Seed Weekly

Asset Class Valuations - The Year to Date

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 guide our tactical asset allocation decisions, where we under- or overweight certain asset classes in the short term, compared to our longer-term target weights. Our methodology ranks each asset class on a quantitative basis from 1 (expensive) to 5 (cheap), with these rankings then confirmed or overruled by input from the Investment Committee. Let's take a look at how our views on some of the local asset classes and currencies have changed for the year to date.

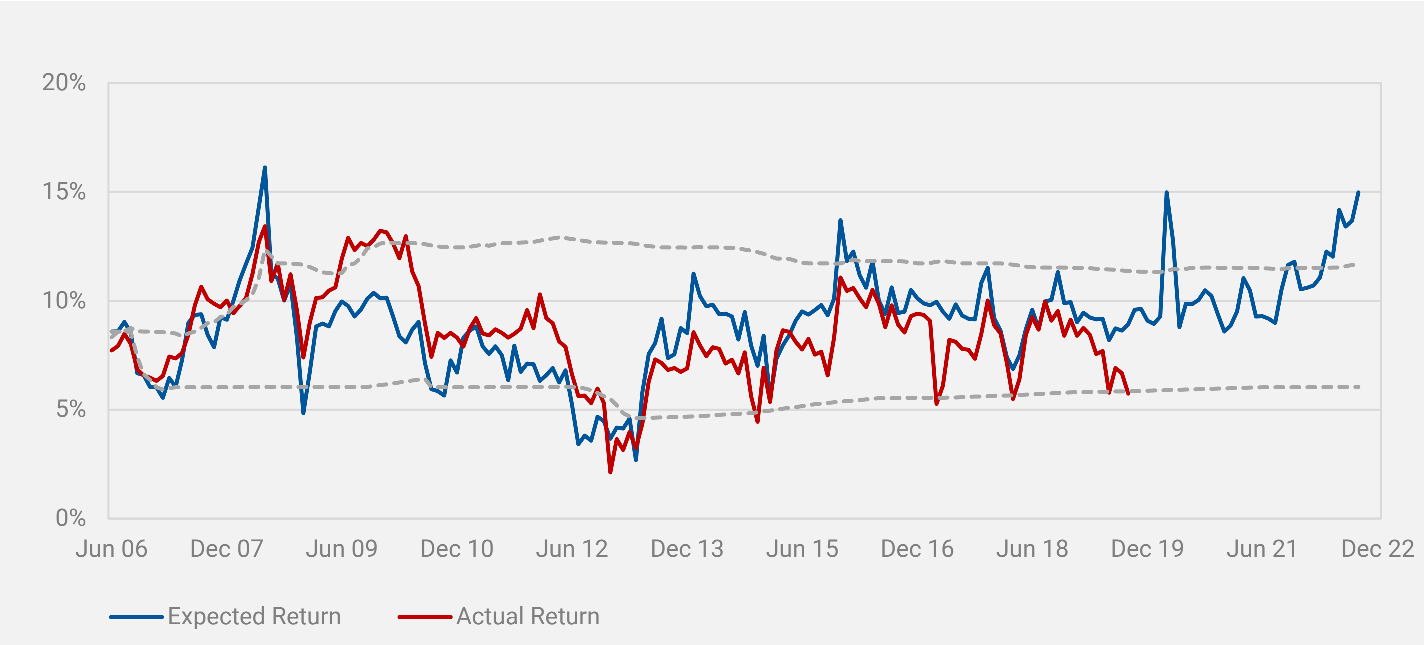
In terms of the trailing Price/Earnings ratio, a simple valuation tool, the local equity market as measured by the JSE All Share Index (ALSI) has been cheap all year. This ratio improved from an already attractive 12.5 at the start of the year to 10.4 as at 30 September, a 42% discount to the 10-year average of 18 times.

Chart 1 : ALSI Price/Earnings Ratio

Although the ALSI has derated (become cheaper) by -17% this year to date, there has been significant differences at a sector level. Financials (34% cheaper from 13.5 PE to 8.9 PE) has derated most, with earnings growth coming through strongly at +41% and the total return still down -3% YTD. Resources, however, are only -11% cheaper, with the total return down -10% on the back of a -4% drop in earnings. In summary, Local Equities has been at a 5 ranking quantitatively for most of the year, but has been downgraded to a 4 based on the risks posed by a rising interest rate environment.

Local bonds have also shown great value for most of the year, with the generic 10-year government bond yield moving from 9.7% in January to a very attractive 11.3% at the end of September. Our in-house bond valuation model evaluates the underlying components of SA government bond yields (the US 10-year yield, inflation differential and risk premium) and assumes an element of mean-reversion to arrive at an expected return. The chart below illustrates that 1) the model has worked reasonably well in the past (expected and actual returns are plotting close together and 2) the latest expected return is very attractive. Therefore, Seed has maintained a 4 or 5 ranking on Local Bonds all year.

Chart 2 : Bond Valuation Model



On the Global Equity side, we take our cue from BCA Research, an excellent global research house based in Canada. From a starting ranking of 4 in January, BCA has downgraded Global Equities to a 3 at the end of March, reasoning correctly that 'uncertainty has become too high to be overweight risk assets, and inflation may surprise further to the upside.' During July BCA recommended a further downgrade to 2 (underweight), stating that the level of uncertainty remains exceptionally high, and that analysts' earnings forecast were still far too optimistic at that stage.

But how has this influenced Seed's asset allocation decisions this year?

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In the portion of the Seed Balanced Prescient Fund managed on a Tactical Asset Allocation basis, the portfolio is currently slightly overweight Local Equity and more significantly overweight Local Bonds, with the necessary underweights then being Local Property, and Property, Bonds and Cash on the global side. In line with BCA's recommendation, our global equity sector selection via Fundsmith and Lindsell Train is tilted towards Quality and Consumer Defensives.

Kind regards,

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Portfolio Manager

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