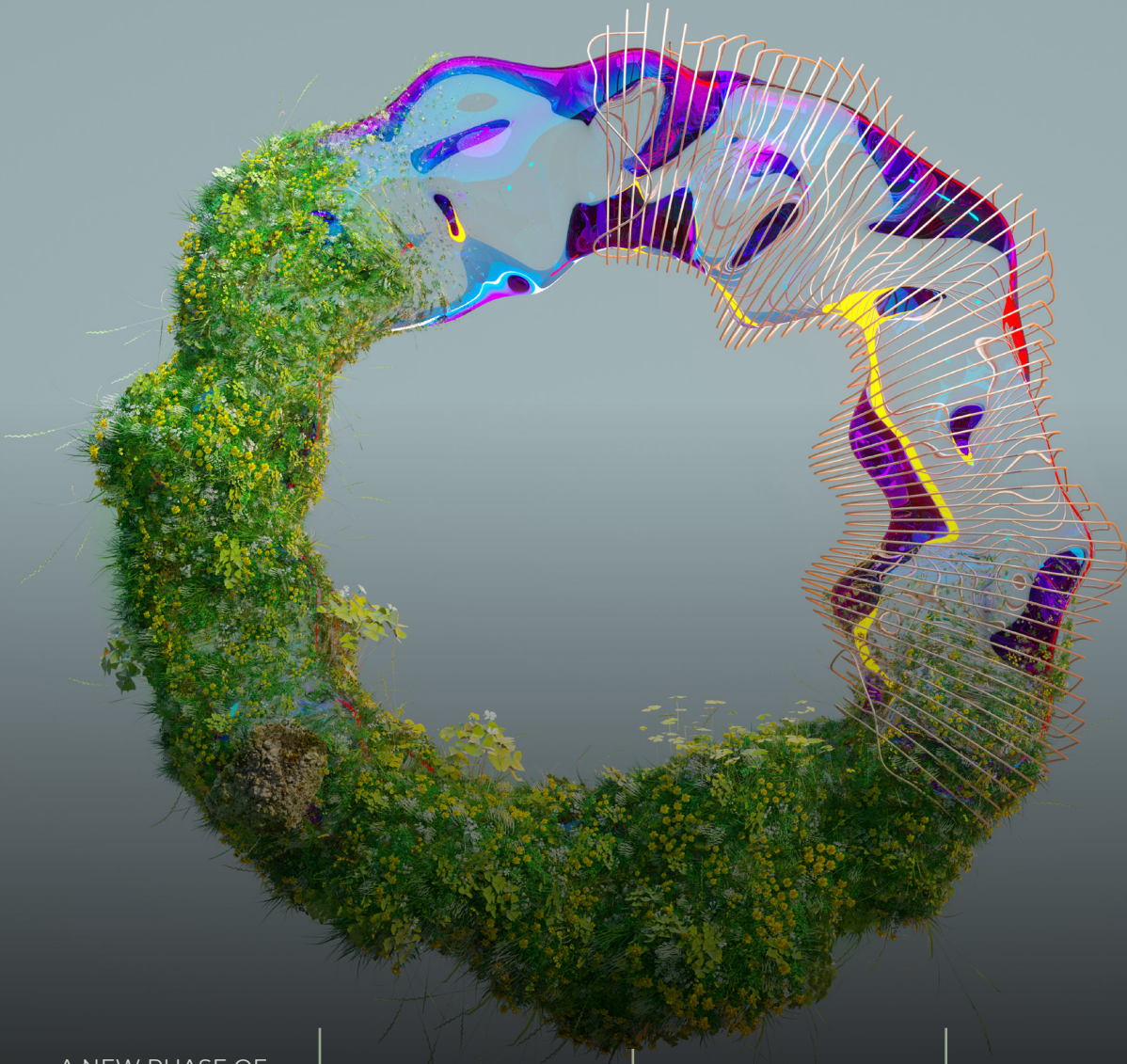


Cognizant

2ND QUARTER 2023



A NEW PHASE OF
GROWTH: FROM
SECULAR TO
CYCLICAL

LUXURY GOODS
SECTOR: TIMELESS
QUALITY

SA RETAIL – VALUE
IN THE EYE OF THE
BEHOLDER

THE RUNAWAY
RAND

Private Clients

by  Old Mutual Wealth

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A New Phase of Growth: From Secular to Cyclical

ANDREW DITTBERNER, CHIEF INVESTMENT OFFICER AT PRIVATE CLIENTS BY OLD MUTUAL WEALTH

In identifying and assessing investment opportunities, understanding how a business derives its revenue is paramount, as revenue and earnings growth ultimately drives equity returns. For any business, the key to driving earnings growth lies in ensuring that there is healthy demand for its products and/or services. Therefore, the state of an economy is an important factor as it impacts consumer demand and revenue, ultimately influencing earnings growth and equity returns.

However, solely and passively relying on economic growth to drive demand

and earnings will inextricably link a business' success to the cyclical nature of the economic environment. Within South Africa, we have seen how businesses need to be able to withstand the gravitational pull of a sluggish economy. Relying solely on economic growth to drive revenue and earnings over recent years would have been catastrophic. For this reason, many businesses look abroad – some successfully, others not. Alternatively, some businesses are very good at creating their own economies by either taking market share through innovating around frustrations, superior products and

better pricing, or introducing new products to the market.

Over the past few years, we have seen examples of businesses, operating within sectors undergoing structural transformation, that are actively harnessing innovation to create new avenues of growth. As a result, these businesses are benefiting from (and sometimes even driving) the secular themes unfolding within their respective sectors and are therefore far less susceptible to economic cycles.

At a high level, secular growth falls into three categories:

01

FOUNDATIONAL TECHNOLOGY

This is a technological innovation that becomes so impactful that it creates its own wave of demand, as well as a foundation upon which other businesses can grow. Examples include the internet, smartphones and cloud computing. Many businesses have profited from the internet infrastructure; smartphones have bred businesses such as Uber, Spotify and many others; while cloud computing has enabled the many benefits of cloud deployments as opposed to the costly exercise of local installations.

02

REPLACEMENT PRODUCTS WITHIN EXISTING MARKETS

This entails building a better product and ultimately taking market share from incumbent operators. Amazon is a great example. Online shopping has been disrupting traditional retailers from the outset, and Amazon has not only benefited from this transition, but has also been the primary catalyst for this transition. Capitec is an excellent example of a local business that has introduced a superior product into an existing market.

03

NEW PRODUCTS FOR NEW MARKETS

Creating a new product for a new market means developing a product for a previously unsolved problem. Google is a good example of a business enjoying this type of secular growth. With the onset of the internet, people needed a tool to navigate this new, rapidly expanding landscape. Before the internet, there was no need for Google. Today, Google is a verb.

RIDING THE WAVE

After the dotcom bubble, the onset of the digital economy provided the impetus for all three types of secular growth. Many technology-orientated businesses that were able to capitalise on the digital transformation have enjoyed a very long runway of growth. This propelled their market valuations and generated vast amounts of wealth for both entrepreneurs and investors. However, over the last 18 months, the sustainability of some of these secular themes has been questioned and concerns around whether certain of these businesses are becoming more cyclical have been raised.

Considering the three different types of secular growth categories and related examples, it is evident that while benefiting from the onset of the digital economy, the technologies are vastly different and are constantly evolving. Many of these companies have to be extremely agile and evolve with time in order to remain relevant. In this way, enjoying secular tailwinds is by no means a free ride for all.

For instance, Apple began in 1976 selling personal computers. Over the following 40 years, it evolved with the introduction of the iPod, iPhone, iPad and the Apple eco-system. So while Apple benefited from the digital economy transformation, it created its own economy. Similarly, Amazon evolved from an online bookstore to become the world's largest online retailer and the world's largest cloud computing services business. Again, assisted by the digital economy transformation, but by no means solely reliant upon it.

NOT ALL SMOOTH SAILING

As companies capitalise on secular growth trends, competition naturally increases. Alongside this, over time, consumer preferences and behaviours change, technological innovation takes place, and the economic and regulatory environments evolve. Any of these factors can result in the growth of a company (or sector) becoming more cyclical and less secular in nature. In fact, Morgan Stanley¹ points out that only 30% of growth companies are likely to repeat their success in

successive bull markets. The other 70% experience slowing growth trends following a bear market, as the underlying growth drivers change.

Meta Platforms (previously Facebook) is an example of a business that has shown exceptional growth over the past 10 years, as it created new products for new markets in the form of social media and online advertising. It is a business that has constantly evolved in order to stay relevant. The acquisitions of Instagram and WhatsApp were both significant in Meta's evolution and success. Today, however, as Meta looks for its next growth vector, the company's revenue has started to decline for the first time, with the share price having retreated significantly in the later stages of 2022. Concerns around its reliance on online advertising, increased competition in the social media space, regulation around privacy and data protection, and the profitability of its metaverse business, Reality Labs, suggest that the business' growth may become more cyclical going forward.

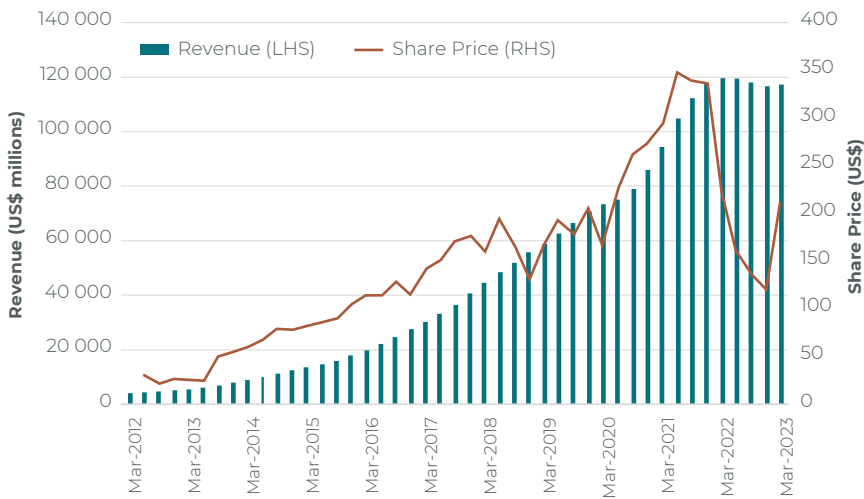
Several long-term trends result in the semiconductor industry enjoying secular growth. Most recently, the advancement of artificial intelligence/machine learning has played into the industry's hands, resulting in soaring demand for semiconductor chips that

can process and analyse large amounts of data in real time. It is important to note that, despite this long-term trend, the industry does go through short-term cyclicalities for various reasons. Most recently, the industry was hindered by supply chain disruptions, while

increasing competition is another factor to monitor.

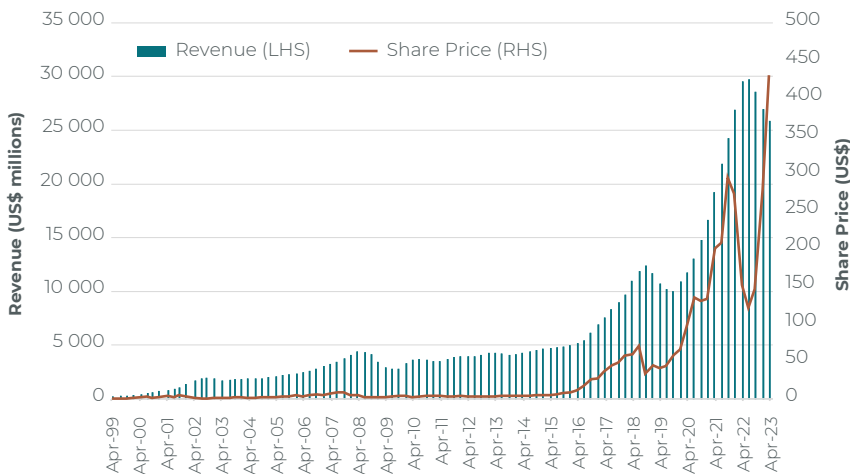
Nvidia is an example of a semiconductor business that is well positioned to benefit from this secular trend. Its recent share price appreciation is evidence of this, with it now ranking as the fifth most valuable company on the S&P 500. However, it is not immune to the shorter-term cyclicalities of the industry, as can be seen from the cyclical growth rate in graph 2. Nvidia is the largest holding in the iShares Semiconductor ETF which is held in the Private Clients Global Equity Portfolio.

Graph 1: Meta Platform's Revenue and Share Price



Sources: Refinitiv Datastream, Private Clients

Graph 2: Nvidia's Revenue and Share Price



Sources: Refinitiv Datastream, Private Clients

NEW AVENUES OF GROWTH

At Private Clients, we identify and invest in businesses that we believe are well positioned to profit from strong secular growth, while avoiding those that face the risk of a material growth slowdown. This means that we constantly monitor developments and trends – both locally and globally.

While technology-orientated businesses have been the overall beneficiaries of strong secular growth over the last few years, recent developments point to divergent prospects going forward. This means that businesses will need to actively harness innovation to create new avenues of growth. The progress within artificial intelligence is one area that is currently generating significant interest and our long-term holdings in Alphabet and Microsoft, among others, will ensure that our clients are well positioned to benefit from such emerging themes.



Luxury Goods Sector: Timeless Quality

VICTOR MUPUNGA, HEAD OF RESEARCH AT PRIVATE CLIENTS BY OLD MUTUAL WEALTH



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he relationship between consumers and luxury brands is fascinating, deeply emotive and personal. While there is no doubt as to the excellent craftsmanship that goes into a classic hand-made Louis Vuitton handbag, it is the emotional attachment to the brand that appeals to new

customers and retains existing ones for decades. By combining marketing, pricing strategies and managing the customer experience, luxury companies are among the best businesses in the world in terms of pricing power. Consistent with our investment philosophy, we are attracted to sectors and companies

that have proven themselves over time. Globally, few industries have endured in the way luxury companies have done. As such, within our global and local equity model portfolios, we have exposure to both Richemont and LVMH.

HERITAGE: AN INDESTRUCTIBLE MOAT

It takes time for a luxury brand to gain credibility, with the most successful luxury brands such as Louis Vuitton, Cartier and Hermés having been around for almost 200 years. While there are newer brands in the sector (e.g. Michael Kors and Coach), they tend to cater to the mid-range luxury market and are often not regarded as directly comparable to the century-old brands.

From a consumer psyche perspective, there is a greater appreciation for brands that have stood the test of time, perhaps similar to how vehicle enthusiasts purchase vintage cars and art at exorbitant premiums. Comparable examples within the luxury goods sector are the Birkin and Kelly bags from Hermés or Louis Vuitton's Keepal and Noé bags that were designed in the 1930s and stylistically remain the same. With prices for high-end used variants of these classics selling above their initial purchase price (over US\$100 000 per bag), consumers often regard the bags as investments rather than functional items. In our view, this highlights the well-established histories and heritage built over centuries that are near-impossible to replicate over shorter periods. This slow rate of industry change places luxury companies in a unique position where they get to see emerging brands (competitors) decades ahead of time.

APPRECIATING THE VALUE OF SCARCITY

To maintain the exclusivity of their goods, luxury brands are obsessed with balancing two key revenue drivers – price and volume. The most successful

firms tend to grow by increasing prices while limiting volume growth. In fact, Hermés, Louis Vuitton and Tiffany are some of the brands that never run promotions or sell via discount outlet stores. Across the industry, it is common for luxury companies to destroy excess inventory rather than devalue their brands by selling their products at a discount.

For many sought-after luxury watches from the likes of Rolex and Audemars Piguet, there are growing waiting lists with collectors queuing for up to a decade to purchase their desired timepieces. In some cases, customers may not even get onto the list unless they are already VIP clients with a substantial purchase history, or are invited to purchase. This strict adherence to managing product supply for the benefit of the brand is illustrative of an industry that structurally operates with a long time horizon. This is contrary to what occurs in many industries when they are faced with high demand, and it points to a factor that plays in consumer minds in enhancing the exclusivity and desirability of leading luxury brands.

MANAGING THE CUSTOMER EXPERIENCE

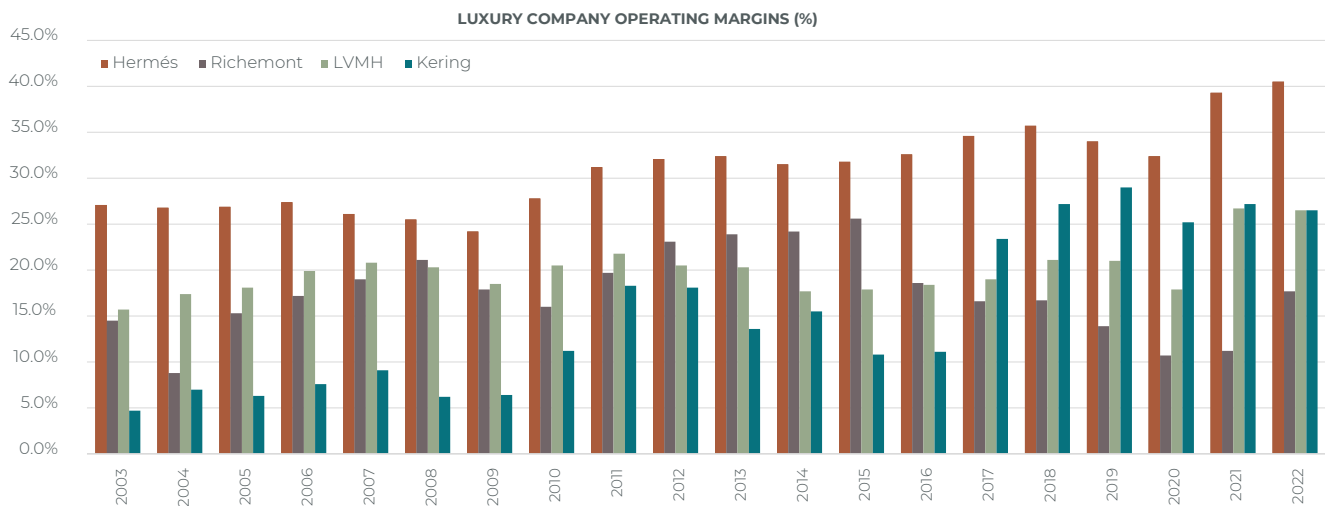
An often ignored strength of luxury companies is their success in managing the distribution of their goods. While many industries have been quick to shift online, ironically, some of the leading luxury brands limit their online product range to ensure that customers still set up an appointment to come into the store and enjoy the “ceremony-like” experience of purchasing a branded product.

Limiting sales through wholesalers is another way luxury companies ensure that they control the customer experience and get to know their end customers. While a few luxury brands generate more than half their revenue through wholesalers or third-party companies, the likes of Burberry, Gucci and Hermés sell less than 20% of their products through third parties. Tiffany and Louis Vuitton, on the other hand, are at the extreme and sell almost entirely through their own stores. Invariably, the brands' knowledge of the end customer translates into increased personalisation in the form of invitations to exclusive events, which naturally strengthens the brands' emotive connection with their preferred customers.

INCREASINGLY RESILIENT

Despite luxury goods being classified as consumer discretionary items, historically, leading companies within the sector have proved to be somewhat resilient. Hermés and LVMH, for example, only reported a decline of 1.3% and 1.8% respectively in operating margin in 2009 during the Global Financial Crisis (GFC), and showed similar resilience during the COVID-19 pandemic. Richemont fared worse during the GFC as margins halved over the period, largely due to the company's limited diversification and significant exposure to the luxury watch market. In 2008, Richemont generated approximately 50% of its revenue from luxury watches. However, this has significantly reduced over time and contributed less than 20% of revenue in 2022, which has made the business less cyclical.

Graph 1: Operating margin



Sources: Refinitiv/Private Clients

STRONG FUNDAMENTALS

Perhaps the most attractive quantitative aspect of luxury goods companies is their margin structure. Unlike typical manufacturing businesses, luxury companies enjoy great margins. In fact, the highest-margin luxury business, Hermès, has operating margins that are akin to software companies. Given the capital investment requirements within the luxury industry versus the capital-light software sector, this is a remarkable feat. The industry's high margins are borne from strong pricing power, which ordinarily is administered via price increases of 6% - 8% per annum. In the current inflationary environment, the sector has been able to pass through double-digit price increases, once again proving its pricing power. Luxury companies are often criticised for having "lazy balance sheets", meaning that they tend to hold substantial cash reserves and little debt. Indeed, among the largest

seven listed luxury companies, none of them has long-term debt that exceeds the profit they can generate in a single year, which is very conservative. During previous good times, this may have been seen as a negative; however, in the current uncertain and rising interest rate environment, it is a positive attribute.

In our view, the conservative balance sheets likely stem from the shareholding structures of many luxury companies, which tend to have family owners as large anchor shareholders for many generations. Naturally, this reduces the pressure on management from short-term focused investors and the need to take on debt to accelerate near-term growth. To the extent that such conservatism results in management decisions that benefit the business over the long term, we regard the "lazy balance sheets" to be a positive attribute.

A LONG-TERM HOLDING

Richemont's chairman, Johann Rupert, once remarked that "as long as people want to say I love you, or I'm sorry, or I want to go to bed with you, then we have a business." Apart from being amusing, we believe this remark points to the emotive and personal attachment that luxury businesses have enjoyed with their customers for decades. The unique attributes of businesses within this industry are hard to replicate, as they have been built over centuries. Our preference within the sector is for diversified luxury businesses that are led by strong management teams. We regard such businesses as ballasts in our portfolios that provide timeless quality.

SA Retail – Value in the Eye of the Beholder

TASNEEM SAMODIEN, RESEARCH ANALYST AT PRIVATE CLIENTS BY OLD MUTUAL WEALTH



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outh African asset managers commonly refer to the years following 2010 as the “lost decade”. This refers to the decline in economic growth (as measured by GDP per capita) experienced over the period and the economic potential destroyed during the era of state capture. The lack of growth experienced in SA poses a challenge to businesses and investors seeking growth in the local market. This is because economic growth is a key driver of a company’s ability

to generate sustainable long-term organic sales and earnings growth.

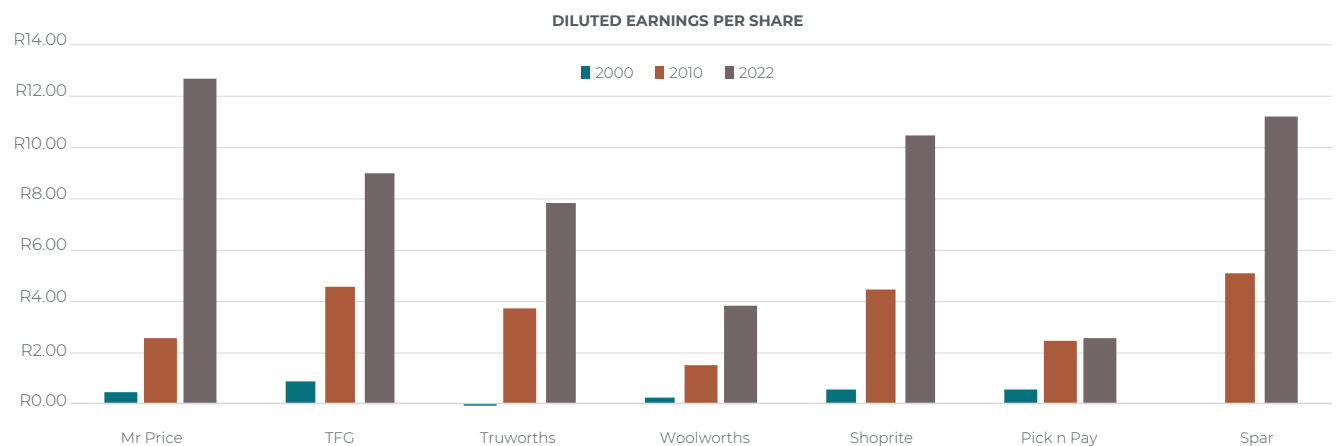
While it’s been a challenge, South Africans and their corporate counterparts are known for their resilience. Many local companies have managed to grow despite the lacklustre economic growth, with one industry particularly standing out for its ingenuity – local retailers.

Despite operating in an economy that has become “poorer” and is dogged by corruption and load shedding,

certain local retailers (across both food and apparel) have managed to grow their earnings in multiples.

The local retail industry has been fiercely competitive, with each retailer vying for a share of a shrinking consumer wallet. The growth reported by retailers over the period is therefore testament to successful execution of targeted growth strategies by the respective management teams. We briefly comment on the strategy employed by each retailer in their pursuit of growth.

Graph 1: Retailer earnings outpaced economic growth¹



Source: Refinitiv Eikon

¹Pepkor excluded from graph as they listed in 2017.

MR PRICE: KEEPING UP WITH TRENDS



Mr Price is our preferred operator in the apparel retail sector. The group achieves superior profitability in the industry in terms of operating margins and returns on equity and capital, partly due to previous capital allocation decisions and partly due to market positioning. Mr Price has positioned itself as the mass provider of value fashion, balancing consumers' desires to keep pace with current fashion trends and quality, with their limited discretionary spend budgets. Successfully executing this strategy for years, Mr Price was ranked as the most valuable fashion apparel retailer in South Africa in 2022 by Kantar BrandZ. Operationally, Mr Price has been a prudent capital allocator. While peers have made large bets with offshore expansions, they've made smaller bets. Their prudence paid off with a superior growth profile as management had more time and capital to invest in the local market.

PEPKOR: STICKING TO THE BASICS



63% of the South African population are considered poor or working poor, earning between R0 and R8 000 per month. These consumers have significant budgetary constraints and when it comes to apparel, often value price above all else. Pepkor has positioned itself as the leading local value apparel retailer. They are known for dominating sales of basic staples including baby clothes, underwear and school clothes. While the group's history is tainted by parent company Steinhoff, since listing in 2017, Pepkor has made significant strides in improving its balance sheet and focusing on cash as opposed to credit sales, thereby improving the overall quality of its business model. The group generates growth by employing a dynamic pricing policy in order to maintain its positioning as the most affordable apparel retailer in the country. And, in serving the largest and fastest growing income segment, growth is often driven by merchandise volumes.

TRUWORTHS: CAPITALISING ON CREDIT



Truworths is best known for its relatively relaxed credit granting policies. They've positioned themselves as the credit retailer of choice for cash-strapped consumers and charge a premium for their product to cover the costs of this strategy, reflected in a gross margin of 54%, well ahead of peers. This has turned out to be a successful strategy in SA where the consumer has been under immense financial pressure with salaries recently failing to keep up with food and fuel inflation (private sector real wages shrunk by 0.7% per annum between 2015 and 2019 before falling 5.4% during the COVID-19 pandemic²).

SHOPRITE: EFFICIENCIES THROUGH SCALE



Retail store inventory management is part art, part science, and demands an understanding of sales patterns, profit margin and seasonality, among other factors. Shoprite manages its stores' inventory through a centralised supply chain, that is, suppliers deliver to Shoprite's distribution centres from where products are dispatched to over 2 000 stores. Shoprite currently maintains a network of 29 distribution centres located close to the dominant locations of their suppliers and close to their stores. Their distribution network, including 820 trucks and a state-of-the-art supply chain management system, underpins what is the quickest, most agile and responsive supply chain in South Africa. Their supply chain management system ensures optimum availability of products in stores and is one of their most enduring competitive advantages, one which competitors have found difficult to replicate.

WOOLWORTHS: LEVERAGING ITS BRAND



Fondly known as Woolies by shoppers, Woolworths has ingrained itself into the lifestyles of its affluent consumers. The strategic execution of the launch, scale and expansion of the Woolworths food offering in SA has been commendable. From private label penetration to Café NowNow, Woolworths Food has been the growth engine of the group, its success eclipsing that of their legacy business, fashion, beauty and home. Woolworths was the only retailer bold enough to focus on sustainability, wellness and quality, targeting the affluent consumer, and their strategy has paid off with a market-leading brand value of US\$1.2bn in 2022, ahead of peer Shoprite at US\$801 million (according to the Kantar BrandZ report).

PICK N PAY: SMART SHOPPERS



Sticking out like a sore thumb, Pick n Pay has failed to grow earnings meaningfully over the past decade. Poor strategic execution, poor capital reinvestment and an increasingly competitive food retail landscape are a few reasons for their decline. They have arrested this trend with the investment in Boxer and relaunch of their core brand to better segment the market and more directly target middle and upper income consumers. What Pick n Pay has got right, however, is its loyalty programme, Smart Shopper. Loyalty programme consultants Truth indicated that on average in South Africa, loyalty programmes can generate between 4% and 6% incremental revenue growth annually. Pick n Pay Smart Shopper is the second most used loyalty programme by the SA mass market (defined as households earning less than R10k per month). Leveraging the data generated by their loyalty programme, they are capable of launching more targeted ads, which is critical when competing with the likes of Shoprite and Woolworths Food.

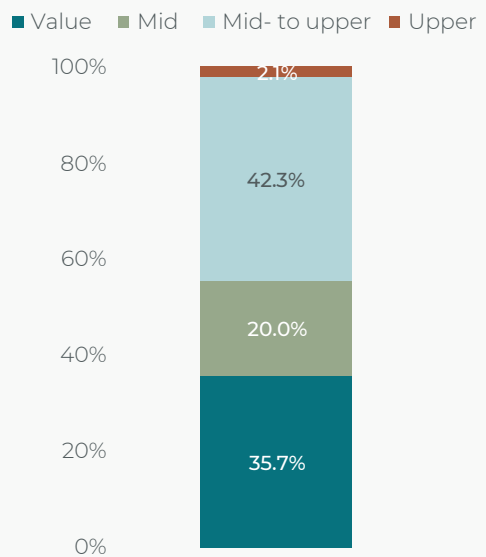
10 ²According to Nedbank economists, private sector wages have declined by an average of 0.7% per annum between 2015 and 2019 and declined 5.4% during the COVID-19 pandemic.

THE FOSCHINI GROUP: JACK OF ALL TRADES



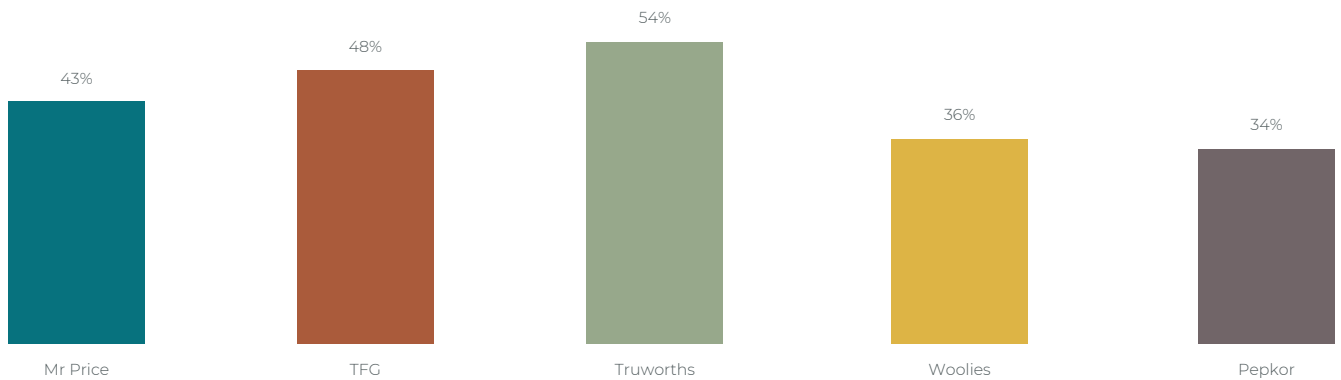
The Foschini Group (TFG) has pursued growth through diversification. The group acquired brands in SA (for example, Jet) and abroad (Hobbs), and launched its own brands across product categories, including fashion apparel, athleisure, sneakers, jewellery, cosmetics, mobile communication, financial services and more. In addition to diversification from a product category perspective, the group also operates brands across the income spectrum catering to the mass and affluent markets with brands including The Fix, Exact, @home, G-Star, Fabiani etc. In the local market, the group offers international branded apparel such as Nike, Adidas etc. through stores including Sportscene and Archive. In pursuit of further diversification, the group operates fashion apparel retailers in London and Australia. Through this diversified business model, the group improved its capacity to generate growth, reducing reliance on any single income stream.

Graph 2: TFG's contribution to revenue by price point



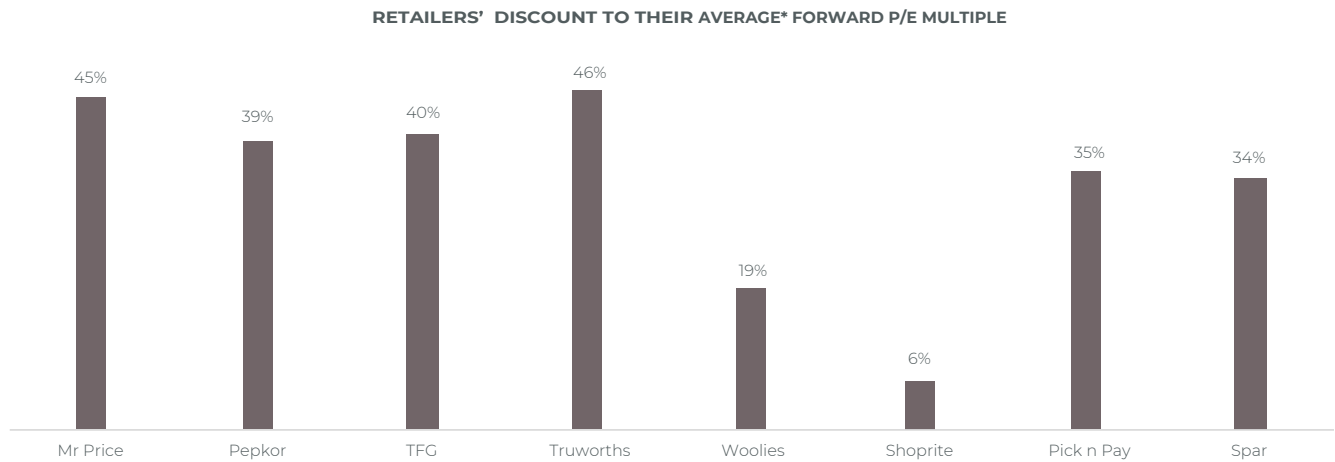
Graph 3: Retailer gross margins

APPAREL RETAILERS: GROSS MARGIN (2022)



Source: Refinitiv Eikon, company financials

Graph 4: Retailers trading at a considerable discount to their long-term average forward P/E multiple



Average forward P/E calculated per retailer over period from January 2010 to March 2023

VALUATION

South African retailers have illustrated their ability to generate earnings growth throughout various economic and market cycles, employing differentiated market positioning, acquisition and diversification strategies. In building an investment case, earnings growth is a prerequisite. But what determines the potential

payoff of the investment relates largely to the value paid upon acquisition. Overpaying for growth can be just as value destructive as buying a poorly managed company. At Private Clients, we employ various valuation models when assessing the valuation of a potential investment. For the purpose of this exercise, we'll focus on an easily observable market-related valuation

metric, forward earnings per share. The absolute level is not as important as the level in relation to the historic average. With the exception of Woolworths, as at the end of March 2023, food and apparel retailers are trading at a discount to their average multiples as illustrated in graph 4.

FOCUSED ON THE LONG TERM

Many would argue that the discount at which retailers are trading is warranted, given the myriad of risks that these companies face – including crippling load shedding and inflation – that might be difficult to pass on to financially constrained consumers. While we acknowledge these risks, they are not new. These companies, corporate South Africa and South African management teams have been contending with these challenges for more than a decade. We acknowledge that earnings may come under pressure in 2023 due to the macro-economic factors already mentioned. However, we have no interest in forecasting earnings growth for this year or next, as our investment horizon extends beyond that. As long-term quality investors, we believe in the power of compounding and while many would argue that now is not the time to be invested in retailers, we would argue that time in the market is far more important than trying (unsuccessfully in most instances) to time the market.

We view the current valuation discounts as an attractive entry point into a sector that has proven its relevance and resilience in the context of SA. In line with our quality focused investment philosophy, our top picks are value fashion retailer Mr Price and market-leading grocery retailer Shoprite.

The Runaway Rand

IZAK ODENDAAL, INVESTMENT STRATEGIST AT OLD MUTUAL MULTI-MANAGERS



The rand has been under severe pressure since the start of the year, reaching record lows against the US dollar along the way. Since it is probably the most visible financial metric, and the one that has the biggest impact on our day-to-day lives, everyone is talking about it. There are also misconceptions around our much-maligned currency, with many calling it the share price of the country. However, it is not, since an exchange rate is a swap ratio of two currencies, and therefore there are always two different sets of dynamics at play.

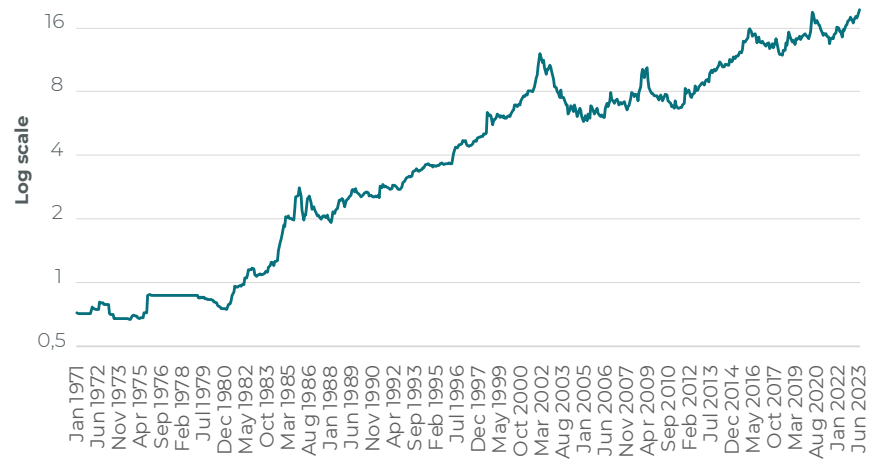
In the case of the rand/US dollar exchange rate, it is both the rand and the dollar that matter. While most of the rand's weakness over the past two years can be explained by a stronger US dollar, since late last year, the greenback has been softer against other currencies. The decline of the rand over the past six months is therefore largely due to domestic factors, notably the deterioration in the load shedding situation.

LOOKING BACK TO LOOK FORWARD: A QUICK HISTORY LESSON

The rand was introduced in 1961, and was named after the Witwatersrand, where gold was discovered. Before the early 1980s, the rand was pegged against the pound and later the US dollar, with the exchange rate determined by the government at R0.70 (i.e. 70 cents) per dollar.

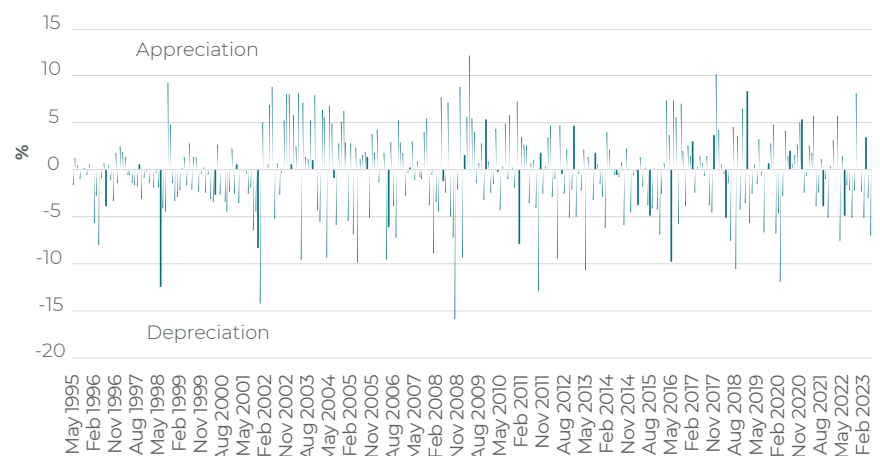
Managed currencies have the benefit of stability, allowing businesses to make decisions about future cross-border activity with relative ease. But over time, the exchange rate can become unrealistically strong or weak relative to the underlying economic realities. Imbalances build up. The experience in most developing countries is that the currency becomes too strong, encouraging excessive imports and foreign borrowing. Ultimately, the country runs out of the foreign

Graph 1: Rand/US dollar exchange rate over 50 years



Source: Refinitiv Datastream

Graph 2: A volatile currency: monthly changes in rand/US dollar exchange rate



Source: Refinitiv Datastream

exchange reserves needed to keep the currency pegged, forcing the government to adjust the exchange rate. In this way, the currency can fall by 20% - 30% overnight, sometimes even more. This happened to the rand when it was devalued by 13% in late 1971, and again by 21% in September 1975.

After 1981, it was left to the market to determine the exchange rate, though it would only be until 1995 that the system of parallel currencies used to manage capital controls was finally abolished. Between 1985 and 1995, foreigners investing in financial assets

in South Africa had to trade through the financial rand, often at a discount to the commercial rand.

Almost as soon as the rand became a free-floating currency, it came under pressure in the form of the surging US dollar of the early 1980s. It slumped to R2.90 per dollar by December 1985, losing 71% of its value. Plotting the rand/US dollar exchange rate on a logarithmic scale shows that this was the worst period of rapid depreciation, but not the last.

FREE AND VOLATILE

Today, we have a currency that trades completely freely at the whim of the market and, as a result, can be very volatile. As a reminder, the rand was ranked as the 18th most traded currency in 2022 by the Bank of International Settlements (BIS), ahead of larger economies such as Brazil, Poland and Thailand. Foreign investors can buy and sell the rand very easily, and most trade in the rand occurs outside of the country's borders.

The benefit of the rand's infamous volatility is that it discourages reckless foreign borrowing and overreliance on imports. Everyone knows they can get their fingers burnt, whereas a managed exchange rate usually lulls people into a false sense of security. Moreover, with a sophisticated domestic financial system, foreign borrowing is rarely necessary. The South African Reserve Bank oversees this system as a regulator, but also provides credibility with sound monetary policy. Unfortunately, this credibility doesn't always come cheap, and the Reserve Bank has had to raise rates sharply over the past two years to curb inflationary pressures and relieve pressure on the currency (higher short-term interest rates make it more attractive for foreign investors to buy the rand).

These are key strengths that act as a bulwark against the kind of financial implosion suffered in Latin America in the 1980s and early 1990s, East Asia and Russia in the late 1990s, and now again in Argentina, where the currency has lost 95% of its value over the past five years and where annual inflation is running in triple digits. Turkey's lira has lost almost 80% over the same period.

While the rand has a history of blow-outs, these are not as catastrophic as what some other countries have experienced. This is largely because we have never had the same build-up of major imbalances in the domestic economy. Also, a weak currency has some positive side effects.

SHOCK ABSORBER

Exchange rate shifts rebalance income and activity in an economy, especially if it is a relatively flexible economy. A weak currency boosts the income of locals earned from exports or foreign

investments and makes the country a more attractive tourism destination. Imports become more expensive, which hurts consumers but helps businesses that compete against imported goods and services. The rand therefore acts as a shock absorber for the local economy.

So, can the rand recover from these levels? History suggests that it can. The biggest declines in the currency in 1984, 2001, 2008, 2015 and 2020 all coincided with global conditions turning negative for emerging markets. A strong US dollar falling commodity prices and a financial crisis – or some combination of the three – are toxic to the rand.

Each of these blowout episodes was followed by a recovery when global

conditions improved. Even in 1986, the rand rallied as the dollar retreated from elevated levels, despite the fallout from the Rubicon Speech, the debt standstill and increased global sanctions.

Some good news on the electricity front is probably required for the rand to recover from current levels. However, this will largely depend on whether the US dollar once again retreats from its globally strong position. Since 1970, the dollar has only been stronger on a real trade weighted basis 13% of the time. Further sustained dollar weakness will require a further closing in the expected interest rate gap between the US Federal Reserve (the Fed) and other major currencies, and probably outright cutting by the Fed.

TIME VERSUS TIMING

The volatility of the rand has a big impact on investment returns, and as South Africans increase their offshore assets, managing this volatility becomes ever more important. It is crucial to be clear about time horizons. If you are concerned about what happens over the next three years, then there is a good chance that the rand will be stronger than it is today based on historic recoveries from blowouts. This in turn implies tactically bringing some money home.

On a longer-term horizon, it is a different story. The rand could rally sharply over the next three years but still end up at R28 per dollar 10 years later if it resumes its historic depreciating trend of 7% per year. This is not a forecast, simply a reasonable assumption, unless South Africa fundamentally restructures its economy. Again, it would not imply that the country has been falling apart, rather that the exchange rate did what it needed to compensate for the relative lack of competitiveness.

Equities should always have a much longer investment horizon, so when investing in international equities, shorter-term currency fluctuations should be less relevant.

In summary then, we have to remember three things:

- It hurts sentiment when your currency falls while your peer group sees theirs rallying. Especially when one of the main underlying reasons for the decline – load shedding – could get worse before it gets better.
- A weak rand helps some sectors of the economy even if it makes life more expensive for others and puts upward pressure on interest rates.
- The currency should recover to more reasonable levels when the storm has passed but is also very likely to resume its long-term depreciating trend eventually.

This calls for cool heads on the part of investors. There is little point in responding to a sharp move in the currency after it has fallen. Always beware of a knee-jerk response and don't be surprised if the rand stages a seemingly miraculous recovery at some point in the near future. It has done so many times before. On the other hand, however, if you decide that a strategic long-term offshore allocation is appropriate, do not try to time the "perfect" exchange rate and forget to look at what you are buying on the other side. As with any investment, it is all about balance, valuation and patience.

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Andrew joined Private Clients in 2017 and was previously employed at Cannon Asset Managers. He joined Cannon in 2007 as a research analyst and during his tenure, he rose through the ranks to become a portfolio manager in 2011 and was then appointed CIO in 2014. Andrew has extensive knowledge of and insight into valuing businesses across multiple industries and identifying suitable investment opportunities. He holds a master's degree in Economic Science from the University of the Witwatersrand, where he lectured for a while. Andrew also holds a PhD in Investments and Securities from the University of Pretoria.



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