

INVESTMENT NOTE

08 APRIL 2024

THINKING FAST AND SLOW ABOUT VALUATIONS



IZAK ODENDAAL

OLD MUTUAL MULTI-MANAGERS

The world recently learned of the passing of Daniel Kahneman, the psychologist who revolutionised economics, along with Amos Tversky and other collaborators. He was awarded the economics Nobel Prize in 2002 for his studies on decision-making. He showed that, unlike the traditional models of very rational economic actors, humans are prone to making systemic judgement errors. People are biased in how they make decisions; they make the same mistakes repeatedly, across time and cultural context. This is not merely a matter of emotions – such as fear and greed – getting in the way. These biases consistently creep in due to the use of mental shortcuts and compartmentalisation. It is just the way our brains are wired.

Kahneman and his peers spawned the field of behavioural economics, and its investment-related offshoot, behavioural finance. This work is by now well known, and many good summaries of this field are available, including Kahneman's most well-known book, *Thinking Fast and Slow*. Much has also been

written about Kahneman's life and work, so we don't need to expand on it further here.

Rather, we can ask if there is anything behavioural economics can tell us about the current investment landscape.

One of the biggest cognitive mistakes people make – even highly paid professionals – is to extrapolate from recent trends, arguing that what has gone up, must keep going up.

To be clear, some trends don't reverse. We get older every day, for instance. Consumer prices tend to rise over time (inflation), though the speed varies from year to year. But most economic processes have some mean reversion tendencies. Strong demand for a particular item tends to encourage higher supply. Excess profits invite competition. Very low prices attract bargain-hunters. The law of diminishing marginal returns applies in production and consumption. Booms are followed by busts, etc. In other words, when one economic variable moves strongly in relation to another, it usually invites some form of reversal.

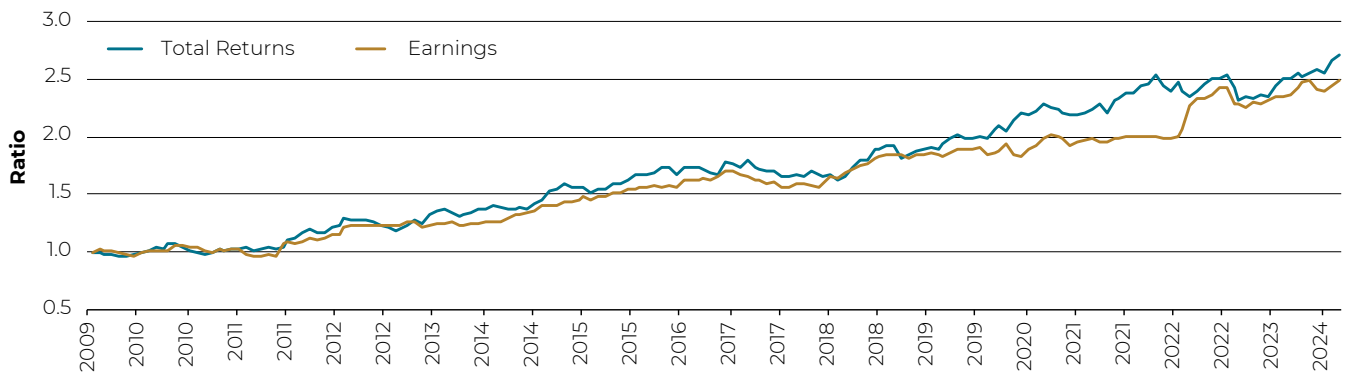


AMERICAN EXCEPTIONALISM

So, let's turn to perhaps the biggest question equity investors must grapple with. US equities have outperformed the rest of the world since the Global Financial Crisis. How long can this trend persist? This is not a trivial matter since US equities

today account for 60% to 70% of global equity benchmarks. A related question is whether the underperformance of South African equities against the rest of the world (especially the world) will continue.

CHART 1: US VS. NON-US EQUITIES IN DOLLARS



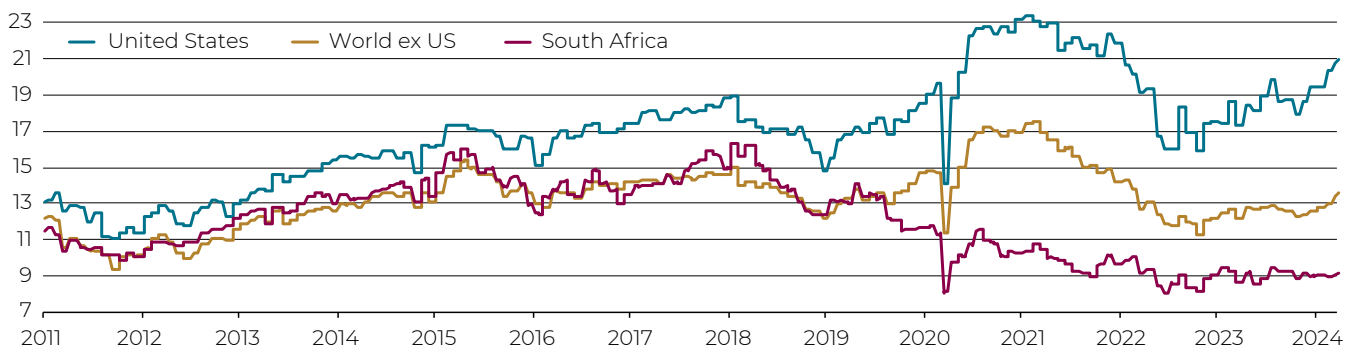
Source: LSEG Datastream

There are at least two approaches to answering this question. The first involves unpacking the reason for the trend, and the factors that could influence it in future. One reason has been a strong dollar. A strong greenback suppresses non-US returns when measured in dollars. It also tends to weigh on economic activity outside the US, including by making it more expensive to service dollar-denominated debt.

Another reason for US outperformance is the superior earnings growth of US-listed companies, as illustrated in

chart 1. But a big part of the story is that investors have been prepared to pay more and more for each dollar of US earnings. In other words, the price: earnings ratio on US equities increased much more than in the rest of the world. In percentage terms, US equities are now 40% more expensive than non-US equities when measured using the forward PE ratio. It is not a perfect measure, but it is telling.

CHART 2: FORWARD PRICE: EARNINGS RATIOS



Source: LSEG Datastream

We can then try and make predictions or educated guesses about the future, for instance by making assumptions about the adoption of artificial intelligence, political and geopolitical shifts, or demographics. We could list the many relative strengths the US has: its unrivalled geography, energy independence, deep capital markets, culture of innovation

and entrepreneurship, and world-beating universities that remain a magnet for global talent.

Kahneman himself was a case in point. Born in Israel and raised in France during the Nazi occupation, he ultimately settled in America as so many leading scholars do. Around 40% of all Nobel Prize winners are American citizens, of

which around a third were born outside the US (including two South African-born laureates, the chemist Michael Levitt and biologist Sydney Brenner).

These are important things to think about. A behavioural approach, in contrast, does not require assumptions on these matters. It is simply a case of asking that, having already experienced a large multiple expansion in absolute and relative terms, how likely is this to repeat over the next decade or so?

The answer is surely: not very.

Kahneman once told Jason Zweig, the finance journalist, that the most important question to ask before making a decision is 'What is the base rate?' He meant that before an important decision is made, one should get an objective

idea of the odds of success, such as looking at the historical range of outcomes in similar situations. For instance, half of marriages end in divorce. That is the base rate. Before marriage, every couple believes they will be happy, but the statistics tell a different story. Every marriage has only a 50/50 chance at the outset, including yours. Similarly, a certain percentage of new businesses will fail within a year. No one starts a business believing it will fail, but some will. This doesn't mean you shouldn't try, rather we should always be realistic on the probability of success in any given situation - and be aware of the pitfalls that usually lead to failure.

The "base rate" in this instance is that, usually, when a market trades at 20x forward earnings, the returns earned over the subsequent five to ten years are below par. PE multiples don't move inexorably higher.

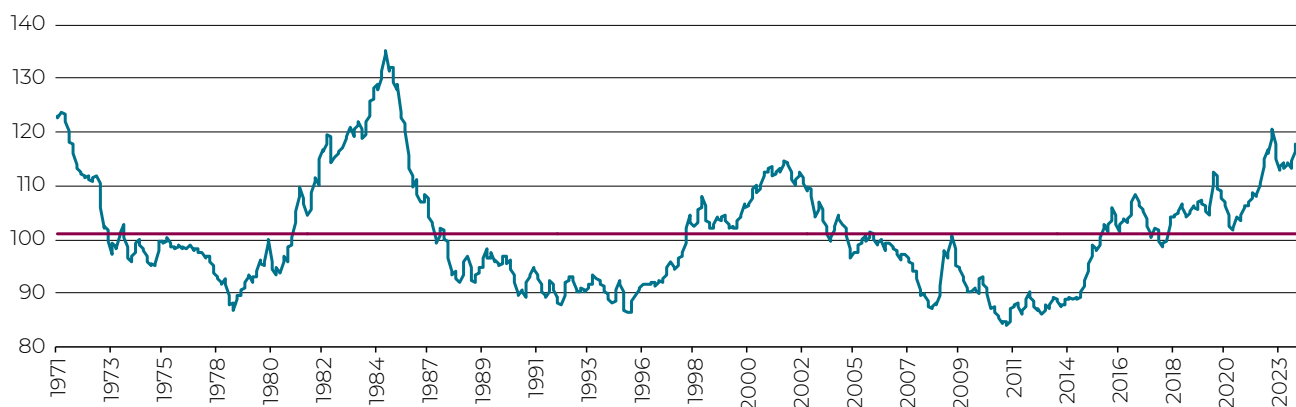
KING DOLLAR

Similarly, we can ask whether the US dollar will strengthen substantially from current levels. As chart 3 shows, the dollar is well above its long-term average and in the 90th percentile of historic values on a real trade-weighted basis (in other words, it has only been stronger 10% of the time since 1971, when the link with gold was abandoned). A behavioural approach to this question does not require assumptions about the dollar's status as global reserve currency, or whether fanciful ideas such as a BRICS currency can take

off, or on the outcome of the upcoming US election, or the next Federal Reserve interest rate decisions.

It simply asks whether a decade-long trend can continue in what has historically been a mean-reverting series. On this basis, it seems unlikely that the dollar experiences another sustained upward move. If the dollar ends up hovering around current levels, it will not provide any further uplift for US returns relative to the rest of the world. If it falls, it should favour non-US markets.

CHART 3: REAL TRADE-WEIGHTED US DOLLAR

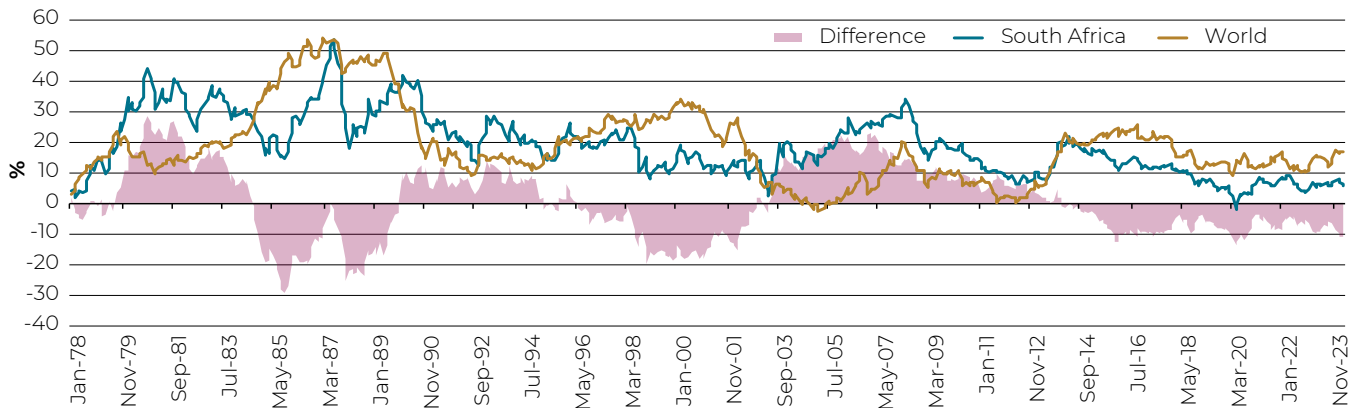


Source: LSEG Datastream

SOUTH AFRICA'S DISMAL DECADE

Finally, we can turn to the case of South Africa versus the rest of the world. South African equities have historically on average delivered attractive real returns. In fact, the well-known work of London Business School Professors Elroy Dimson, Paul Marsh and Mike Staunton suggests it

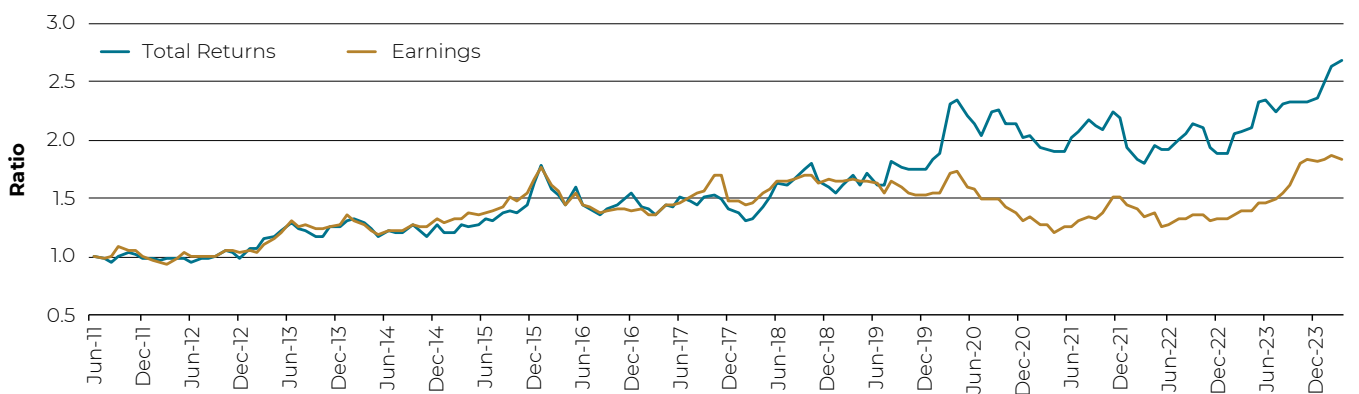
is one of the top markets over the past century-plus, with an average annual real return of 7%. However, there were big cycles, and since 2013 we've seen a cycle of underperformance, not necessarily a "lost" decade but certainly a dismal one.

CHART 4: FIVE-YEAR ANNUALISED TOTAL EQUITY RETURNS IN RAND

Source: LSEG Datastream

Chart 5 shows that since 2011, global equity returns have outpaced South African returns (in common currency) by

more than the earnings growth outperformance.

CHART 5: WORLD VS SA EQUITIES IN DOLLARS

Source: LSEG Datastream

As chart 2 above shows, SA equity valuations were in line with the rest of the world prior to 2016 but have derated substantially since then. Today it trades on a single digit forward PE ratio (along with the likes of Brazil and China). Again, the question is how likely it is that this trend continues?

One can get lost in arguments whether South Africa will ever get a grip on its myriad of social problems and whether its economy will ever get out of first gear. These are useful debates to have but are also a minefield of cognitive biases.

In fact, one of the biggest cognitive errors people make – one that can be very costly to investors – is confirmation bias, the tendency to seek out and believe information that supports a belief you hold, while ignoring information that contradicts it. We are all familiar with people (particularly salespeople and politicians) cherry picking data points to support an argument to the outside world. The problem is that we also tend to cherry pick facts even when we are quietly thinking about a topic. Both the SA-bashers and the SA-boosterers can be guilty of this.

But once a market experiences a large and persistent derating in absolute and relative terms, it seems unlikely to suffer another similar decline.

To the extent that the underperformance of South African equities relates to the currency, (of course there is a strong rand-hedge element on the JSE), one makes a similar point about the rand. It is to some extent a mirror image of the dollar discussed above. We shouldn't be surprised that the rand had such a torrid ride since 2011 since the dollar has been on a tear as chart 3 shows.

Approaching these questions with a behavioural mindset – e.g. how likely is it that a given trend persists – will never give us the full picture. The future is unpredictable, and all sorts of weird and wonderful things can happen. Importantly, this line of thinking can tell us nothing about when these trends reverse or what might be the catalyst for this to happen. Valuations can't predict short-term returns. Over the next few quarters, the cheap can get cheaper and the expensive can get dearer since momentum is a powerful force in markets. But over longer periods – five to ten years – starting valuations have historically had a significant inverse relationship with returns.

Fortunately, in a balanced portfolio one does not need to take extreme, all-or-nothing views. It does not have to be the US or the rest of SA against the world. One can tilt allocations based on valuations and the probabilities that each asset class delivers a given return, but still remain diversified.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 402.0	-1.02%	-1.05%	7.35%	22.20%
United States	S&P 500	US\$	5 204.0	-0.95%	-0.95%	9.10%	27.24%
Europe	MSCI Europe	US\$	2 091.0	-1.04%	-1.04%	3.51%	9.59%
Britain	FTSE 100	US\$	9 997.0	-0.42%	-0.44%	1.53%	4.68%
Germany	DAX	US\$	1 697.0	-1.05%	-1.16%	7.44%	13.36%
Japan	Nikkei 225	US\$	257.2	-3.09%	-3.12%	8.37%	21.41%
Emerging Markets	MSCI Emerging Markets	US\$	1 046.0	0.58%	0.29%	2.15%	5.87%
Brazil	MSCI Brazil	US\$	1 618.0	-1.70%	-1.70%	-10.11%	16.40%
China	MSCI China	US\$	54.6	0.74%	0.65%	-1.62%	-17.29%
India	MSCI India	US\$	989.5	1.37%	1.39%	7.32%	37.24%
South Africa	MSCI South Africa	US\$	392.0	2.08%	2.08%	-5.54%	-5.54%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	74 775.0	0.32%	0.32%	-2.75%	-2.45%
All Share	All Share (Total Return)	Rand	13 313.0	0.50%	0.50%	-1.76%	1.01%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	32 582.3	0.51%	0.51%	-1.81%	1.96%
TOP 40/Large Caps	Top 40	Rand	12 115.0	0.69%	0.69%	-1.58%	0.03%
Mid Caps	Mid Cap	Rand	21 169.0	0.73%	0.73%	-2.83%	6.13%
Small Companies	Small Cap	Rand	31 818.0	-1.54%	-1.54%	-2.58%	5.60%
Resources	Resource 20	Rand	5 153.9	5.15%	5.15%	6.01%	-8.05%
Industrials	Industrial 25	Rand	22 196.0	-0.90%	-0.90%	-0.03%	2.29%
Financials	Financial 15	Rand	11 949.0	-0.40%	-0.40%	-7.45%	10.19%
Listed Property	SA Listed Property	Rand	1 904.9	-1.58%	-1.56%	2.19%	14.75%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	75.2	-0.76%	-0.68%	-4.12%	-5.72%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	934.6	1.23%	1.20%	-0.62%	5.25%
Government Bonds	BESA GOVI	Rand	920.7	1.22%	1.19%	-0.68%	5.17%
Inflation Linked Bonds	BESA CILI	Rand	348.1	0.01%	0.00%	-0.33%	5.47%
Cash	STEFI Composite	Rand	560.3	0.18%	0.16%	2.23%	8.40%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	91.2	4.79%	4.79%	18.40%	7.26%
Gold	Gold Spot	US\$	2 289.0	4.38%	2.51%	10.95%	13.04%
Platinum	Platinum Spot	US\$	932.0	2.76%	3.44%	-5.57%	-6.71%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.69	1.34%	-0.12%	-2.09%	-3.42%
ZAR/Pound	ZAR/GBP	Rand	23.62	1.23%	0.93%	-1.35%	-4.74%
ZAR/Euro	ZAR/EUR	Rand	20.25	0.87%	0.62%	-0.27%	-2.79%
Dollar/Euro	USD/EUR	US\$	1.08	0.00%	0.00%	2.22%	0.93%
Dollar/Pound	USD/GBP	US\$	1.26	-0.11%	-0.29%	0.50%	-1.08%
Dollar/Yen	USD/JPY	US\$	0.01	0.17%	0.20%	7.52%	15.47%

Source: I-Net, figures as at 05 April 2024

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.



WEALTH

Old Mutual Wealth is brought to you through several authorised Financial Services Providers in the Old Mutual Group who make up the elite service offering. This document is for information purposes only and does not constitute financial advice in any way or form. It is important to consult a financial planner to receive financial advice before acting on any information contained herein. Old Mutual Wealth and its directors, officers and employees shall not be responsible and disclaims all liability for any loss, damage (whether direct, indirect, special or consequential) and/or expense of any nature whatsoever, which may be suffered as a result of or which may be attributable, directly or indirectly, to the use of, or reliance upon any information contained in this document.