How to invest in a changing world

At Allan Gray, we are bottom-up investors, but we want to be on the right side of long-term trends, particularly at secular turning points. Duncan Artus reflects on where we are currently and how this is influencing portfolio positioning.

We have been saying for some time now that we believe the investing environment may look different over the next 10 years compared to the recent past post the 2007-09 global financial crisis (GFC).

Central banks have created significant credit since the GFC, with this activity accelerating further during the pandemic. This is a contributing factor to the levels of inflation we are currently witnessing globally. The cost of money has repriced quickly and somewhat violently. The interest rate on a two-year US government bond has gone from 0.11% in 2021 to 4.4% today. However, the expansion in central bank balance sheets that has underpinned asset prices appears to be coming to an end. If so, this will result in a very different context that many investors have not experienced before.

The world is also increasingly dividing along geopolitical lines. This is happening against the background of mounting strategic competition between the USA and China. China is important to South African investors directly through big shares, such as Naspers, Richemont and the large, diversified miners and indirectly as a purchaser of our commodity exports, which have underpinned the South African economy. A significant portion of Chinese demand has been funded by a rapid increase in credit. The risks associated with China is something we think about carefully when constructing our portfolios.

The third secular theme is the shortage of energy, which may result in higher energy prices persisting. While well off their peak war levels, prices could stay high for longer than investors expect due to material underinvestment in energy because of historic government policies and an increased focus on environmental, social and governance (ESG) issues. Although this can change – witness Germany restarting coal plants – the investment required in infrastructure and new resources is not something that can be easily achieved in a short space of time. It also won't be cheap.

Lastly, as an investor in South African assets, we need to be realistic about the fundamental risks that our country unfortunately faces in the long term and account for those risks in the portfolios. A key component is a lack of competency and delivery by the public sector, including our state-owned enterprises (SOEs), such as Transnet.

Benefiting from and managing the risks of these trends

So, how do we invest in what could be a changing world?

We can use active asset allocation, weighing the benefits of local versus offshore assets, as well as risk assets such as equities versus "safer" assets such as cash and bonds. This has not been easy, especially in a world where we believed for several years that developed world bonds were extremely overvalued. One way to solve for this is to have a position in hedged equities, which have a different return and risk profile. They have been a big contributor to returns over the last year, as both equities and bonds produced negative returns but still lag cash returns over five years.

The other way to reduce the risk and perhaps even benefit in an inflationary, energy-short and increasingly divided world is to think about the type of shares we own.

Sentiment towards global consumer staple shares is poor. As it has underperformed the market, we have been accumulating Anheuser-Busch InBev (ABI), the world's largest brewer. ABI is one of the most profitable and well-run global consumer staple businesses, yet it trades on a comparatively low valuation relative to its peers. It has single-digit exposure to China and will benefit as travel and leisure increase in the wake of the pandemic.

Our portfolios are positioned to benefit from an energy-short world. We own a basket of energy companies involved in oil and gas and businesses that build, maintain and operate key infrastructure needed to power our economies while we transition to cleaner energy. A good example is Woodside Energy, a top 10 independent oil company, created by the merger of Woodside and BHP Petroleum. Over 70% of Woodside's production comes from liquefied natural gas (LNG) and gas, which will play a vital role in the future energy mix globally.

We have been able to find value in certain multinational businesses that happen to be listed in South Africa. One of our largest purchases has been Mondi, the integrated packaging and paper company spun out of Anglo American. Mondi is an example of a company that has produced great results despite operating in what many would regard as a poor industry. Its integrated nature, good position on the cost curve and strong management have been key drivers. Current tailwinds include the preference for paper packaging over plastic and the growth in e-commerce. In addition, Mondi has sold its Russian operation and may pay out the proceeds as a special dividend.

A different approach

In conclusion, while we don't have a crystal ball, we believe there is a reasonable probability that the investment landscape over the coming years will look different. This means that investment strategies that worked since the GFC may not be the strategies that work going forward.

We have tilted the portfolios to benefit and be protected from these secular trends. This has aided recent performance, but we remain very aware that investment performance rarely unfolds in a consistent, linear fashion.

Commentary contributed by Duncan Artus, chief investment officer, Allan Gray

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