multiple, equates to an additonal 33% capital return. It is worth noting this can also happen in reverse – a company which gets worse attracts a lower rating, which reduces return.

We can also earn additional return by buying a company which is trading below its fair value, thereby earning a rerating in addition to dividends and earnings growth.

We now have: My return = earnings growth rate + dividend yield + rerating

Different types of investors target different parts of this investor return equation. Value investors will aim for rerating and dividend yield as a large component of return, whereas growth investors want a high earnings growth rate, often with zero reliance on dividends and generally need to bear a derating cost too. Quality investors are happy to pay a higher rating to get the steady earnings and dividends profile.

We can see that over time earnings prevail as the driver of value, rather than noise, hope or speculation. Additionally, with dividends factored in, we can estimate our average return. In the US market overall, this translates to an average earnings growth of around 6.5% per year, and a dividend yield of about 2.5%, resulting in a total return expectation in the region of ~9% per year in US$ from equities. In South Africa this is closer to 9% earnings growth and a 3% dividend yield resulting in a total return of ~12% in rands, but

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you are invested in a depreciating currency which offsets some of the benefit. Over the past decade US investors have benefitted from a market rerating of 4.0% per year (the PE increased from 18x to 27x), while local investors have endured a capital loss due to derating of 2.7% per year. Looking ahead, it is important to assess whether these current rating levels are fair, or if they could do with some upward or downward adjustment which would impact investor returns quite materially. In general, we would not provide for structural reratings or deratings in our long term return assumptions, but they can certainly impact your outcomes if they deviate meaningfully from the growth in earnings for the market, as we have discussed above.

Over the short term – with equities this is anything up to 5 years or so – the noise can dominate the perception of value and create these price versus earnings anomalies. This is why fund managers will always reference 'the long term' to allow time for price and earnings to converge to a sensible level to help realise their investment case. More often than not, wild share price swings are temporary and noise related, but occasionally there is meaningful change in a company which necessitates a significant change in prospects and valuation. The better fund managers are equipped to tell the difference to be able to add value for clients.

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[1] *Source:* https://novelinvestor.com/the-biggest-short-squeeze-of-the-last-century/
[2] *A short squeeze occurs when the market realises that some investors have borrowed shares to sell short on the premise the price is too high and they can profit by it falling. By bidding the prices up, it was possible to bankrupt these short sellers and force them out of the market.*
[3] *A rating, or PE, is the price per unit of earnings someone is willing to pay. A higher rating equates to a higher quality company with better growth prospects.*

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MARKET REPORT

31/03/2024

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
SA Equity	ZAR	-2.4%	-2.4%	0.9%	7.4%	8.9%	7.2%	17.1%	14.3%
SA Listed Property	ZAR	3.7%	3.7%	19.9%	13.3%	0.2%	2.6%	27.0%	21.3%
SA Bonds	ZAR	-1.9%	-1.9%	3.6%	6.8%	6.4%	-	8.5%	-
SA Cash	ZAR	2.0%	2.0%	8.3%	6.1%	6.0%	6.5%	0.5%	0.4%
Balanced Benchmark	ZAR	0.3%	0.3%	7.2%	8.8%	9.2%	8.3%	11.8%	9.7%
SA Inflation (1 month lag)	ZAR	1.1%	1.1%	5.6%	6.1%	5.2%	5.1%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity	USD	8.6%	8.6%	25.2%	8.7%	12.2%	9.5%	18.0%	15.0%
Emerging Markets Equity	USD	2.1%	2.1%	7.2%	-5.4%	1.8%	2.7%	19.1%	17.4%
Global Property	USD	-2.3%	-2.3%	7.4%	-1.2%	-0.2%	3.0%	20.6%	16.7%
Global Bonds	USD	-2.1%	-2.1%	0.3%	-4.7%	-1.2%	-0.1%	7.5%	6.2%
US Cash	USD	1.3%	1.3%	5.3%	2.7%	2.1%	1.5%	0.6%	0.5%
MAJOR INDICES BASED TO RANDS									
SA Equity	ZAR	-2.4%	-2.4%	0.9%	7.4%	8.9%	7.2%	17.1%	14.3%
Global Equity	ZAR	11.4%	11.4%	33.6%	18.1%	18.5%	16.2%	15.8%	15.6%
Emerging Markets Equity	ZAR	5.7%	5.7%	14.4%	2.8%	7.5%	8.9%	14.3%	13.8%
Global Property	ZAR	0.2%	0.2%	14.6%	7.4%	5.4%	9.2%	18.5%	17.1%
SA Bonds	ZAR	-1.9%	-1.9%	3.6%	6.8%	6.4%	6.9%	8.5%	8.1%
Global Bonds	ZAR	1.4%	1.4%	7.1%	3.5%	4.3%	5.9%	13.3%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	7.3%	7.3%	11.7%	9.3%	11.1%	5.3%	14.7%	13.6%
Gold (Rands)	ZAR	11.1%	11.1%	19.2%	18.7%	17.4%	11.7%	18.0%	16.9%
CURRENCIES									
Rand / Dollar	ZAR	-3.4%	-3.4%	-6.7%	-8.6%	-5.6%	-6.0%	14.3%	14.7%
Rand / GBP Pound	ZAR	-2.6%	-2.6%	-9.1%	-5.4%	-5.0%	-3.1%	12.3%	14.2%
Rand / Euro	ZAR	-1.2%	-1.2%	-6.0%	-5.6%	-4.8%	-3.5%	11.6%	13.0%

KEY

Asset Class	Represented By:
SA Bonds	Satrix Bond Index Tracker
SA Cash	STeFi
SA Equity	Satrix ALSI Index Tracker
SA Listed Property	Satrix Property Index Tracker
Emerging Markets Equity	iShares Emerging Markets Equity Index Tracker
US Cash	Fidelity Institutional Liquidity The United States Dollar
Global Bonds	iShares Core Global Aggregate Bond ETF
Global Equity	iShares Developed World Index Tracker
Global Property	iShares Developed Real Estate Index Tracker

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Spot Rates		31-Mar-24	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	18.9	18.9	17.7	14.4	10.5	6.4
Rand/GBP	Rand	23.9	23.9	21.9	18.8	17.5	11.7
Rand/EUR	Rand	20.5	20.5	19.3	16.2	14.5	7.8
RATES							
SOFR 6m $	US$	5.6	5.6	5.3	2.7	0.3	1.2
Repo Rate	Rand	8.25	8.25	7.75	6.75	5.50	8.00
Prime	Rand	11.75	11.75	11.25	10.25	9.00	11.50
All Bond Index Yield	Rand	10.7	10.7	11.6	9.4	8.5	9.7
COMMODITIES							
Gold ($/oz)	US$	2,214.3	2,214.3	1,976.5	1,295.7	1,289.3	420.0
Platinum	US$	907.0	907.0	981.0	850.0	1,418.0	906.0
Oil (Brent Crude) $	US$	87.4	87.4	79.8	68.6	107.0	32.5
INFLATION							
SA Inflation	%	5.6	5.6	7.1	4.6	6.0	9.4

data provided by FE Analytics

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Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.

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