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BEAR MARKET A BUYING OPPORTUNITY

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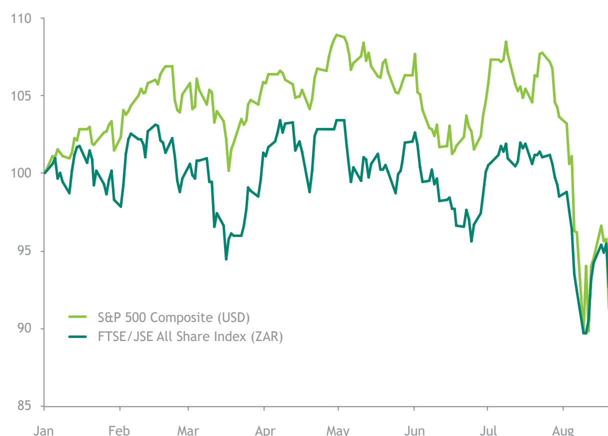
Recent events, specifically the political dissent in the US and the consequent downgrade of US debt on Friday 5 August, intensified a market downturn that started earlier this year, with the S&P 500 plummeting 6.7% by the following Monday. Month-to-date, the German market is down more than 20%.

S&P 500 and FTSE/JSE All Share indices
Data from 1 Jaunary 2011 to 19 August 2011



While markets have clawed back some of these losses, we continue to experience shockwaves of volatility, and investors are jittery. However, systemic risks have been a reality for some time now and we implemented protection measures in our portfolios as early as April, accounting for the "risk triad" comprising the threats of 1) a 'double dip' recession, 2) Eurozone debt contagion and 3) a hard landing for China, when implementing our views.

Ironically, the biggest risk to the global economy right now is that sustained market panic could itself trigger a recession. Weak markets would sour consumer and business confidence, with the knock-on effect of cutbacks in household and corporate spending. However, while economic risk is high, I don't believe that we are in for another deep global slump characteristic of the one following the 2007/2008 sub-prime crisis. What is certainly true is that companies are now in better condition, having improved balance sheets, reduced inventories and cut surplus labour.

The current volatility is creating even more opportunity, with valuations on equity becoming increasingly attractive. Despite strong earnings growth, the decline in markets has meant that price:earnings ratios have fallen sharply. The forward price:earnings ratio on the world market is down to nearly 10 times, which is cheap. As a result, we have increased the expected real return for international equity from 6.5% p.a. to 7.0% p.a. (in US dollars). It remains our preferred asset class for the medium term.

For local equities, the recent fall in share prices and an expectation of good earnings growth over the next 12 months have resulted in the forward price-to-earnings multiple dropping to below 11 times (as at the middle of August). There are now in the region of 50 stocks that are attractively valued on a forward multiple of less than 9 times, with solid dividend yields. We have increased the expected real return to 6.5% p.a. from 6.0% p.a.

Lack of alternatives

The strong performance of bonds has meant that their returns will be lower going forward and the slowdown in the world economy has meant that cash yields are not going up. Local bonds offer limited potential for capital gains, but should deliver a real return of 2.5% p.a. over the next five years, which is attractive compared to the 1.0% p.a. we expect from cash.

Internationally, cash and bonds are not worth consideration on account of the deadly combination of the US downgrade, the Fed's announcement that they would keep rates at zero until at least mid-2013, and the ongoing Eurozone debt debacle.

This means that equities are now fair value on an absolute basis and attractive on a relative basis. In line with our expected returns and our investment time horizon of five years, we see this weakness as a buying opportunity. In fact, we have bought for all of our funds and have moved overweight equity.

Diversification and risk management key

Now is not the time to start selling, as investors who sell in market downturns only lock in losses in their portfolios. In fact, as mentioned, we are doing the opposite and are using the current weakness as an opportunity to buy shares. Note, however, that our optimism is not broad-based, and investors still need to be selective when stock picking, as our bullish equity stance is against a backdrop of what remains a low-growth world, where most other asset classes remain even less attractive than they have been.

Sensible risk management is still important and we have not taken our portfolios to their maximum equity exposures, reflecting the high level of macro-economic risk in the current environment. We are also well diversified by asset class, country and company to minimise the risk of a single event. If you are invested in a solution, your portfolio manager will have already acted on your behalf within the sensible risk parameters that match your risk profile. Not panicking and sticking to your long-term savings plan will ensure wealth creation.

MSI long-term asset allocation view

Asset Class	Real Return	View	Comment
SA		N	Long-term real depreciation
Equity	6.5%	+	De-rated in last six months. Expect a better H2
Property	5.5%	N	Should produce steady real returns backed by yield
Bonds	2.5%	N	Limited potential for capital gains but attractive carry vs. cash
Cash	1.0%	–	Lower rates for longer means lower returns
International (USD*)		N	Diversification is valuable.
Equity	7.0%	+	Preferred risk-adjusted asset class
Bonds	0.0%	–	Longer-term bearish
Cash	-1.0%	–	Cash is still unattractive

NB: These are long-term, annual real returns expected over the next five years, as at 15 August 2011.*The international return expectations above are in US dollar terms; any rand depreciation will add to returns in rands.

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