PRUDENTIAL
INVESTMENT MANAGERS

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SEPTEMBER 2021

South African investments hold much promise

Since last year's global market crash sparked by Covid-19, most financial markets have recovered strongly, including South Africa's. Many investors justifiably now question the return prospects going forward, and whether these gains can be sustained, especially in light of July's social unrest.

Though at Prudential we would never pretend to know the future, and many unexpected events will happen, what we can say from observing current asset valuations is that the outlook for real returns from both SA equities and bonds is still favourable. In fact, we think it's possible for SA equities to generate close to double-digit real returns over the medium term, compensating investors for taking on the risks involved.

It's an attractive risk-versus-prospective return equation, certainly when compared to history and against most other markets. This is why we continue to prefer these asset classes in our multi-asset portfolios.

Pessimism weighing on asset prices

There is no doubt that investor sentiment towards SA continues to be fairly pessimistic, despite the rebound in asset prices and some progress on the broader reform agenda. As a consequence, we have seen our equity market valuations remain depressed as prices have not kept pace with improvements in earnings.

Based on consensus forward earnings expectations the JSE now trades at only a nine times forward price-earnings ratio compared to its historic average of 12.5 times. Viewed from a price-book perspective the South African market stands on 1.7 times compared with the world's 3.2 times. This differential is the widest since before the global dot-com bust of the early 2000s. In that instance SA equities subsequently went on to handsomely outperform the rest of the world.

The unrest we observed in July did not affect the share prices of the most affected businesses, such as retailers or property companies, in a meaningful way. While the situation was brought back under control sufficiently quickly, and adequate insurance protection was mostly in place, we believe part of the reason for the subdued price reaction was also due to the high degree of pessimism already priced into SA assets.

Within our funds' equity exposure we have been mindful to ensure wide diversification across sectors, geographies and different company profiles to manage portfolio risk. Among our top 10 largest holdings, for example, are British American Tobacco and Anglo American. Both are defensive, high-quality companies that source their earnings globally and have long track records of delivering returns to shareholders.

Looking at more locally focused companies, SA banks feature prominently in our funds, including Standard Bank, Absa, Investec and First Rand. Banks are well capitalised and did not report losses resulting from the pandemic or engage in aggressive lending practices for a long time before that. They are well on their way to recovering their historic levels of profitability and have restarted paying dividends.

Across the general industrials landscape there are some standout businesses that have emerged strongly from the Covid crisis. Common features include the reduction of debt and/or cost levels, excellent cash flow management and other astute management moves. Many have proved themselves to be resilient, yet we don't think prices adequately reflect these positive developments as yet.

MTN is another large portfolio holding. During the height of the Covid-19 market crash in early 2020 we substantially added to our MTN position, due not only to its cheap valuation at the time but also due to evidence of improving operational performance and execution of management's asset realisation plans. Despite a pleasing share price performance in the past 18 months, we think attractive upside remains.

In retail, we hold Foschini across the portfolios. Its acquisition of Jet stores has the potential to create meaningful value and added a new group of consumers to its customer base. Its earnings recovery is further supported by the reopening of stores in its UK and Australian brands. In our view the market still underestimates the overall business potential going forward.

We remain overweight on Naspers and Prosus. Via its exposure to Tencent, investors are at an interesting juncture after the dramatic sell-off in Chinese technology shares on the back of increased regulatory intervention across the sector. Tencent has been both conservative and flexible in its approach to a changing regulatory environment in the past. With multiple sources of both current earnings and future growth options, as well as a very large portfolio of own investments, we believe now is a good time to buy into a leading global business.

Naspers and Prosus continue to trade at a substantial discount to the now-depressed price of its Tencent shares alone. The group has been active with plenty of corporate action of its own, including the recently completed exchange offer transaction. In short, the future return from SA assets holds much promise.

For more information please contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.