KEY INVESTMENT LESSONS FROM A **DRAMATIC YEAR**

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Last year South Africans rode an economic, financial and political rollercoaster. It ended on a fairly dramatic note with markets responding very favourably to the conclusion of the ANC's elective conference. From an investment point of view, what lessons from 2017 can we take into 2018 and beyond?

1. The downgrade dog's bark was worse than its bite

What used to be a fairly arcane corner of global finance ended up as a frequent topic for braai-fire discussions: credit ratings. South Africa suffered several downgrades to its rand-denominated and foreign currency-denominated government bonds in 2017 (the former make up 90% of the total). The first round of downgrades occurred after the firing of Finance Minister Gordhan in March, and the second round in November. As it stands now, only Moody's has rated South Africa as investment grade, while Fitch and S&P Global had us at junk status. Moody's were clear that they too would cut our rating to junk status if the February 2018 Budget Speech does not deliver credible measures to reduce Government's deficit.

But for all the hype around the drop to junk status, the market response was muted. Many predicted a surge in interest rates (the Reserve Bank instead cut rates) and a collapse in the rand. Yet following the ANC's elective conference late last year, the rand rallied to end the year at R12.31 against the US dollar, the strongest level in more than two years (and stronger even than when the country was still investment grade in late 2015).

Why? Markets respond to the factors that give rise to ratings changes – weak economic growth, rising government debt, financial challenges at Eskom – in real time, long before the ratings agencies do. Much of the bad news, including the downgrades, was priced in by the time the agencies made their official announcements. The muted market response to the downgrade reiterates that investors should not over-react to negative news headlines.

2. The hazard of waiting for the dust to settle

On 19 June, an 18% rally on the FTSE/JSE All Share Index kicked off without warning and despite any meaningful discernible improvement in economic or political conditions in South Africa. On the contrary, things were looking bleak mid-year: junk status, technical recession, and major political uncertainty. The temptation to sit on the side-lines and wait for the "dust to settle" would have been great for many investors. History shows us that returns are lumpy – you have to sit through periods of poor, even negative returns to benefit from the gains. The market moves up over time, but if you take a closer look at the charts it does so in bursts and leaps. By the time the dust has settled, the market has already priced in the new reality and investors would have missed out. Unfortunately, missing out on such leaps upwards in the market could result in mediocre long-term returns.

3. Your portfolio has more international exposure than you think

There were suggestions from prominent commentators that South African investors should externalise most (if not all) of their assets, given the political uncertainty, downgrades and gloomy outlook for the economy. However, local investors have less exposure to South Africa in their portfolios than they realise.

Consider a typical balanced fund: it has around 25% direct global exposure, but of the remaining 75%, only a small portion is directly exposed to domestic economic growth. JSE-listed companies generate more than half their revenue abroad and therefore the FTSE/JSE All Share index generally benefits from a weak rand these days. The five biggest companies on the All Share (accounting for 41% of the index) are all global companies, in the sense that only a very small percentage of their revenue is from South Africa (Naspers, Richemont, British American Tobacco) or they are mining companies dependent on global commodity prices (BHP Billiton and Anglo American).

It is not just the South African market that is global in nature. The top 500 US-listed companies generate in excess of 40% of their income outside the US – think of Apple or any other major American brand. The Eurozone equity markets also derive more than 40% of income from outside the single market. The UK's FTSE 100 is even more global, with almost two thirds of the companies' income coming from outside Britain (which is why the market rallied when the pound crashed after the shock Brexit vote). So when making decisions about equity allocations, investors need to think globally and consider the state of the world economy. Currently, it is still in a sweet spot with improving growth and subdued inflation. Interest rates, on balance, will probably rise but this reflects better growth conditions rather than surging inflation and should not threaten equity returns.

4. Just because it hasn't popped, doesn't mean it is not a bubble

It is easy to get sucked into a negative narrative. But the staggering price increase of Bitcoin and other crypto-currencies in 2017 shows that it is even easier to get sucked in by a good story.

The block chain technology that underpins bitcoin is clearly very promising, and might very well form part of our day-to-day lives in the near future. But does that justify a 15-fold increase in price in the space of 12 months? Actual bitcoin transactions have only increased by 30% over the same period (according to blockchain.info). By many accounts, it is becoming more difficult to transact with bitcoin. And the more valuable bitcoin becomes, the less it can function as a currency, since people will simply hoard it. This seems to go against its original means-of-exchange purpose. It seems to increasingly be viewed as a store of value instead of as "digital gold". But that label can only apply if it is not replaced by any one of the other hundreds of crypto-currencies, or regulated out of existence. Its unusual volatility – there were five declines of more than 20% (the traditional definition of a bear market) in 2017 – also argues against the notion of a stable store of value.

Obviously, some early adopters have become fabulously wealthy (and they will encourage others to buy) but it remains a very speculative investment with no way of determining an intrinsic value. Many buyers of bitcoin now are simply doing so because they've seen rapid price increases, not because they have a deep understanding of the technology.

A key lesson from past bubbles has been that prices can keep rising much longer than you think. The worst thing to do is to grudgingly sit out until it hurts so much that you climb in close to the top. Sir Isaac Newton famously made a decent return during the early phases of the 18th century South Sea bubble, and cashed out. But as the share price continued to rise and the mania intensified, his greed got the better of him and he eventually climbed back in near the top, and lost it all. "I can calculate the motion of heavenly bodies, but not the madness of people" he later said of this experience.

5. **Diversification is the best defence against dodgy dealings**

While the local investment community was divided over Steinhoff's aggressive debt-fuelled global expansion path and exceptionally low tax rate, even the sceptics would have been shocked by the revelation of suspected accounting manipulation. That so many equity managers missed the irregularities at Steinhoff (including some of the managers we invest with) despite hundreds of hours of debate, analysis, engagement with management, directors, legal experts and lenders, is obviously disappointing and much soul-searching will follow.

But to then conclude that active management is therefore inherently flawed or futile is to throw the baby out with the bathwater. Ratings agencies, regulators in Europe (where the company listed in 2015), banks, and crucially, independent auditors, all had the wool pulled over their eyes. The full details have yet to emerge, but clearly it is possible to deliberately deceive even some of the sharpest minds in finance and auditing. Passive investing would not have helped though: index trackers held Steinhoff shares at benchmark weight, even after it became clear that the company was in serious trouble.

The real lesson then is that the best defence against such an unexpected event is diversification. A diversified portfolio would have suffered a knock, but not a wipe-out.

THE BOTTOM LINE

There is every chance that 2018 will be just as eventful as 2017. In South Africa, attention will fall first to potential changes in government leadership and policy following the election of Cyril Ramaphosa as ANC president. Focus will quickly shift to the February Budget, and whether it addresses the crucial (but potentially contradictory) needs of closing the fiscal deficit and stimulating growth. Globally, the big questions relate to how quickly the major central banks raise interest rates. No doubt there will be lessons to learn as well, and sometimes, lessons are only learned the hard way. Successful long-term investing is not about getting it right all the time, but rather about minimising the impact of mistakes and through patience, letting compound growth work its magic.

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