

# COGNIZANT

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MIND THE  
**PIGEONHOLE**

**BIG TECH:** PANDEMIC HIGHLIGHTS MORE  
DIFFERENCES THAN SIMILARITIES

**BERKSHIRE HATHAWAY:** RECOGNISING THE  
GROWING VALUE IN PRAGMATISM

WHAT DOES THE **ENERGY AND COMMODITY  
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**OLDMUTUAL**

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# MIND THE PIGEONHOLE

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ANDREW DITTBERNER, CHIEF INVESTMENT OFFICER AT PRIVATE CLIENT SECURITIES



There is an assumption that complex systems such as financial markets require complex investment strategies. As a result, based on the view that the more complex the approach, the more effective it is likely to be, complicated investment strategies are often favoured over more simplistic ones.

A photograph of Warren Buffett sitting at the same desk he has worked from for over 60 years has become quite well known and is used to portray the power of keeping things simple. Buffett, widely regarded as the world's most successful investor, does not use a Bloomberg terminal nor does he employ an army of analysts to make his investment decisions. Instead, he keeps things simple by identifying great businesses and not overpaying for them. In principle, we at PCS agree with and follow this investment approach. However, we

recognise that in oversimplification, there is a risk of overlooking key nuances, particularly in today's complex world of investing.



















































## IDENTIFYING THE NEXT BIG THEME

The table below lists the world's top 10 companies by market cap. As shown, the top 10 largest companies in 1980 were largely oil-related business given the oil boom of the 70s. In 1990, Japanese companies were the dominant force, given Japan's success in the 80s. The onset of the internet in the 90s resulted in the dotcom bubble, which unsurprisingly saw many technology, media and telecommunication companies in the top 10 largest companies. Through the commodity boom of the 2000s on the back of China's rise to dominance, many Chinese and commodity-related companies were counted among the top 10 largest companies in the world.

And finally, today, after 15 years of strong growth from many tech-related businesses, the top 10 are once again dominated by tech companies.

From this, it is easy to conclude that simply predicting the next major theme and maintaining broad exposure to it is a sure way to achieve great investment results. Of course, this is very difficult to do, as we know that humans are poor forecasters. A simpler approach would be not to invest in companies that are part of yesterday's theme, as the majority of them fell from the top 10 largest companies list over the following decade. This would suggest they likely underperformed after a period of significant outperformance. But following this type of approach is likely too simple. Firstly, it is evident that a number of companies were able to maintain their top positions, despite not benefiting from the

### THE WORLD'S TOP 10 LARGEST COMPANIES BY MARKET CAPITALISATION (EX ARAMCO)

1980: Peak Oil	1990: Japan will take over	2000: TMT bubble	2010: China will take over	2022: Only Tech grows
 IBM	 NTT	 Microsoft	 Exxon Mobil	 Apple
 AT&T	 Bank of Toyjo-Mitsubishi	 General Electric	 PetroChina	 Microsoft
 Exxon	 Industrial Bank of Japan	 NTT DoCoMo	 Apple	 Alphabet
 Standard Oil	 Sumitomo Mitsui Banking	 Cisco Systems	 BHP Billiton	 Amazon
 Schlumberger	 Toyota	 Wal-Mart	 Microsoft	 Tesla
 Shell	 Fuji Bank	 Intel	 ICBC	 Meta
 Mobil	 Dai Ichi Kangyo Bank	 NTT	 Petrobras	 Nvidia
 Atlantic Richfield	 IBM	 Exxon Mobil	 China Construction Bank	 TSMC
 General Electric	 UFJ Bank	 Lucent Technologies	 Royal Dutch Shell	 Berkshire Hathaway
 Eastman Kodak	 Exxon	 Deutsche Telekom	 Nestlé	 Tencent

theme of the day. These include businesses such as Exxon Mobil, General Electric, Microsoft and Apple. Secondly, investment themes do not emerge on the count of a decade, as evidenced by a number of tech-related businesses having performed exceptionally well over multiple decades.

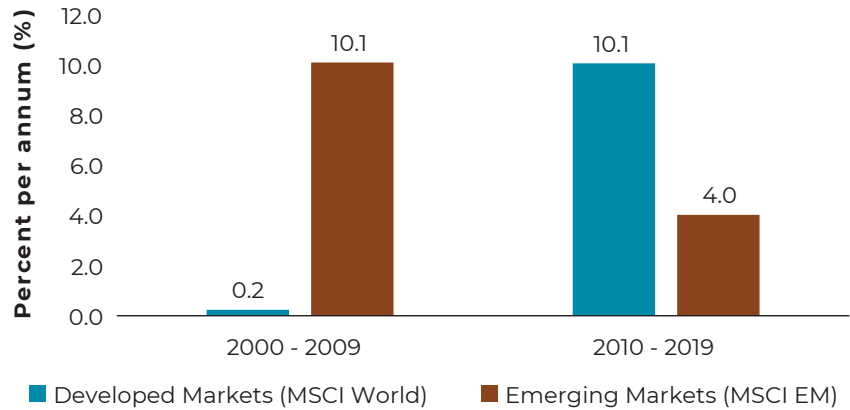
This tendency to broadly categorise companies or even countries on the assumption that they are similar (or will likely follow a similar fate), is extremely widespread. Investors and economists often coin catchy acronyms to describe seemingly similar groups of companies or countries – Blue Chip, Nifty Fifty, FAANGs, BRICS and the Fragile Five spring to mind. Once pigeonholed in this way, it is easy to fall into the trap of believing that those companies or countries will follow a similar trajectory. For example, blue-chip companies are supposedly well-established, well-recognised and financially sound businesses that are safe investments. Yet, looking back, it is easy to identify many of them that were fraudulent or subsequently went bankrupt (think Enron and Lehman Brothers!)

Emerging markets, commodities, tech companies and value/growth stocks are just some of the pigeonholes that we believe investors need to be particularly cautious about, as the underlying countries or companies all have very specific nuances that set them apart.

### THE EVER-EMERGING MARKETS

Depending on the prevailing mood, emerging markets (EMs) are either the dogs or the darlings of the investment world. You may recall in the 2000s, EMs could do no wrong and generated returns that were far

Graph 1: Differing decades



superior to what was achieved in developed world markets.

Following the 2008 Global Financial Crisis, EMs fell out of favour with the investment community. Entering a decade of low growth and low inflation, investors flocked to companies that they believed could deliver growth in the prevailing environment. Those companies were found in tech-related sectors, generally within developed markets, and more specifically in the US. Graph 1 shows the performance of EMs and developed markets over the preceding two decades.

The decision to invest in emerging markets is one that investors still grapple with today. Valuation divergences and growth outlooks are key considerations, with emerging markets often more attractively priced (i.e. cheaper) despite their superior economic growth outlooks. However, valuation and growth expectations are not the only factors to consider, as there are many other aspects that differ – both across and within countries.

Other factors to consider include the following:

- EMs are less liquid than their developed market counterparts.

- Political instability varies widely across different EMs.
- The fiscal situation of each EM plays an important role in the economic outlook of the country.
- The opportunity set from an investment perspective is more limited.
- Currency volatility can have a significant impact on overall investment results.
- Geopolitics can impact the sentiment (and operating environment) within countries.
- The demographics of countries are often very different – some EMs have young, vibrant populations, while others have ageing populations.
- Commodity exposure plays a big role in an EM's potential as an investment destination.
- The regulatory environment can often be exceptionally unpredictable, as witnessed in China last year.

In considering each of these factors, it is clear that every EM is vastly different to the next. Some have a higher probability of actually emerging, while others appear unlikely to ever emerge, remaining

stuck in the low- or middle-income trap. As such, markets are likely to be priced differently, given their outlooks and respective risks. One should therefore expect each market to perform very differently too, as highlighted in graph 2.

Interestingly, even within countries, there can be a wide variance in performance. This was evident in 2021 when the tightening regulatory environment in China negatively affected offshore equities, but had very little effect on onshore equities. In this way, investing in EMs entails much more than simply deciding whether or not to invest in a group of countries.

### THE COMPLEXITY IN COMMODITIES

Commodities have a reputation of being notoriously difficult to invest in. Time the cycle correctly, and commodities can deliver significant investment results; get it wrong, and they can wreak havoc on both short- and long-term investment returns. This is due to the inherent cyclical nature of commodity prices, as highlighted in graph 3.

Investing in a resource-heavy market like South Africa means that investment managers often have to answer questions regarding their views on commodities. The problem, however, is that pigeonholing all commodities into to a single bucket is an oversimplification. Commodities face very different short-term market dynamics, with equally different long-term outlooks.

Listed in the next column are a number of short-term market dynamics, as well as longer-term themes that are currently affecting commodity prices and outlooks.

Importantly, not all commodities are affected to the same degree:

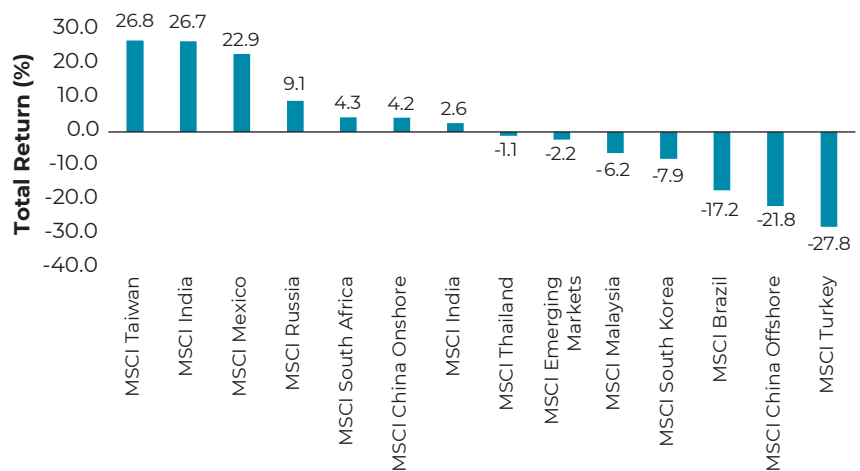
- The move to cleaner energy
- A reduced carbon footprint
- A slowdown in Chinese investment
- Concerns around the global monetary system
- Transportation constraints
- Geopolitical events
- Growing populations
- Supply and demand dynamics

Over the course of 2021, commodity prices (viewed as a basket) increased significantly,

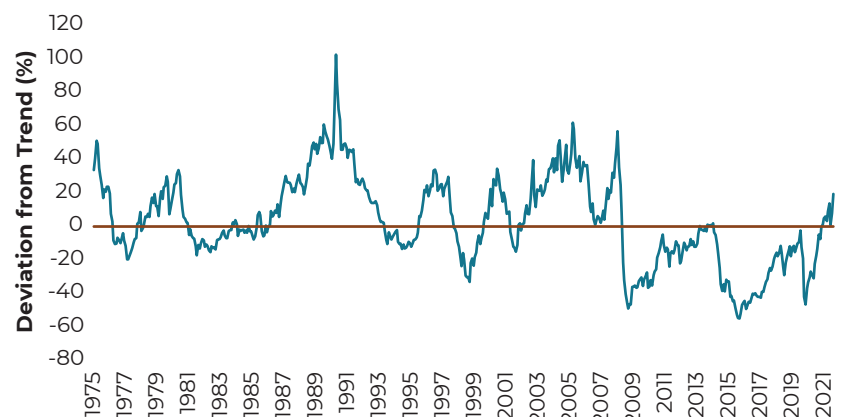
predominantly driven by higher energy prices. Yet, upon closer inspection, there was a very wide dispersion in price movements across the various commodities, as shown in graph 4.

So, rather than trying to determine current views on commodities, the emphasis should be on which commodities are currently favoured. With this shift in perspective, the cyclical nature of commodities as a basket becomes less important, and the long-term outlook plays a far more significant role in the investment decision.

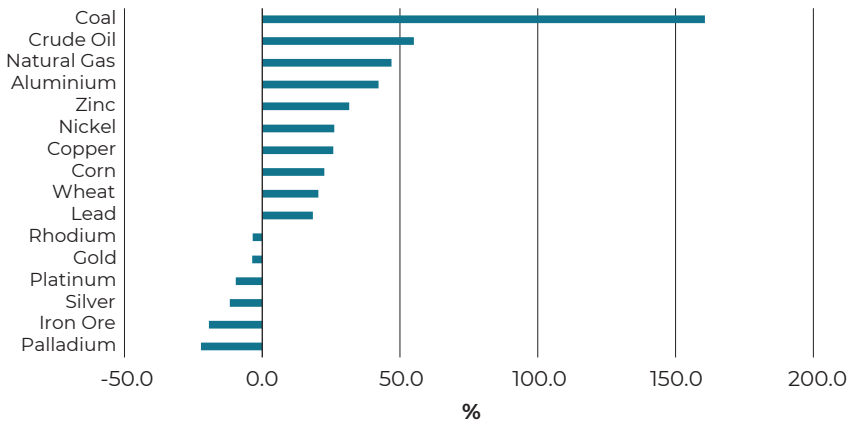
Graph 2: 2021 Emerging Market Total Returns (2021)



Graph 3: Real S&P GSCI Commodity Index deviation from long-term trend



Graph 4: Commodity price changes in 2021 (%)



**LET’S GET TECHNICAL ABOUT TECHNOLOGY**

From FAANGs to FAAMGs and MANGA to MAMAA – these are but a few of the acronyms increasingly used over the past few years to categorise certain tech companies. And while acronyms can be fun, they are dangerous in the sense that once certain companies are grouped together, investors assume they are all of a similar ilk. In reality, these companies can be anything but similar.

For the better part of a decade, large tech companies (such as Apple, Microsoft, Alphabet, etc) have proven to be the ultimate investment and have been credited with doing much of the heavy lifting in global markets – and rightfully so. On the back of this stellar performance, and particularly through the COVID-19 lockdowns, this select group of companies were elevated to “antifragile” status, a designation previously reserved for US treasuries. Once again, a dangerous assertion to make, and the first few weeks of 2022 certainly provided a wake-up call.

As evidenced in graph 5, which shows the 2022 year-to-date

performance of individual large tech companies, these companies do not all perform similarly, and are by no means antifragile. There are two factors currently driving this divergent performance, namely valuation and business model.

A great business can quickly become a poor investment if one overpays for it, and not all tech companies are valued equally. From a business model perspective, many of these companies have to continuously reinvent themselves in order to attract new users. The market has become fixated on the number of active users, forgetting that there is a finite universe from a user perspective. This is ultimately what happened to Meta Platforms (formerly known as Facebook) following the release of their 2021 financial results.

Conversely, other companies have the necessary competitive moats in place, and they can focus on doing what they are good at. Typically, such businesses have diversified revenue streams, and are not at the mercy of the market from an active user number perspective. Examples of such companies include Apple, Amazon, Microsoft and Alphabet.

Understanding these two factors, as opposed to painting all tech companies with the same brush, is key to navigating the technology quagmire that is often presented to investors in an overly simplistic manner.

Big tech is yesterday’s theme. Today every company, in one sense or another, can be considered a tech company, as every company employs some form of technology in its operations. Therefore, just having exposure to the broader theme may not be an optimal strategy.

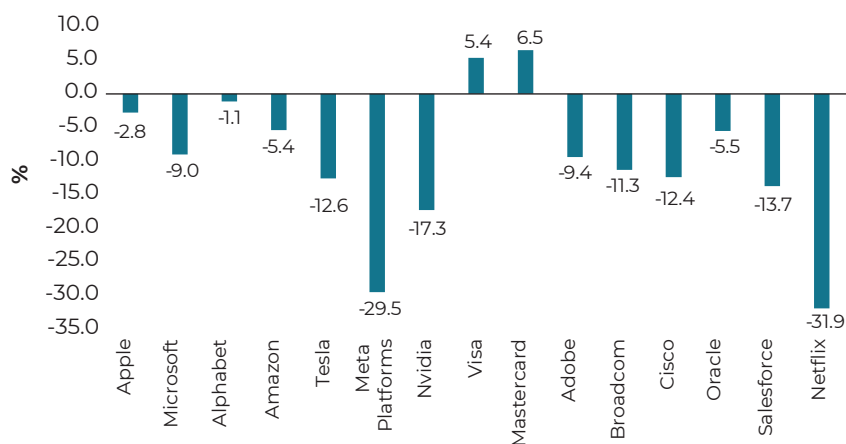
**AN ACADEMIC ARGUMENT**

The current investment environment is highly complex. There are a number of known unknowns currently playing out in the market: geopolitical tensions, rising inflation, COVID-19, the US Federal Reserve (Fed) tapering asset purchases, and the question of how quickly and for how long the Fed will raise interest rates. Combined, these factors are creating an increasingly uncertain outlook for financial markets.

Not only is there uncertainty across various asset classes, but also within. For the better part of the past 15 years, global equity markets have been driven by what are referred to as growth companies. This term is used to describe companies that the market believes can grow (revenue, earnings and cash flows) at a faster rate than the average company. Effectively, investors hold these businesses because they believe in their long-term prospects, and they factor those growth expectations into their valuations. Therefore, in the low growth environment that we have endured

<sup>1</sup> Coined by Nassim Taleb, antifragile is used to describe things that benefit from disorder, and technology businesses have undoubtedly benefited from the chaos that ensued following economic shutdowns.

Graph 5: 2022 year-to-date returns of large technology stocks (to 28 February 2022)



since the Global Financial Crisis, investors have been willing to pay higher prices for companies with a greater potential to grow.

At the opposite end of the spectrum is what is known as value investing. Value investors place little emphasis on future expectations and instead, they attempt to identify undervalued companies. Benjamin Graham is widely considered as the father of value investing. He used the approach of calculating a business's intrinsic value using factors such as assets, historic earnings and dividends; and then identified companies trading at a discount to their intrinsic values. The difference between a company's intrinsic and market value was what he called the margin of safety. It was of paramount importance to him to invest with a margin of safety, and then remain invested for a sufficient amount of time for that margin of safety to close.

There is an ongoing debate within investing circles regarding growth versus value investing, and both investment styles have had their time in the sun. Depending on prevailing market and economic conditions, one approach tends

to outperform the other over a certain period of time, as graph 6 illustrates. However, the major flaw in the value versus growth debate is how the two sub-sets of companies are defined. Academics and investors alike use the approach of dividing the market into value and growth companies based on a set of valuation multiples. Those companies trading on low valuation multiples are considered value, while those trading on high multiples are considered growth.

The shortcoming in this approach is the implicit assumption that valuations are comparable across companies, which they are not. Graham's philosophical approach to investing is timeless, and remains as relevant today as it was when he first published his world-renowned book "Security Analysis" in 1934. However, what has evolved is the approach to valuing companies. No two companies are identical and so their valuations are not directly comparable, even if they operate in the same geography and industry.

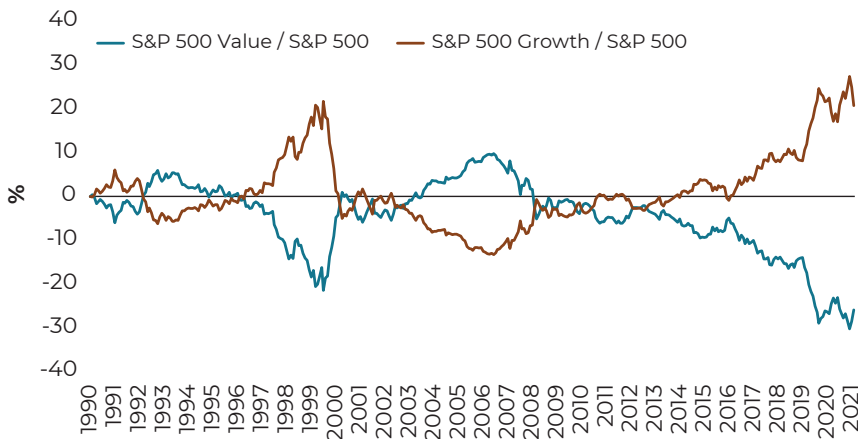
Consequently, we believe that the value versus growth debate is a purely academic one. No-one invests in a business believing

that they are overpaying for it. In this way, everyone believes that they are investing with a margin of safety, and can therefore be considered to be value investors. The differentiation between the two schools of thought resides in how investors value a business.

A pragmatic approach acknowledges that future growth is valuable. Valuing businesses by looking in the rear-view mirror is very likely to result in a lowball valuation, particularly for businesses that have decent growth profiles ahead of them. The net result of only looking backwards is often little to no margin of safety, with the exception of those companies trading on low valuation multiples. Companies that do present a margin of safety through backward-looking valuation techniques are typically companies that can be classified as old economy businesses. These types of businesses tend to have little future growth prospects (ex-growth), and can often be found in industries such as energy, utilities, tobacco and consumer staples – with the caveat that this is a broad generalisation. These types of businesses also tend to generate a significant amount of cash that can be returned to shareholders in the form of dividends or buybacks. Hence they are more defensive in volatile markets, as we have seen in the first few months of 2022.

It is important not to categorise all companies trading on low multiples as value, as some businesses actually deserve to be cheap. Similarly, companies trading on high valuation multiples may deserve their premium valuation, while still offering a margin of safety. However, investors should be cautious of the stock story that has too much growth priced into it.

**Graph 6: S&P 500 Value and Growth Indices' performance relative to S&P 500 Index**



Given that it is too simplistic to label companies as value or growth based on valuation multiples alone, it is important to maintain a pragmatic approach and not to become pigeonholed into a single category, as many great opportunities could be missed. At the end of the day, provided one can see through the “value-growth” cycle, it is the margin of safety that counts.

**WHEN PIGEONHOLING MAKES SENSE**

Acknowledging that there is nuance in every pigeonhole is important, because at times, a simplistic approach to a theme or group of companies is suitable. Attempting to identify a winner within industries with complex structures and many competitors is incredibly difficult, often requiring a healthy dose of luck. Examples include the biotechnology and semiconductor industries.

The nascent biotechnology industry has a significant role to play in the future of healthcare and there will be many companies that will produce ground-breaking technologies. Moderna is a recent example. However, there will also be many companies in the industry who will fail. Identifying the long-term winner comes with a large amount of risk. Therefore, from a risk management perspective,

investing in the broad sector as opposed to a single company is a simplistic, yet sensible approach.

The semiconductor industry is also relatively young in comparison to many other industries, yet it is highly complex. The semiconductor supply chain is multifaceted, with many competing businesses at various parts of the chain. For example, there are the equipment manufacturers, fabricators, foundries and integrated device manufacturers. Compounding this are the many different types of chips being produced for a multitude of purposes. Again, it is a very difficult task to resolutely identify a single business within the industry that will be a long-term winner. As such,

within our Global Equity Model Portfolio, we have taken the simple approach of investing in broad exchange traded funds to get exposure to both the biotechnology and semiconductor industries.

**GETTING THE BALANCE RIGHT**

In an increasingly complex world, we believe that investing requires a simple approach. However, simplicity does not imply naiveté or a lack of expertise. Rather, it entails deep understanding, deliberation, critical thinking and the ability to see the bigger picture, while at the same time knowing when and how to narrow your focus.

At Old Mutual Wealth Private Client Securities, while we follow a simple investment philosophy (based on the principles of quality, valuation, diversification and time), our rigorous process ensures that we remain focused on the right factors and understand the nuances at play within both the macro environment and the companies within our portfolios. In our view, this increases the probability of achieving solid long-term investment results.

Steve Jobs summed it up well when he said: “Simple can be harder than complex, you have to work hard to get your thinking clean to make it simple. But it’s worth it in the end because once you get there, you can move mountains.”



# BIG TECH: PANDEMIC HIGHLIGHTS MORE DIFFERENCES THAN SIMILARITIES

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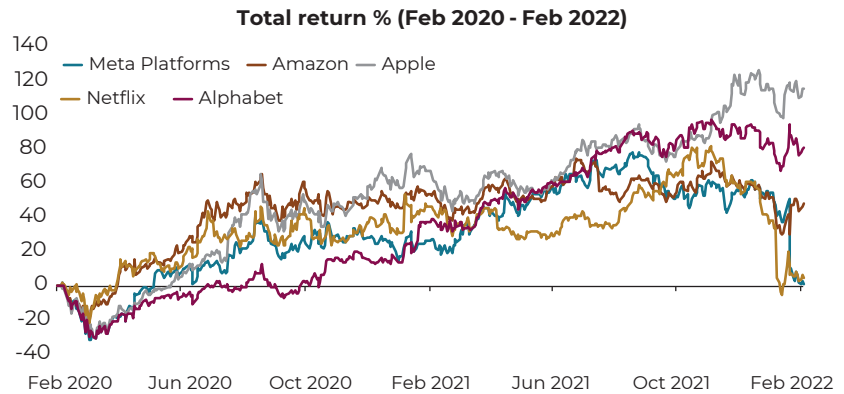
**VICTOR MUPUNGA**, SENIOR RESEARCH ANALYST AT PRIVATE CLIENT SECURITIES



Coined back in 2013 by CNBC host Jim Cramer, FANG was first used to refer to Facebook, Amazon, Netflix and Google. Cramer believed that the four companies were poised "to really take a bite out of" the bear market, giving double meaning to the acronym. FANG was then adapted to FAANG in 2017, when Apple was added to the group.

While these companies were initially grouped due to their similarities, the shortcomings of this type of broad categorisation were laid bare throughout the COVID-19 pandemic. The difference between the best and worst performing share price in this group is more than 100% over the last two years. While Apple's earnings have accelerated and its valuation multiple expanded, those of Meta Platforms (previously Facebook) have decelerated. As we exit the pandemic, it is becoming clearer that the FAANG stocks have more differences than similarities and face divergent prospects.

Graph 1: FAANG total return (Feb 2020 – Feb 2022)



Sources: Refinitiv/PCS Research

### MICROSOFT: STRENGTH IN DIVERSIFICATION

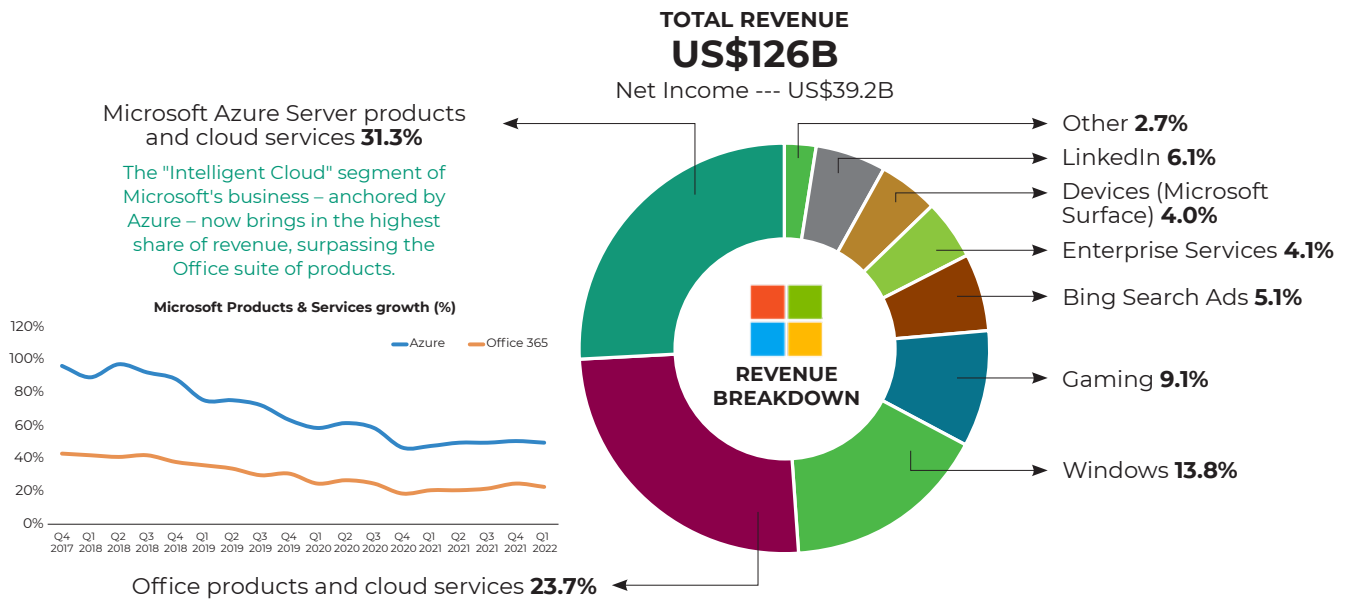
In considering the different risks and drivers of each of the big tech companies, it seems appropriate to start with the oldest, Microsoft. Currently, the group operates under nine sub-segments, with products and services ranging from hardware, software and gaming to advertising and a search engine. This is a far cry from a decade ago when Microsoft generated 55% of its revenue from selling on-

premises software licences. Today, the group has the most diversified revenue stream among the big tech companies and its largest segment (Azure) contributes 31% to group revenue. In our view, Microsoft's proven ability to build such a well-diversified group and to continuously adapt its business to current trends is a key ingredient that has allowed it to keep pace with newer tech companies.

The ability to adapt is well illustrated in Microsoft's current growth



Graph 2: Microsoft's revenue breakdown



Sources: Visual Capitalist/Company reports

drivers, namely, Azure, Office 365 and Gaming. It is interesting to note that decades-old software such as PowerPoint and Excel remain growth engines for Microsoft, thanks to a shift from the historic licensing model to a cloud-based subscription service. Since its launch in 2011, Office 365 has enjoyed rapid adoption and is estimated to have over 250 million monthly active users. Azure, Microsoft's comprehensive set of cloud services, allows users to build, deploy, manage and utilise applications on remote devices, and is the fastest growing service within the group. While the shift to the cloud is not new, we have seen it accelerate in the later part of the last decade, and throughout the pandemic, making it a growth driver for the group in the coming years.

**LEVELLING UP**

More recently, Microsoft's acquisition of Activision Blizzard for US\$69 billion has highlighted the

potential that lies within the group's gaming business. Once complete, Microsoft will be the third largest global gaming company (just behind Tencent), with a sizeable offering in the faster-growing mobile gaming market. It is worth pointing out that over the last six months, Microsoft's own gaming business grew by 11% despite a strong prior year, highlighting that the Activision acquisition is enhancing a strategy that is already working well.

**AMAZON: MISUNDERSTOOD AND UNDERESTIMATED**

Of the big tech companies, Amazon is arguably the most misunderstood of the group. While industry classifications describe Amazon as a consumer discretionary business, we view it as the most data-rich company in the world and as such, a leader in artificial intelligence. From its inception, a consistent driver within Amazon has been its ability to leverage data to build superior

algorithms that span across product innovation, customer purchase decisions and efficient delivery.

An analysis of Amazon's subsidiaries highlights how complementary its seemingly diverse businesses are. The business-to-consumer (BtoC) operations (left-hand side of graph 3), while loss making, generate significant data for Amazon. On the other hand, the business-to-business (BtoB) operations (right-hand side of graph 3) are high margin, profitable businesses that generate substantial free cash flow. When combined, the two halves are complementary. Amazon Prime, a paid subscription service that gives the group significant scale with over 200 million subscribers, is at the centre of Amazon's ecosystem.

The group's most profitable (and possibly most innovative) segment is Amazon Web Services (AWS). Since its inception in 2006, AWS has popularised cloud computing, built the most developer-friendly

platform and maintained its front runner status with a market share of over 30%. In the last financial year, AWS generated US\$62 billion in revenue, representing around 13% of group revenue but 75% of Amazon's profit. Despite its scale, AWS continues to grow above 30% per annum, reporting high margins while generating significant free cash flow for investment in the rest of the group. The duo of AWS and Prime are, in our view, the cogs that turn the Amazon wheel.

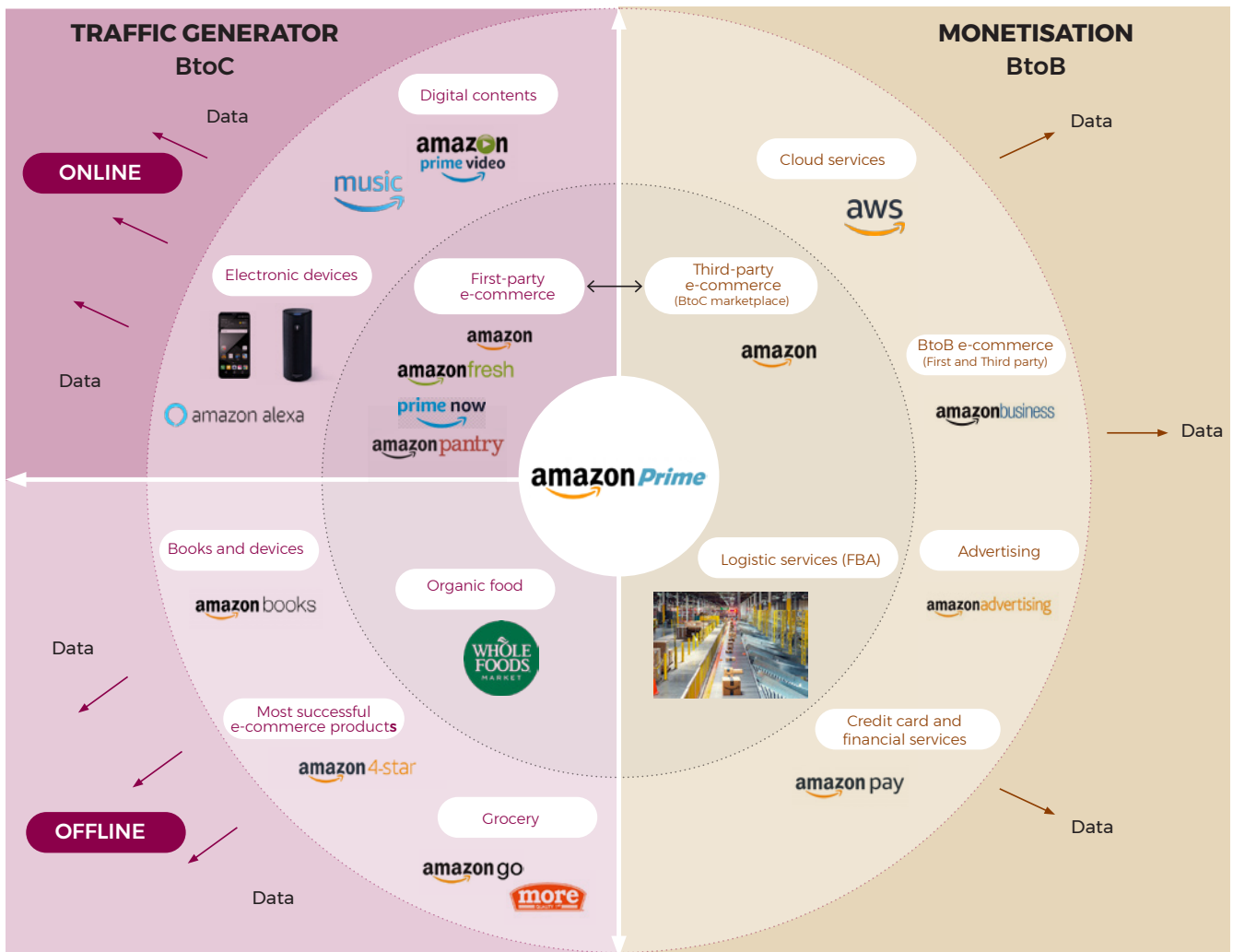
### META & ALPHABET: LEOPARDS CHANGING THEIR SPOTS

Among the tech giants, Alphabet and Meta Platforms (Meta) are the closest competitors in terms of revenue sources. As shown in graph 4, both businesses earn most of their revenue from advertising, albeit via different platforms. With the recent rebranding to Meta, both companies have also gone through the process of a name change (Alphabet was previously known as Google) and a reorganisation

to highlight other areas of their businesses they believe will be avenues for future growth.

A key difference in the rebranding exercises, though, was the timing. Alphabet announced their rebrand in 2015 at a time when the business was thriving, and paired the announcement with the elevation of Sundar Pichai, who later became group CEO. Meta Platforms, on the other hand, announced their name change when the Facebook brand had suffered numerous publicity

Graph 3: Amazon's ecosystem



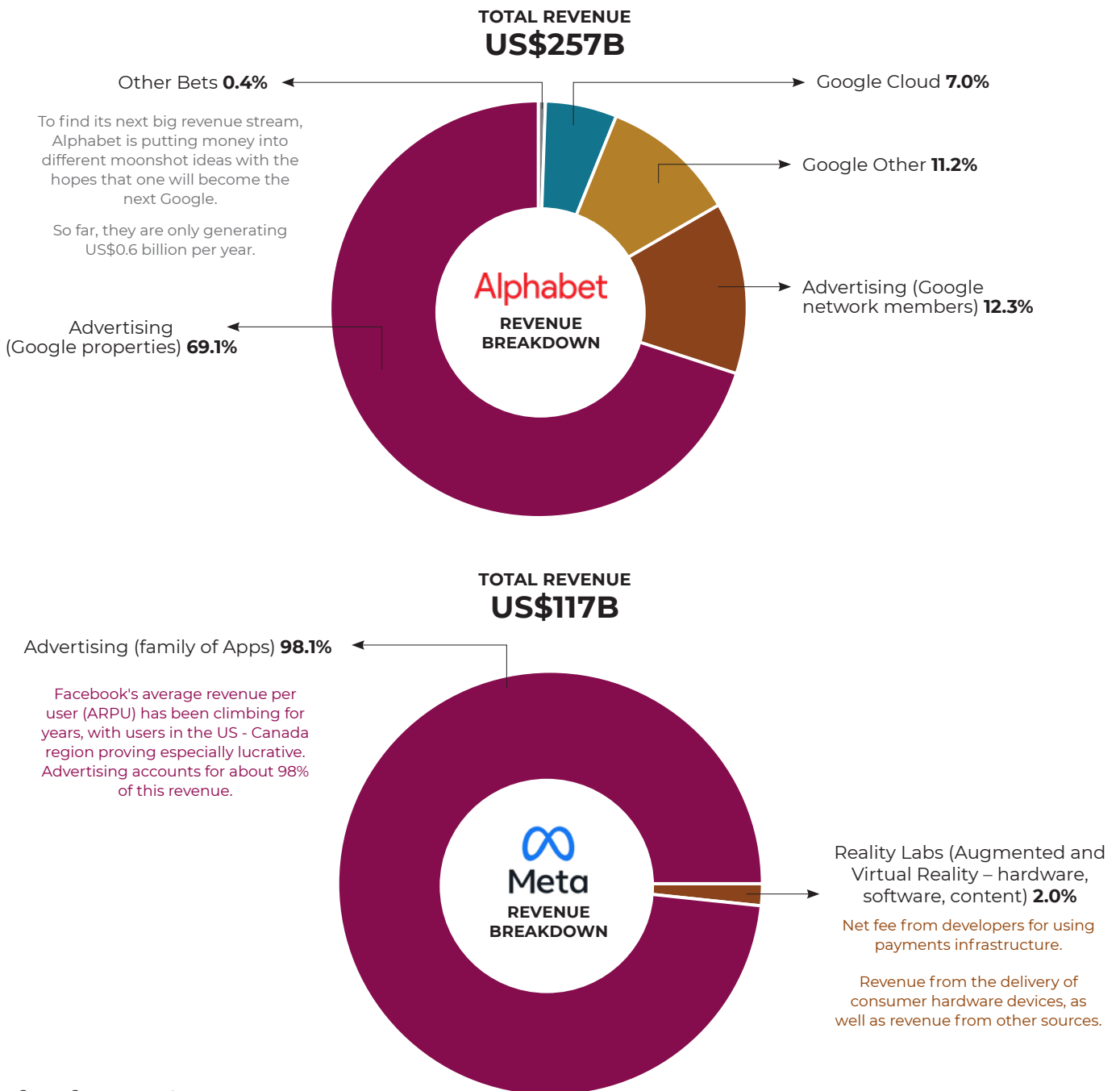
Source: Société Générale

challenges and regulators were circling. As a result, some have concluded that the name change was more of a public relations stunt, rather an indication that the Metaverse will be Meta's next growth driver.

Timing aside, most would agree that given the dominance both companies already enjoy in digital advertising, the best long-term strategy includes more diversification. Alphabet is much further along than Meta in this respect. Alphabet's investments

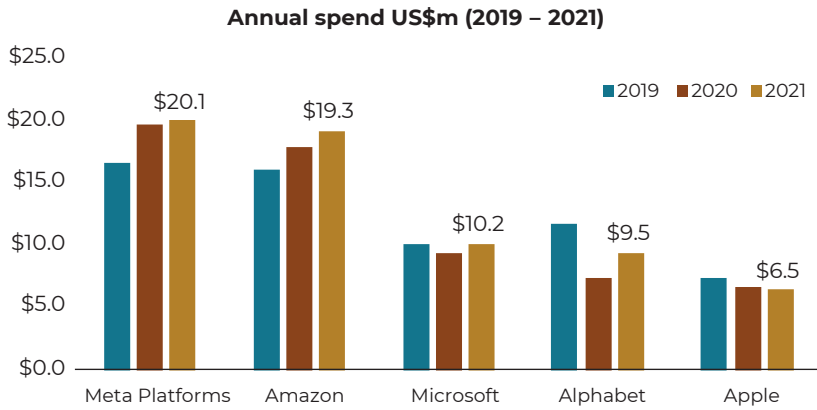
in what it refers to as "Other bets" have been significant and include the likes of Calico, a human health entity; DeepMind, which focuses on artificial intelligence; and Waymo, which develops autonomous vehicle technology. Apart from Search advertising, more established

Graph 4: Meta and Alphabet's revenue sources



Source: Company reports

Graph 5: Big tech spend on lobbying



Sources: Statista, US Senate Lobbying Disclosure

businesses such as YouTube and Google Cloud generate annual revenues of over US\$30 billion and US\$18 billion respectively, pointing to several irons that Alphabet has in the proverbial fire.

**INCREASING COMPETITION**

Meta’s most recent earnings, where the company called attention to increased competition from TikTok, perhaps for the first time underlined the group’s lack of diversification as a weakness when compared with the other tech giants. With Meta owning four of the five most downloaded platforms, we thought it curious that TikTok’s rise to about one billion active users resulted in Facebook’s user numbers shrinking for the first time in its history. Changes to Apple’s privacy policies in 2021, which made it easier for users to opt out of sharing their data, further dented Meta’s business model and increased the urgency for Meta’s management to find additional growth drivers for the business outside of advertising.

**RISKS - NOT ALL EQUAL**

Apart from the ever-present concern of new competitors

already highlighted in Meta’s case, regulatory scrutiny is the other notable risk that continues to plague the tech giants. However, similar to competitive risks, not all the companies are threatened by regulation to the same extent. Graph 5 shows the amount that each of the big tech companies has spent lobbying US regulators for favourable legislation. We believe that there is a relationship between the amount each company spends on lobbying and the risks they face from regulation.

Meta and Amazon are the only two that have grown their lobbying spend in each of the last three years, with Meta leading the group. Apple, on the other hand, has been decreasing its lobbying spend over this period, which we believe is consistent with the perceived view that Apple is somewhat mindful of its users’ privacy and do not readily share data with third parties. Related to regulatory scrutiny, it is worth also pointing out that Microsoft’s recent bid to acquire Activision is the type of corporate activity that we suspect not many tech companies would receive regulatory approval for. This is partly due to the existing concerns surrounding a lack of competitiveness and misuse of user data by some of the big tech players.

**THE DEVIL IS IN THE DETAIL**

While pigeonholing companies by some metric (such as sector classification or a catchy acronym) is common by market participants, a close look often reveals that the companies in the grouping have little in common. In the case of big tech, the pandemic has made these differences apparent. Given these companies’ widely divergent prospects and while they are facing different risks, we believe that more than before, it is important that investors differentiate within such groupings. Among the tech companies, our preferred exposure remains through our long-term holdings in Amazon, Alphabet, Microsoft and Apple.



# BERKSHIRE HATHAWAY:

## RECOGNISING THE GROWING VALUE IN PRAGMATISM

SAMEER SINGH, RESEARCH ANALYST AT PRIVATE CLIENT SECURITIES

The current investment environment has seen the resurrection of the age-old value versus growth investing debate. While there is an abundance of research on this topic, more often than not, they reinforce a binary view of one style's superiority over the other. At PCS, rather than dogmatically endorsing one style over another, we adopt a more pragmatic view. Contrary to popular belief, there likely is not a more fitting example of the appeal of pragmatism in investing than Berkshire Hathaway and its legendary founder, Warren Buffett.



## GROWTH AND VALUE: A PRIMER

Value investing at its core aims to identify undervalued companies. It involves the calculation of a company's intrinsic value and then comparing it to its market value (i.e. the company's price as determined by the market). If the intrinsic value is above the market value, then the stock is trading at a discount and presents a buying opportunity.

On the other hand, growth investing entails a focus on maximising capital gains. Rather than cash generation or dividend yield, an investor looks to identify businesses with high growth characteristics and typically businesses that are reinvesting their earnings back into their operations. These businesses come in various sizes but are usually operating in fast-growing industries characterised by innovation and new technologies and services. Other characteristics include high return on equity, high profit margins and low dividend yields. For an investor, the hope is that fast growth in revenues and/or earnings will result in higher stock prices. This explains why many growth stocks trade at higher price/earnings (PE) multiples, as their earnings (although growing

fast) are being reinvested back into the business while the price adjusting higher reflects the prospect of higher earnings in the future.

In this sense, it would appear that value and growth investing are diametrically opposed, with one hunting low PEs and the other maintaining high PEs as a result of the underlying opportunity. In reality though, one could argue that the two investment styles share the same ultimate goal – to purchase a business for less than it is worth (i.e. intrinsic value). The key differentiator is whether the "gap" represents under-appreciated fundamentals right now, or the prospect of future earnings growth.

## WARREN BUFFETT AND THE EVOLUTION OF BERKSHIRE HATHAWAY

Warren Buffett is one of the most successful investors of all time. Without unpacking the entirety of his 70+ year investment career, it is worth noting that through his listed investment vehicle, Berkshire Hathaway, he has generated 20.9% in annualised returns over the past 45 years. Clearly, he has been doing something right for a very long time, considering that the S&P 500



TRAIT	GROWTH INVESTING	VALUE INVESTING
<b>Company features</b>	Growing quickly, hot new product, tech stocks	Growing slowly or not at all, older products
<b>Valuation (PE ratio)</b>	Higher	Lower
<b>Stock popularity</b>	In favour, "momentum" stocks	Out of favour, "cigar butts"
<b>Dividends</b>	Less often	More often
<b>Stereotypical stock</b>	Amazon, Apple, Meta	Proctor & Gamble, Exxon Mobil, Johnson & Johnson
<b>Volatility</b>	Higher	Lower



delivered 11.8% per annum over the same period.

Perhaps second only to his fortune, most people will know Buffett for being a student and one-time business partner of Benjamin Graham, who is widely considered as the father of value of investing. Taking the baton from Graham, Berkshire Hathaway and Buffett have long been considered as the foremost proponents of value investing into the 21st century. Yet, over the past 30 years, Buffett and his management team have added selected growth stocks to Berkshire Hathaway's investment portfolio.

In their 1992 annual report, Buffett wrote: "Most analysts feel they must choose between two approaches customarily thought to be in opposition: value and growth... In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value."

A milestone purchase for Berkshire Hathaway was Coca-Cola in 1988 – a company which, at the time, had a book value per share of US\$1.07 and a market price of US\$5.70. Additionally, Coca-Cola was trading at a PE of 16.8 times relative to the S&P 500 at 12.4 times. This purchase represented a shift in attitude from only buying good but cheap companies to also buying good companies at an acceptable price.

It is well known that technology stocks were excluded from the Berkshire Hathaway portfolio for a very long time. Buffett has been candid with his stance on technology companies and his views can be summarised to two points. Firstly, tech companies have a limited track record and untested

Sectors - to end Feb 2022	1M	3M	6M	1Y	3Y*	5Y*	10Y*
<b>S&amp;P Information Technology</b>	<b>-4.9%</b>	<b>-8.5%</b>	<b>-2.6%</b>	<b>18.8%</b>	<b>31.1%</b>	<b>26.6%</b>	<b>20.8%</b>
S&P Consumer Discretionary	-4.0%	-13.5%	-4.7%	8.5%	18.3%	16.5%	16.7%
S&P Healthcare	-1.0%	0.6%	-3.1%	17.2%	14.6%	13.8%	15.8%
S&P Financials	-1.4%	2.0%	1.3%	21.6%	15.8%	11.8%	14.7%
S&P 500	-3.0%	-3.9%	-2.6%	16.4%	18.2%	15.2%	14.6%
S&P Industrials	-0.9%	-0.5%	-3.7%	11.8%	11.5%	10.4%	12.5%
S&P Consumer Staples	-1.4%	7.2%	5.6%	23.4%	14.8%	9.7%	11.7%
S&P Real Estate	-4.9%	-4.1%	-4.1%	24.6%	12.7%	10.7%	11.0%
S&P Utilities	-1.9%	4.1%	0.6%	20.1%	9.6%	9.2%	10.8%
S&P Materials	-1.2%	-1.0%	-1.6%	15.5%	17.4%	12.0%	10.7%
S&P Communication Services	-7.0%	-10.5%	-18.5%	1.2%	16.1%	9.1%	10.0%
S&P Energy	7.1%	31.5%	50.8%	55.0%	8.7%	4.7%	3.0%

Sources: Refinitiv / OM Wealth PCS

competitive advantages, and secondly, it is difficult to identify the winners as well as acquire them at reasonable prices. Essentially, uncertainty around the longevity of the innovations, coupled with uncertainty about future cash flows, made it difficult to estimate the market opportunity and reliably value a company. It is important to note that these were Buffett's sentiments at the height of the dotcom bubble when the majority of tech companies had been in operation for less than a decade. History proved him right at that particular point in time. However, the tech sector has since evolved and matured, and has grown to become the dominant contributor to the broader market's growth.

From the table above, which reflects the S&P 500 sector returns, it is clear that technology has been the top performing sector over almost all periods over the past 10 years.

It would be unfair to say that Berkshire Hathaway did not participate in any of the technology bull market. As early as 2011, Berkshire acquired stakes in two companies that could be considered the grandparents of today's most innovative companies: IBM and Intel. Another was Verisign. However, these companies were not the ones grabbing the headlines, as the FAANGs (Facebook, Amazon, Apple, Netflix and Google) were very much in vogue. Hindsight shows that the IBM trade was a misstep, which was exited four years later, while the Intel position was sold less than a year after the initial purchase. Verisign remains in the portfolio.

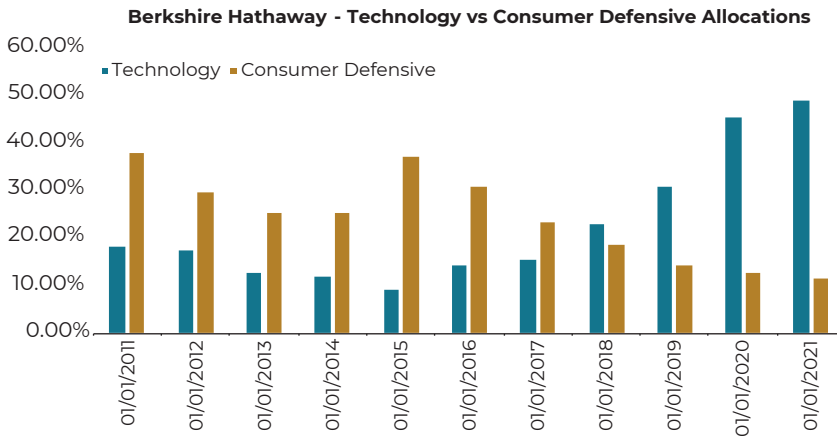
Many were quick to criticise Buffett for deviating from his well-known buy and hold strategy. But what few were willing to appreciate was that these were key learning experiences that have contributed to the more "new economy" Berkshire Hathaway portfolio we see today.

## BREAKING THE MOULD AND ADAPTING TO A CHANGING WORLD

Looking at the past seven years, keen portfolio observers would have noticed a shift in sector allocations across the Berkshire Hathaway portfolio – most notably, reduced exposure to consumer defensives and increased exposure to information technology.

From just 18% in 2011, the allocation to technology has grown to almost 50% of the portfolio. Rather than reflecting unease of not holding the most popular stocks, this shift is more illustrative of pragmatism and the appreciation that areas of the technology sector have become indispensable to everyday life. Furthermore, many tech companies are now mature businesses with sound competitive advantages and clear market opportunities, while others are fast-developing, innovative intellectual properties. Learning from the folly of past dogmatism, Berkshire Hathaway

**Graph 1: Berkshire Hathaway's Technology vs Consumer Defensive Allocations**



Source: GuruFocus

now owns a handful of tech companies, with Apple being its largest holding.

Apple is a prime example of how a label such as value, growth or even technology can often distract from the underlying fundamentals. As one of the world's largest software and hardware manufacturers, Apple has spent the past 15 to 20 years innovating and producing some of the most desirable devices, and pairing them with excellent software and a great user experience. Simultaneously, they have built a powerful complementary ecosystem (iOS) that makes switching very difficult. Through this, Apple has been able to grow earnings consistently over a long period of time. They have also created a moat, maintaining high profitability and generating above-average returns on equity. Furthermore, strong cash generation has allowed the company to amass one of the largest cash balances on the S&P 500, providing them with a sound balance sheet and optionality to fund growth. Considering that fundamentals are Buffett's main

focus for potential investments, Apple ranks well regardless of peer group. Moreover, Apple maintains strong intangible assets in its brand and the network effect afforded by its iOS platform. It is therefore clear why Apple is Berkshire Hathaway's largest investment outside of insurance and rail.

Amazon is another tech holding within the Berkshire portfolio. The other tech companies held in the portfolio are at significantly lower weights than Apple and do not tick all of the fundamental boxes. However, these companies maintain attractive growth prospects with hard-to-replicate intellectual properties. Activision-Blizzard, for example, is one of the largest game developers in the world with a portfolio that includes long-time fan-favourite franchises like World of Warcraft and Call of Duty. Beyond the actual sale of games, Activision-Blizzard generates billions of dollars from micro transactions as gamers interact with and within the digital worlds in the games. Activision-Blizzard has since been marked for acquisition by Microsoft, leaving Berkshire Hathaway

with a healthy 40% return over a short period of time. Holdings in Snowflake (a multi-platform cloud infrastructure provider) and Nu Holdings (a Brazilian fintech with expertise in cryptocurrencies) are also fairly new to the portfolio and confirm that even an "old-economy" conglomerate like Berkshire Hathaway can evolve and invest with and ahead of the times.

## PRAGMATISM – A STYLE FOR THE AGES

Appreciating that few things remain constant indefinitely, we view the debate around value vs growth investing as purely academic. Practically, any company's share price can fall below its intrinsic value, making it a "value play". Similarly, just because a company maintains an above-average PE does not mean that it does not offer value.

Rather than rigid categorisations, our pragmatic approach aims to identify exceptional companies with growth characteristics underpinned by sustainable competitive advantages and high returns on capital, with due consideration to reasonable valuations. This ensures that we avoid being over-exposed to a particular sector, theme or style-based investment, while allowing access to the best investment opportunities globally. As investors in Berkshire Hathaway, we take comfort in the knowledge that both our interests and culture are aligned with competent managers guided by curiosity, humility and a healthy dose of pragmatism.

# WHAT DOES THE ENERGY AND COMMODITY CRUNCH MEAN FOR INFLATION?

IZAK ODENDAAL, INVESTMENT STRATEGIST AT OLD MUTUAL WEALTH



**T**he short answer is that inflation is going to rise everywhere and place further upward pressure on interest rates. The long answer is: It really depends on a number of factors. The big question for investors is, ultimately, whether a recession is triggered, causing company profits to fall.

Much of the world was already grappling with elevated inflation before news broke that Russian troops were amassing on the Ukrainian border. For investors, inflation was the big risk and the big unknown before Putin's invasion changed the conversation.

Higher energy and food prices will cause headline inflation rates to rise across the world. Supply chain disruptions – already a headache prior to the invasion – will likely intensify as Russia is effectively cut out of the global economy and financial system. Shortages of fertiliser could impede planting today, which will only show up in food prices six months to a year from now.

## THAT 70S SHOW

The term “stagflation” is increasingly doing the rounds. Indeed, the similarities with the 1970s are notable: a US economy going into the crisis with elevated Vietnam and “Great Society” fiscal spending, a US Fed that was initially very dovish on inflation (largely due to political pressure from Nixon, not because of its policy framework) and then a war and an oil embargo (1973 and again in 1979).

However, before everyone runs for the hills, it is important to a) highlight how the world has changed since the 1970s, (b) explain how oil prices are not necessarily inflationary, and (c) admit that there is so much uncertainty now, forecasts are bound to be wrong (if you are going to forecast, forecast often).

The key difference between the 1973 oil shock and today is simply that the world was a lot more dependent on oil. Abundant and cheap oil had previously discouraged efficient use of oil (3-litre Chevies were standard, and oil was directly used in heating and electricity generation). Manufacturing was also a much larger part of the world economy than today. Columbia University’s Centre for Global Energy Research estimates that every US\$1 000 of inflation-adjusted global economic output required almost a full barrel of oil in 1970, but requires less than half a barrel today.

Therefore, when oil prices tripled virtually overnight in 1973 following the Yom Kippur War, and oil became scarce (not just expensive) as OPEC cut production, eventually by as much as quarter, it gave the world economy a hammer blow.

But here is the crucial bit: instead of pulling prices down, as a recession normally does, inflation continued to accelerate. In the case of the US, CPI inflation rose from 2% at the start of 1972 to 4% at the start of 1973, to 9% a year later before peaking at 12% in January 1975. Base effects took inflation lower in 1976 but by 1978 it was rising again. The 1979 Iran Revolution caused another oil spike and inflation shot up again. This time, it took Fed Chair Paul Volcker’s crushing interest rate hikes to cause a deep recession and finally break inflation’s back.

This is why the 1970s are remembered as such a miserable decade for ordinary people. For investors, it was no better. Bond and equity returns were terrible, but this period of relentlessly rising yields set the stage for the secular bull market in bonds and equities that was to follow.

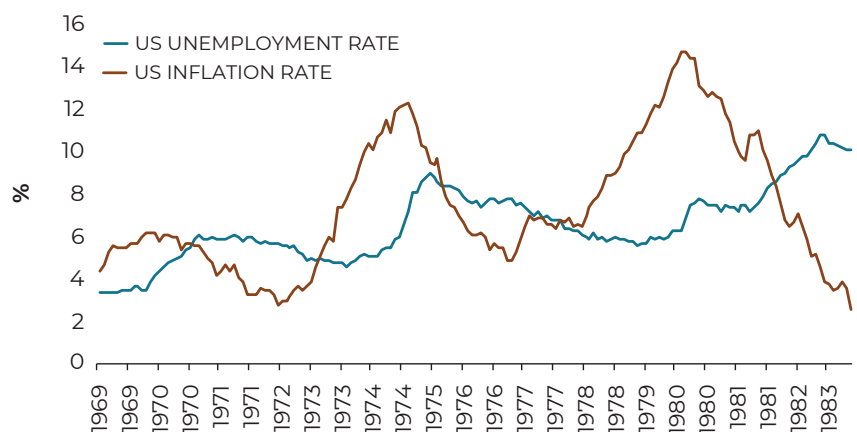
## FLEXIBLE ECONOMIES

Economies were much less flexible and much more regulated in the 1970s. Prices couldn’t freely adjust to shocks, and this often compounded problems. Leading up to the oil crisis, for instance, the US

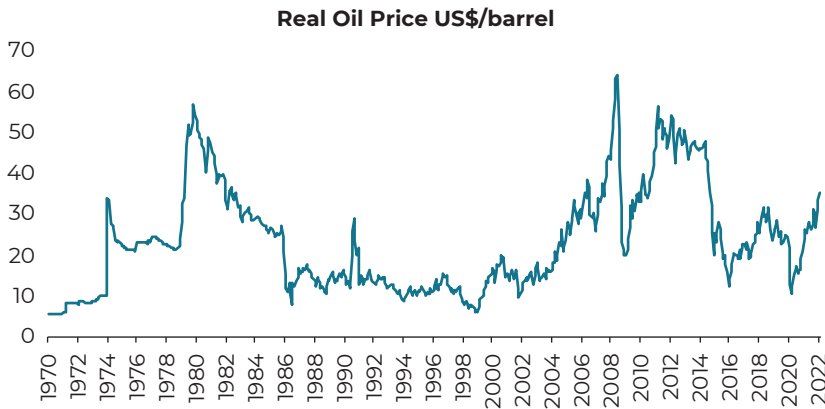
had maintained import quotas and even price ceilings that distorted the true cost of oil and discouraged local production. In particular, labour markets were quite rigid with much higher levels of union membership than today. This meant wage increases were often automatically linked to inflation. Moreover, because the oil shock followed three decades of low and stable prices, people didn’t know how to respond. It took time to adapt business processes and daily life to this new reality. While no-one expected Putin’s war, oil prices north of US\$100/b are not new. In real terms, the oil price today is quite a bit below its peak from a decade ago.

## WHAT TO EXPECT WHEN YOU’RE EXPECTING INFLATION

So, the key question is: When does an oil shock cause inflation to accelerate, and when does it erode real incomes to such an extent that consumers and businesses cut spending elsewhere, and other prices face downward pressure? Central bankers call this the second-round effect: either firms pass on



Sources: Refinitiv/Datastream/Old Mutual Multi-Managers



Sources: Refinitiv/Datastream/Old Mutual Multi-Managers

input price increases to consumers, who in turn push for higher wages, or firms take a knock to their margins and individuals to their real incomes, and the inflation shock fades out of the system.

In other words, it is the behaviour of firms and households in response to inflation that plays a large role in whether inflation accelerates. It can quickly become self-fulfilling if there is a belief that inflation will rise.

Inflation expectations are therefore part of this story. Certainly, central bank policy setting relies heavily on expectations (whether it should be another matter). For now,

expectations still seem “anchored”. Take, for example, the University of Michigan Survey of American Consumers. In the late 1970s, respondents expected inflation over five years to be much the same as over the next year. Today, there is a clear distinction, and the survey shows inflation is expected to decline over the medium term.

### WE DIDN'T START THE FIRE

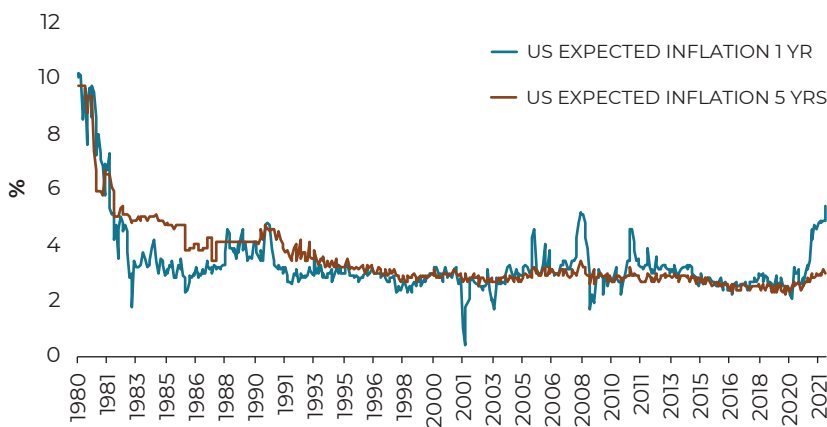
More broadly, we need to think of inflation as a fire: something has to start it (a spark), something needs to accelerate the burning (like kindling or Blitz) and something

needs to sustain it (coals and oxygen). A spark on its own is harmless, and so is oxygen. Similarly, something needs to accelerate the flame of higher commodity prices and sustain it.

Consider the period before and after the Global Financial Crisis. The year-on-year change in the oil price was 100% in July 2008 and 122% in January 2010. Yet, headline inflation in mid-2008 was twice as high as in 2010 (5.5% vs 2.6%). The pre-crisis era was one of robust (reckless) credit extension, overheating, and strong demand. This was fuel to inflation's fire, accelerating the spike in the oil price throughout the economy (in booming South Africa, inflation would peak at 13% in 2008). In the post-crisis era, a similar spike in the oil price found less dry tinder and did not set off broad inflation. Indeed, the decade from 2010 to 2020 will be remembered for inflation persistently disappointing to the downside in the developed world. We are all trying to work out what the 2020s will be remembered for on the inflationary front.

It follows then that economies where consumer demand is the strongest are more susceptible to inflation. The stronger overall demand, the more a given business can raise prices without fearing the loss of customers. But even this is not straightforward. High levels of productivity and flexibility can counteract inflationary pressures.

Given a strong US economy, companies there seem to have pricing power. Margins are close to historic highs. This suggests inflation can remain high as input costs are passed on to a degree. But



Sources: Refinitiv/Datastream/Old Mutual Wealth



a combination of high prices, higher wages and security-of-supply concerns could see the current surge in capex spending continue. This is ultimately good for productivity growth. If companies can do more with less, there is less inflationary pressure.

## BEYOND NOW

Thinking longer term, beyond the current conflict, there is also the question of whether the disinflationary pressures of demographics, technological innovation and globalisation will continue to put downward pressure on prices.

It is too soon to declare globalisation dead, though the nature of globalisation is likely to change after three big shocks in the past five years (Trump's trade wars, Covid, Ukraine). Reshoring, resilience, and certainty of supply are the name of the game, as opposed to efficiency and lower costs (outsourcing, offshoring, just-in-time supply). Globalisation, particularly the explosion of the global workforce following the implosion of isolationist communism, put downward pressure on costs and wages. This is not going to repeat at the same scale (Ethiopia and Vietnam are tiny compared to China). However, the disinflationary impact of technology remains; indeed, the pandemic accelerated technological adoption, as we are all aware. As for demographics, the developed world keeps getting older, and so is China. This tends to drive up savings rates and suppress spending, keeping inflation rates in check. Japan appears to be the leading indicator

here, and its inflation rate remains very low (negative, in fact, if food and fuel prices are excluded).

## NOISY

Statistical noise (base effects) also plays a role. Today's oil price of around US\$110 per barrel is double where it was a year ago. But unless the oil price doubles again, the year-on-year change in oil prices will start to decline by April 2023. If prices stay at current elevated levels, the year-on-year change will be zero. A resolution of the conflict could see the substantial risk premium come out of the oil market to such an extent oil prices are lower a year from now (a less benign scenario is that high prices choke off demand, ultimately leading to falling prices).

Can the oil price double again? Don't rule it out, but it seems unlikely. The US and UK have banned Russian oil imports, but as with Iran, there are other avenues for Russian crude to make it to market. Gas is different since it is directly piped into Europe. But the end of winter will see European gas demand fall, taking some pressure off prices.

## DOWN SOUTH

As for South Africa, headline inflation is therefore likely to breach the 6% upper end of the SA Reserve Bank's target. However, the recent comments from the Reserve Bank show them to be more cautious and less hawkish than their traditional stance. They can't do anything

about global food or fuel prices, nor can they address Eskom's exorbitant tariff increases. Yes, commodity prices are giving the economy a boost, but for most South Africans, conditions are tough and consumer spending is a greater slice of GDP than exports.

This is not a booming economy with rapid credit growth, labour shortages and a risk of overheating. Steep interest rate hikes are not necessary or desirable. The Reserve Bank will keep a close eye on the US Fed's pace of rate increases – no emerging market central bank can afford to ignore the Fed – but can be careful and gradual in hiking. Core inflation is still muted, which is a sign of low demand-pull inflation, while the wide gap between goods and services inflation tells a similar story.

Importantly, the rand is still resilient considering everything that is happening in the world, largely thanks to higher metals and coal prices. A sharp depreciation of the currency has historically seen the Reserve Bank react quite forcefully (though the passthrough of exchange rate weakness to domestic inflation has declined considerably over time). This time, there is no need for such urgency.

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