Seed Weekly

12 June 2019

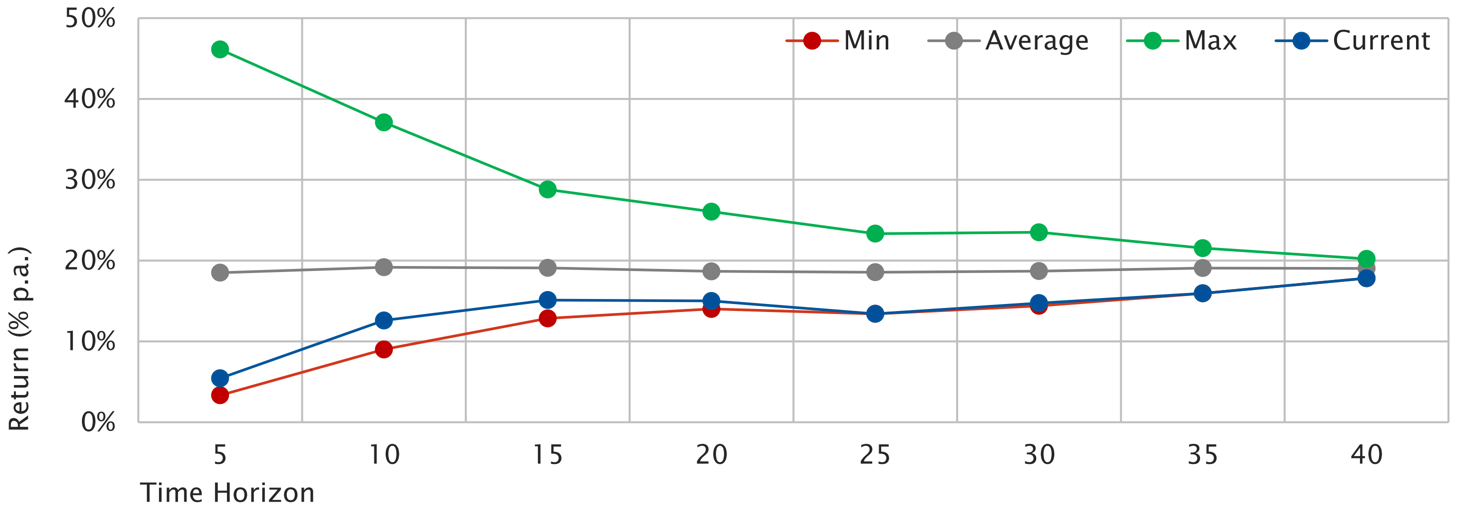
seed investments

Sector Earnings Growth

An important part of Seed's multi management process is performing monthly asset class valuations using our in-house quantitative models. This process covers all the local and global asset classes that are suitable for inclusion in our multi asset class funds and model portfolios. The output of these models guides our tactical asset allocation decisions, where we under- or overweight certain asset classes in the short term, compared to our longer-term target weights.

We spend considerable time looking at local equities, as this asset class is one of the main drivers of long-term balanced portfolio returns. What has really concerned us of late is the very low return from local equities over the last 5 years, which is a reasonable investment horizon for an equity investment.

The chart below illustrates that the latest long-term returns from the ALSI (blue line) indeed ranks very low compared to historical numbers:



In a previous article (Understanding Returns by Mike Browne) we illustrated how an equity index return can be broken down into three component parts, namely dividend yield, earnings growth and re-rating (change in PE ratio). In order to better understand the very low equity returns over the last 5 years, we will extend this analysis to the three main sectors of the JSE.

The rolling 3-year price return for Industrials has come down from above 30% in 2015 to -0.4% today. Earnings growth, measured on a rolling 3-year basis, has come down sharply and was flat or negative for most of 2017 and 2018. The sector had steady positive re-ratings over the last ten years, until the uncertainty in global markets in Q4 last year caused a stumble. A share such as Naspers, which has a high weighting in the Index and had positive price momentum over this period, has contributed significantly to this re-rating.

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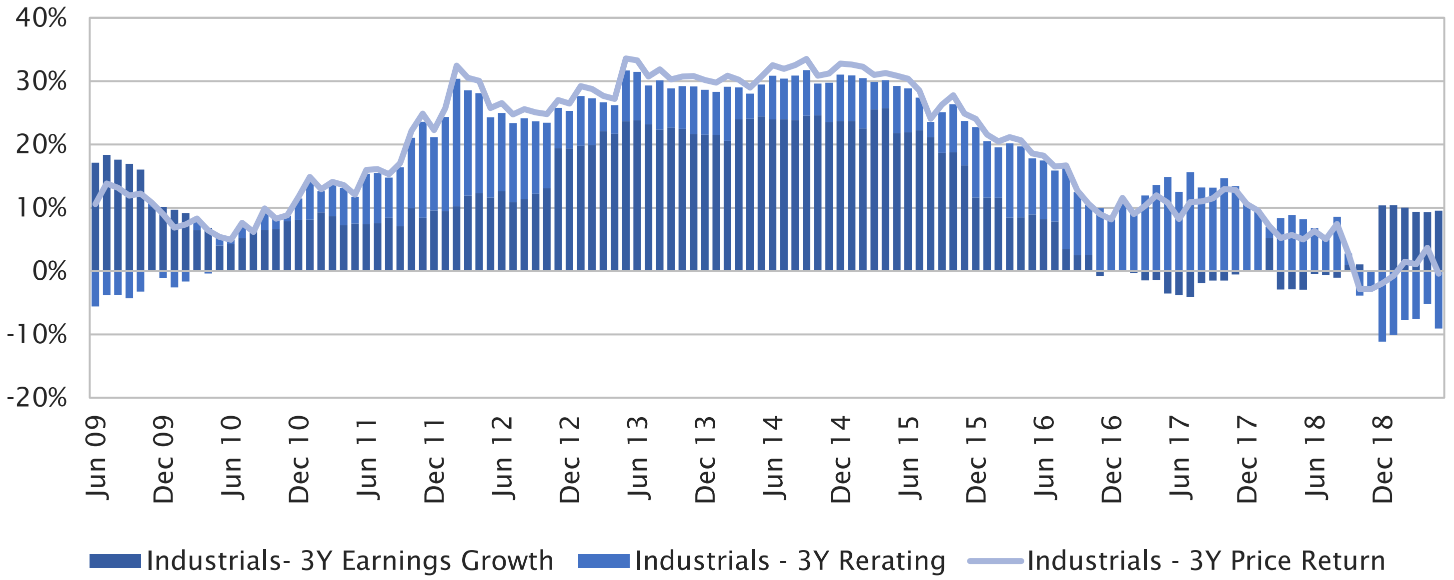
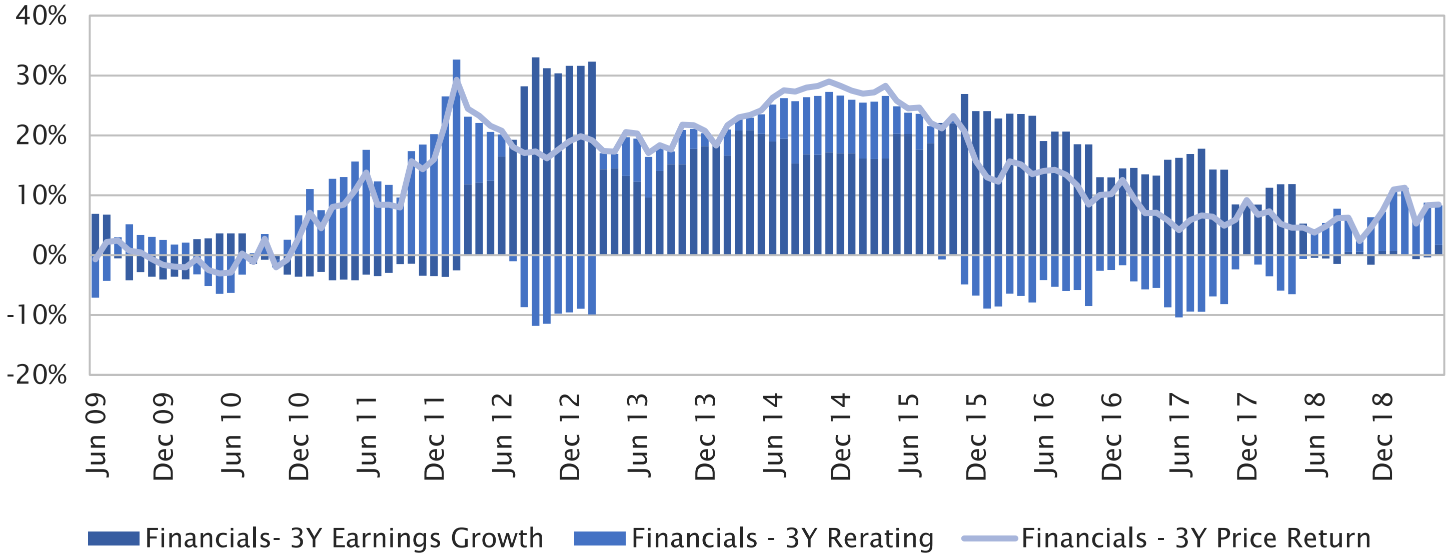


The Financials sector has shown steady earnings growth up to mid-2018, and has de-rated for much of 2016 and 2017. Over the last 2 years however, earnings growth has slowed down completely. The sector is heavily weighted towards banks and insurers, and as a result is mostly geared to local consumers. Given South Africa's very low economic growth rate over the last 4 years, it is understandable that these companies have been unable to grow their underlying earnings.



The Resources sector has always been the most volatile, with underlying company earnings driven by global demand, spot commodity prices in US Dollar terms and unpredictable capital expenditures, amongst others.

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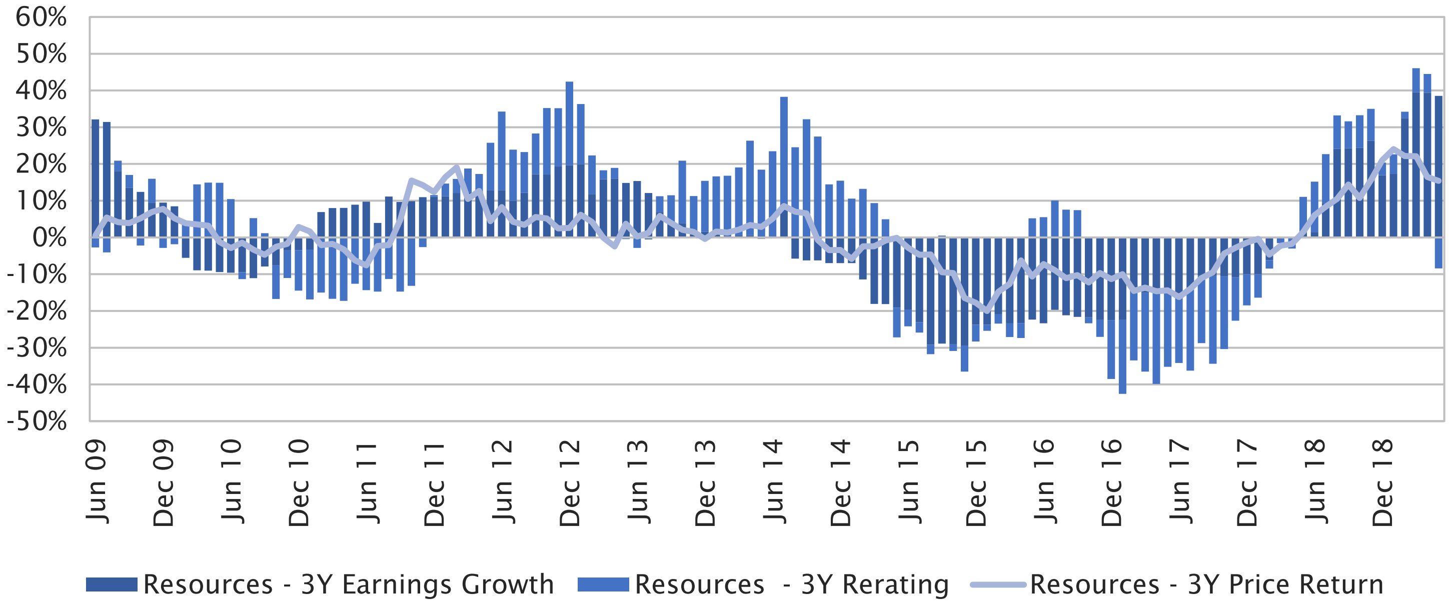
Earnings have plunged from 2015 to 2017, and the market has also punished the sector with a derating on top of that. However, strong earnings growth has driven returns over the last 3 years to make Resources the top performing sector (+15.4% pa) over this period.



In conclusion, earnings growth has really disappointed across all three sectors over the last 5 years, and this has translated into returns much lower than average. Given SA's weak fundamentals and the fact that global growth has been mostly concentrated in the US, local counters have really struggled to grow earnings both locally and overseas. However, the Industrials and Resources sectors have seen some earnings growth over the 3 years, even though it comes off a low base.

The local equity mandates in the Seed Balanced Fund has performed exceptionally well over the last year, and an above-average exposure to the Resources sector has contributed to this outperformance.

Kind regards,

Cor van Deventer *FASSA, CFA®*

Portfolio Manager

Source (charts illustrated): Iress, Seed Investments (31 May 2019)

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ADDITIONAL INFORMATION (where applicable)

Performance has been calculated using net NAV to NAV numbers with income reinvested. Full performance calculations are available from the manager on request.

DEFINITIONS (where applicable)

Annualised Return	Annualised return shows longer term performance rescaled to a 1-year period. Annualised return is the average return per year over the period. Actual annual figures are available to the investor on request.
Highest and Lowest Annual Return	The highest and lowest returns, since launch, for any rolling 1-year period have been shown.