

RIDING OUT THE STORM

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From April 2003 to end-September 2007, the JSE Top 40 index grew by some 300%. Put another way, an investor who placed R10 000 into Satrix 40 in April 2003 would have seen that investment grow to some R41 000 over the ensuing 4 year period to end September 2007 (allowing for re-investment of all dividends over that period).

The Impact of Shocks on Global Markets

Not bad, but then, of course, this changed last October. Like many other bull markets, the end of this extended global bull run was caused by unexpected shocks. The key worldwide shocks were the unexpected rise in the price of oil, plus rising food and other producer prices.

To this was added the sub-prime liquidity crisis in the US. The Federal Reserve and other central banks reacted predictably, pumping liquidity into the banking system and effectively “monetising” the problem. This is a well trodden path: over the past decade or so, the Fed and its other central bank allies (sometime with the help of the IMF) have bailed-out LTCM (Long-Term Capital Management); Mexico, Russia, Turkey (twice) and sundry other basket cases. The good news is that these liquidity crunches always recede in time. What varies is the amount of time required and the extent of the fall-out from such shocks? History tells us that the markets and economies often recover quicker than expected from such disruptions, but that is hindsight, and we don’t know at present what the extent and duration of the present fall out will be.

And on the South African Market

In the South African case, a number of other issues have contributed to the stormy weather down here. Faced with the irretrievable evidence of an overheating economy – the massive balance of payments deficit, the rise in producer inflation prices, excess credit demand, etc., the authorities had no choice but to tighten monetary and fiscal policy in order to reduce domestic demand and to set in motion the economic adjustment process. There is clear evidence in the sales figures that the policy medicine is starting to work.

Soon this declining level of demand will filter through to the balance of payments and to consumer prices, South Africa is also in the position, unlike most other economies, of being able to significantly relax its restrictive monetary and fiscal policy at the appropriate time, which should encourage recovery in the economy and in the markets in due course. The capital spending commitments for the local economy, plus the stimulative impact of the depreciating rand, will also help.

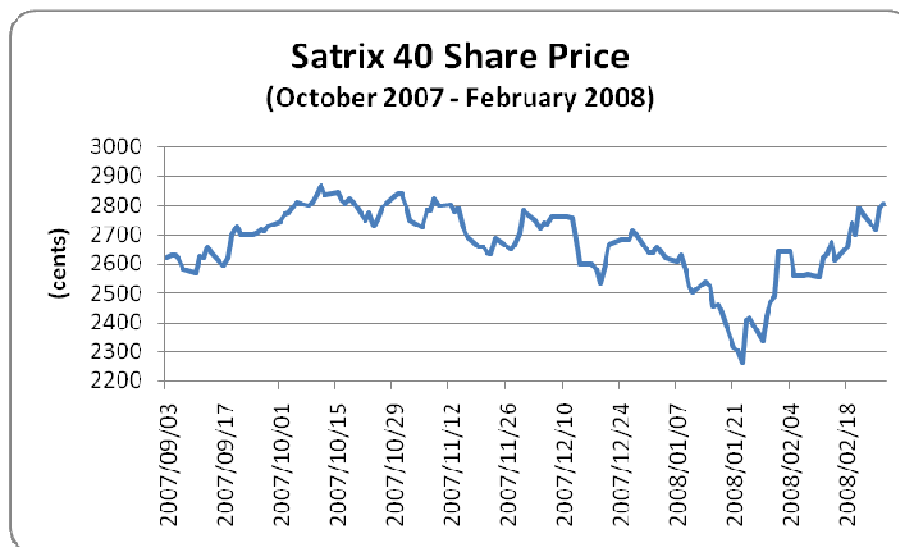
So, the South African situation has added a few shocks of its own to the storm driven waves of uncertainty buffeting the international markets and economies. However, we know that such “shock-induced” downturns are typically of relatively short duration and the sunny skies of recovery and opportunity can often appear sooner than anticipated.

How to Handle Such Conditions

This promise of better weather ahead does not disguise the fact that, since October 2007, the economy and the JSE have encountered some very uncertain conditions. But how bad has it been?

Graph 1 shows the performance of the Satrix 40, which is an index portfolio of the Top 40 shares, listed on the JSE as an Exchange Traded Fund (ETF). At the date of writing, the Satrix 40 was trading at a level only some 2 percent off its peak in late-October 2007. Granted, there was a sharp dip in the Satrix 40 price in January, but this had been entirely recovered by mid-February 2008.

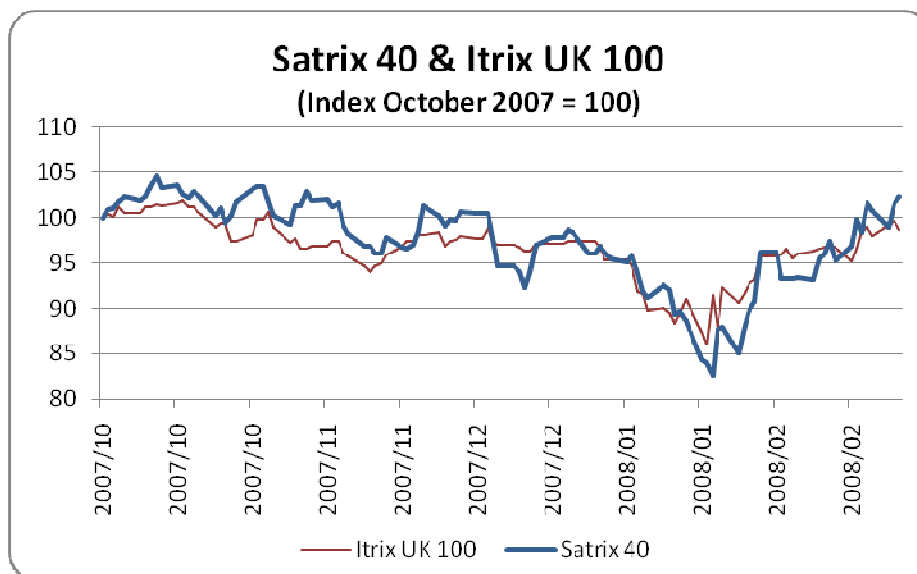
Graph 1



- **Hedge Qualities.** For any investor, wishing to protect their position in a falling market, a large cap portfolio is easier to hedge than a mixed portfolio of index and non-index stocks. Satrix 40, which exactly replicates the FTSE/JSE Top 40 index at all times, can easily be shorted, like any other security listed on the JSE. If you do not own the Satrix 40, it can be borrowed in a very active scrip lending market for this security. Also, there is a futures index on the same Top 40 index used by Satrix 40, so Satrix 40 shareholders can directly hedge their exact portfolio through the extremely liquid futures market.
- **Rand Hedge.** Whilst a large cap index, such as the Top 40, would not specifically be tailored as a rand hedge product, the impact of the rand exchange rate – which is after all the most important price in the SA economy – can be clearly seen in the performance of the biggest companies on the JSE.

Graph 3 compares the performance of the Satrix 40 and the Itrix UK 100 securities over this period of market turmoil (both based to 1 October 2007). There is nothing to choose between them for performance, yet the Itrix is regarded primarily as a rand hedge. For investors looking to remain protected against the vicissitudes of the rand, the Satrix 40 offers a good hedge.

Graph 3

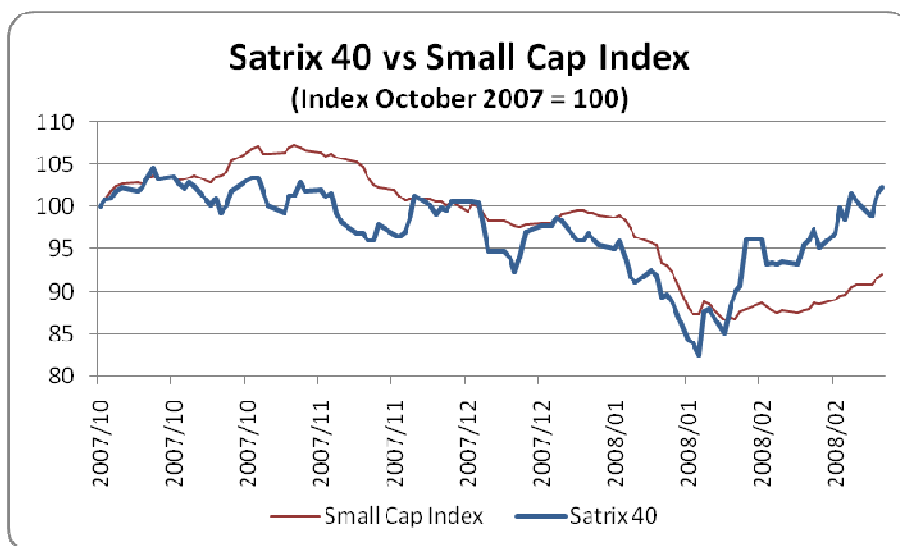


- **Recovery Potential.** When confidence does return to the markets and the large institutional investors look to move cash back into equities in a big way, the first beneficiaries are always the large cap shares. Satrix 40 will then tend to be an early mover and its investors will get the benefit of any early recovery in the market.

Active managers often wait too long for confirmation before committing to a market upswing and therefore miss the benefits of early recovery. Index tracking products, such as Satrix 40, often have a clear advantage in this respect.

Graph 4 shows the relative performance of the Satrix 40 and the JSE Small Cap index, over the past 5 months or so. The sharp recovery of the Satrix 40, from the market lows in mid-January 2008 indicates the tendency of many investors to choose large cap index shares and not illiquid stocks in a recovery situation – even should this prove to be only a temporary recovery.

Graph 4



What lessons can be learnt

What lessons can be learnt from the above analysis of managing investments over turbulent periods?

- **Sit it out.** Over time, markets do recover, shocks to the economy and its systems tend to be temporary and equity investments should always be made with a medium to long-term horizon. Over time, it is very difficult to beat a major index tracking

product, such as Satrix 40, so keeping calm during temporary downswings and staying invested, will be rewarded over the longer-term.

- **Shift to quality.** The Satrix 40, which tracks the large cap, blue chip shares on the JSE, has largely retraced its losses and has shown good resilience to bad news.
- **Maintain monthly debit orders or regular investment contributions.** The big advantage of making regular monthly debit orders into Satrix 40 (or to any unit trust or retirement product for that matter), in a falling market, is that you will be purchasing more units with your monthly contributions – this reduces the average cost of the investments held in your portfolio and contributes to above average performance when the market recovers – the so-called rand-cost averaging effect.
- **Buy into dips.** Most long-term investment studies indicate that one sure way to beat the average returns of the stockmarket over time (or add alpha if you prefer), is to buy when the market dips. This may take courage, but the market tends to return to its previous highs relatively quickly and for value-driven investors, or those looking to lock-in good income returns from the current high dividend yields, such courage is often rewarded.

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