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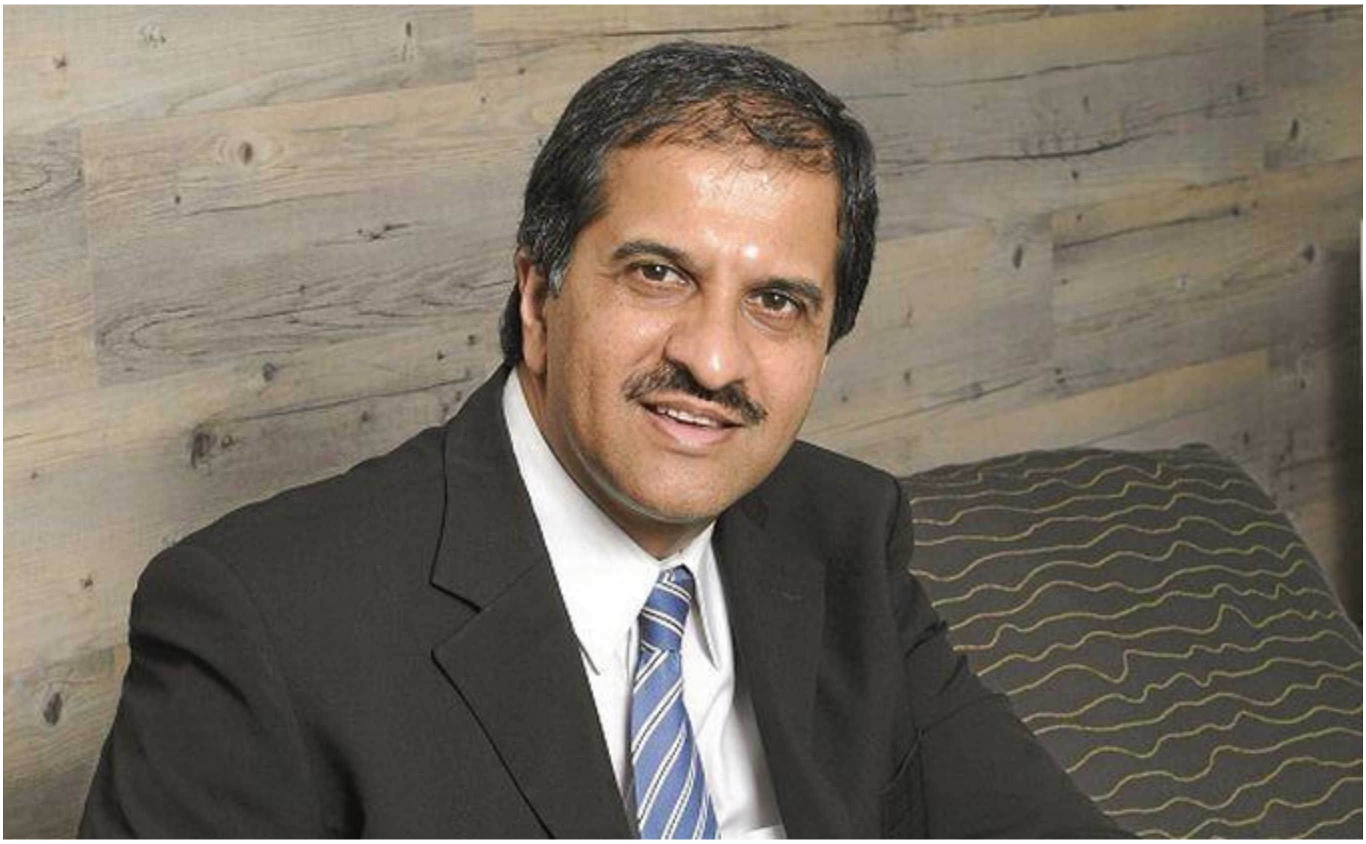
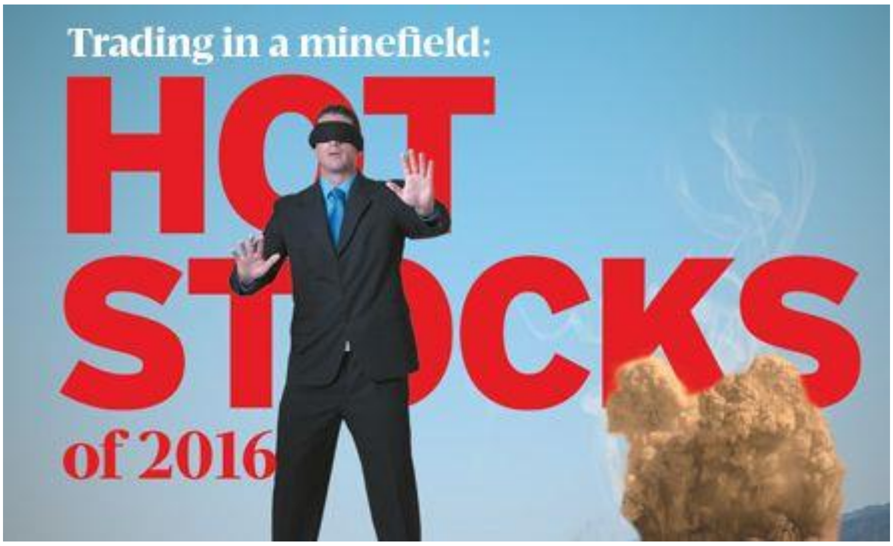
Markets

Hot Stocks 2016: It’s scary out there

BY ROB ROSE AND MARC HASENFUSS, JANUARY 14 2016, 07:39





WHEN Asief Mohamed, the founder and chief investment officer of Aeon Investment Management, walked into his office after the Christmas break, the message that scrolled across his computer screen read: “The future isn’t what it used to be”.

It was an apt welcome to 2016. Within days of markets opening, more than US$2.3trillion was wiped off the value of global stocks, according to Dow Jones.

For investors and anyone with a pension fund who believed that 2015 was a minefield, the grim news is that this year looks to be an equally treacherous war zone.

“Markets — not just ours, but globally — are likely to remain under pressure this year,” says Mohamed. “Sure, China has fallen, but I think there’s more to come there. In all probability the market direction this year will be down. We’ll see more angst, because I can’t think of any particular reasons why markets should improve.”

Locally, the signs portend even more gloom: a country teetering on the edge of a likely ratings downgrade, with economic growth set to remain below 2% and a currency that dipped as low as R17.99/$ this week. So, the dreadful start to the year hasn’t been entirely unexpected.

Ian Liddle, chief investment officer of investment giant Allan Gray, for example, isn’t surprised by the rocky start. “Over the past few years we’ve been stressing that discretion is the better part of valour, and that valuations were high. So when prices began to fall last year, it wasn’t exactly a shock to us,” he says.

In theory, this should mean that some quality shares are now a lot cheaper than they were a year ago.

This includes one-time market darlings like Standard Bank (31% cheaper than a year ago), Growthpoint (20.5% down), Sanlam (20% lower), Mr Price (off 23.6%) and Coronation (55% lower).

Says Liddle: “This suggests better value, but ‘value’ is a relative concept. We tend to think of the JSE as flat last year, which it was for South Africans measuring rand returns. But for foreigners who invested in the local market with US dollars, it really collapsed.”

And sentiment remains particularly rocky since Nenegate — the frantic few days in December when President Jacob Zuma fired well-regarded finance minister Nhlanhla Nene, replaced him with the unknown Des van Rooyen, then fired him and appointed former incumbent Pravin Gordhan to the post.

The resulting shock fall in the rand led many investment pundits to suggest the best investment strategy was to put money into rand hedge shares — stocks that make profits in hard currencies like dollars or pounds.

But the experts say this boat has already sailed. “Now is the wrong time to be stocking up on rand hedge shares,” says Mohamed. “You should have been there two or three years ago, like we were, when we bought Mondi and Richemont. The rand has weakened significantly and we think it’s now undervalued.”

Liddle agrees. “A few years back, we were clear on the risks we saw to the rand. Since then, the rand has depreciated a lot, and it’s hard to know to what extent all the risks are already priced into domestic stocks,” he says.

Its rand hedge strategy has produced some big winners for Allan Gray in previous years, thanks to investments in British American Tobacco (up 99% over three years) and SABMiller (up 139%). By comparison, the JSE’s all share index has climbed only 18% over the past three years.

Today, with the rand touching R17/$, Liddle says Allan Gray is “trimming back” its investment in rand hedges and “looking for opportunities to deploy this capital into domestic businesses”.

“The risks have become more balanced. So while we still have significant exposure to rand hedge stocks, we want a bigger position in selected domestic companies. We’re not switching our view though, we’re just balancing it out.”

Other investment companies are less convinced.

Investec Asset Management says it has been lowering its exposure to domestic shares in recent months. “We have become more concerned about the profit outlook for SA-centric companies. Though banks and insurers can be regarded as reasonably defensive businesses, risks have increased in our opinion,” it said in a research note published in late December.

As a result, one of Investec’s biggest positions is in Old Mutual, whose UK wealth business is expected to help push profits. It recently bought shares in Richemont, which it says is “attractively valued”, and it still has stakes in Mondi and British American Tobacco.

This doesn’t mean Investec is steering clear of domestic-focused companies entirely. It recently bought a big chunk of Vodacom, and it believes the market has taken too harsh a view on Truworths and Tiger Brands.

“While both [Tiger Brands and Truworths] arguably face a number of headwinds, we believe they should benefit from some improved strategic direction,” it says.

Equally, though Mohamed thinks rand weakness is overdone, Aeon continues to favour the rand-hedged Mondi, alongside the likes of Barloworld (a forward price: earnings ratio of 6), as well as smaller picks such as Metrofile.

“It comes down to picking individual shares. Portfolio managers say to me, ‘well, it’s difficult to get a handle on where things are going’, but they say that to me every year,” he says.

So what of the really unloved sectors that, on the face of it, appear to show value — like mining and construction companies?

Again, views are mixed. While some steer clear, Allan Gray is picking up selected resources firms.

Says Liddle: “Sasol has been a big part of our portfolio for a while, and its performance has been disappointing. But there is value there, and it is attractive in the long run.” He says that in all likelihood, mining firms are likely to have a terrible 2016. “But some of the mining companies offer attractive value, which we believe the market will come to see in the longer term.”

In particular, most experts eschew investing in those miners with lots of debt, like Anglo American (down 70% from a year ago) or Glencore (down 59%). By contrast, the relatively debt-light BHP Billiton was down 33%.

But Investec and many other institutions are far more wary. While Investec agrees that mining companies appear to offer value, it says: “It depends how one defines value.”

So where else do the experts see value?

Liddle cites construction shares as being cheap, even if their earnings prospects look particularly brittle. “We’ve been buying a number of construction shares,” says Liddle. “The construction companies generally own valuable assets in addition to their traditional building business. The shares can be bought at substantial discounts to the collective value of their assets.”

Other than that, Allan Gray’s portfolios include companies likely to gain from earning dollars while keeping their costs in rands (such as Sappi and Tongaat), and those with strong growth prospects (including Naspers).

Media giant Naspers, which owns MultiChoice, Media 24 and 34% of high-flying Chinese media sensation Tencent, was one of the few JSE-listed companies to enhance its reputation last year, gaining 39%.

Along with SABMiller (up 55% thanks solely to the buyout offer from AB InBev), these two firms propped up the JSE in 2015.

But Naspers looks particularly pricey, on a p:e ratio of 99, at a time when there are some good quality stocks, like Barloworld, on sale for less than 10 times earnings.

“In our investment team, we’ve had long discussions about Naspers. It’s on a high price-to-earnings ratio, sure, but that high multiple is a bit misleading,” says Liddle.

“The key is to understand Tencent’s long-term growth potential and whether that is adequately reflected in the share price.

“It’s hard to know how much further Naspers can grow.”

Still, Naspers remains one of Allan Gray’s top ten largest positions.

All of which illustrates that investors who picked individual shares would have done better last year than those who took a general punt on a sector.

This seems to be a key theme for this year.

How, then, did the Financial Mail ’s portfolio of stocks for 2015 perform? Over the past decade, we had a proud record of picking stocks that outperformed the wider JSE. This time, we came crashing back to earth.

The Financial Mail portfolio fell 4.5% last year, compared with the marginal 1.8% gain in the all share index.

This is largely attributable to three picks that had an awful 2015 — African Dawn and Wesizwe both fell by 50%, while Invicta shed 33% of its value. (It could have been much worse: had we picked Lonmin, down 99%, or ArcelorMittal SA, down 83%, our portfolio would have drowned in the red.)

It’s little consolation that we picked some of last year’s winners too, including Naspers, life assurer Old Mutual (up 19%) and horse racing company Phumelela, up 23.2%.

Only 21 of the JSE’s top 40 stocks yielded positive returns in 2015.

The best performer was private equity company Brait, whose share price more than doubled after a series of savvy deals, including selling its stake in Steinhoff and buying 80% of gym group Virgin Active and UK fashion retailer First Look.

Other market favourites like PSG (up 75%), Capitec (55%) and Woolworths (30%) stood out.

We warned readers to “tread carefully in 2015”, and it is interesting to note that investors would have outperformed the all share index easily by opting for a “defensive treble” in the form of SABMiller, Richemont (6% up) and British American Tobacco (38%).

But some of the JSE’s mainstay stocks — companies that have long been default portfolio selections — took awful beatings.

Any adherence to holding resources shares, and a sentimental position in Anglo American, would have devastated returns. Even the JSE’s big banks finished the year down by 15%-25%.

Stalwart performers like Shoprite, Mr Price, Aspen, Remgro and Sasol finished the year down, and the less said about MTN's painful engagements with Nigerian communications authorities the better.

Looking outside the JSE's top 40, star performers included logistics and shipping group Santova (up 55% in a year), low-cost property developer Calgro M3 (up 47%) and revamped BEE company African Empowerment Equity Investments.

Some sectors produced superstars as well as outright losers.

Quarrying specialist Afrimat, headed by the redoubtable Andries van Heerden, rose 71% to near its record highs — but this was a stark contrast to other infrastructure companies (most notably Aveng and Murray & Roberts) that dribbled to new lows.

Equally, while asset manager Coronation Fund Managers touched record lows last year, sprightly new contenders like Anchor, Sygnia and Anchor-aligned Astoria shot through the stratosphere thanks to waves of frothy sentiment.

Private education ventures Curro and AdvTech both benefited from an unsuccessful (and hostile) tilt by the former at the latter. Both tested new highs at year end, which suggests the corporate confrontation might have brought out the best in both management teams.

While our Hot Stocks cover story inevitably focuses more on top-performing stocks, it would probably be amiss not to point out more than a dozen "solid counters" which, at the time of writing, had dwindled close to 12-month lows. But the hazards of picking well-established shares with tangible asset underpins was reinforced a few weeks ago when Masonite, a traditionally profitable building supplies company with a reassuring tangible net asset value, unexpectedly applied for business rescue.

Trading conditions in the local economy, especially the manufacturing sector, are dire and circumstances for (especially smaller) companies can change quickly.

But "bottom pickers" might be warily watching for signs that the share prices of quality counters are ripe for plucking.

This includes shipping business Grindrod, services group Adcorp, mobility specialist Imperial, steady asset manager Prescient, technology hub Datatec, industrial equipment conglomerate Invicta and packaging giant Nampak.

There's also plenty on sale for the fearless. This includes construction stalwart Aveng (seemingly priced for disaster), franchiser Taste Holdings, cement producer Sephaku, technology group Ellies and technology cluster Altron.

The broader consensus is that the JSE, like all markets, won't be hitting any new highs in 2016.

But those willing to take a microscope to individual stocks may come out of this year with the least damage.