PERSONAL T·R·U·S·T

Disruption, Creative destruction and "the new normal"

Today, the 'internet of things' amongst other new technologies is disrupting long established patterns in virtually every market.

While it appears full of opportunities, this era is deeply unsettling. And while I acknowledge that there is a great deal of work to be done given the potential of disruptive technologies, as investors we need to realise that much of what we think we know about how the world works is dead wrong. We need to get a handle on the disruptive forces transforming the global economy; to identify the long-standing trends that are disrupted; to develop the courage and foresight to clear our thought processes and to prepare to respond.

Yet, for all the ingenuity, inventiveness, and imagination of the human race, we tend to be "shy" to adapt to change. There is a powerful human tendency to want the future to mirror and look very much like the recent past. On these shoals of "Creative destruction", established corporate vessels have repeatedly foundered over the ages. To quote Joseph Schumpeter who coined the term creative destruction, "it is the process of industrial mutation that incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one". Revisiting our assumptions about the world we live in and doing nothing; will leave many of us incredibly vulnerable. A clear-eyed perspective on how to negotiate the changing landscape will assist us to harness above average returns.

The rear view mirror shows over the past 30 years that financial investors have had to contend with two equity market collapses, in 2000 and 2008; the steepest one-day decline in history on the New York Stock Exchange, in 1987; an emerging-market crisis that erupted in Asia in 1997 and spread to Russia and Brazil in 1998; and a worldwide financial meltdown and banking crisis in 2008. Despite these challenging episodes, financial markets, in particular in the United States and Western Europe, still delivered total returns to investors between 1985 and 2014 that were considerably higher than the long-term average.

The past 20 years on the JSE, early 1996 to date, is particularly instructive. Average JSE All Share Total returns, with dividends reinvested, resulted in an annual 14.3% return. Put differently, a doubling of your money every five years. So R100 invested in the broad JSE All Share in early 1996, with dividends received reinvested, would be worth today after four doublings 200, 400, 800, and 1600. The best performer on the JSE was the Indi25 (top 25 industrial shares) with a cumulative gain of 550%, followed by property shares with 350%, the fini25 (top 25 financial shares) with 200% while the resi10 (resources) only could manage to breakeven, during the past 10 years by way of reference.

Interest rates do have an impact on share prices and equity returns through portfolio rebalancing, where low yields on fixed-income securities result in an increased demand for equities, thus driving up prices. Lower interest rates and inflation can also boost other classes of assets besides equities and fixed income, including real estate or REIT's.

The most important driver for bonds globally as indicated by using the US ten-year government bonds as a proxy were the large capital gains driven by declining interest rates in the past 30 years and Inflation that was lower than anticipated.

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For equities, changes in price-to-earnings ratios, which reflect investor expectations of future real profit growth, inflation, and return on equity, played a decisive role in lifting returns over the past 30 years. Since 1960 (55 years), the JSE price/earnings multiple (share price divided by earnings per share) has averaged a P/E ratio of 12.5. Since then we have experienced a steady drift higher towards a 17.5-20.0 P/E in recent years, shaped by ever lower interest rates and inflation globally and locally since the mid-80s.

Two drivers of historical GDP growth are notable, particularly with a view to prospects for future growth. The first of these was the rapid growth in the working-age population (15- to 64-year-olds) and employment creation. However, today are the baby boomers saving for retirement exacerbating / or fuelling deflation? An aging world population means that one of the twin engines that powered growth over the past half century i.e. the growing number of working-age adults has stalled. The second engine of historical GDP growth is corporate profit margins. Corporates, similarly are facing tougher competition from three sources that could reduce their margins and profits.

The first source is new competitors from emerging markets. Emerging markets are here to stay: their share of world GDP is up from 35% in 1993 to 50% today, and will continue to grow. Many of the world's great companies come from emerging markets, which offer investors well-managed, high-quality businesses, at present at attractive valuations.

The second is disruption from new Technology and tech-enabled firms represent a source of margin-threatening competition which, to say the least, is unpredictable.

The third source of heightened competition for large businesses will increasingly come from small and medium-sized enterprises. The likes of Alibaba, eBay, Amazon, and other online platforms are now providing a way (Cloud; distribution) for thousands of small and medium-sized enterprises to achieve immediate global reach.

The decline in interest rates around the world starting in the 1980s gave a strong boost to both equity and fixed-income returns, as we have witnessed. While the future path of interest rates is unclear, the steep declines of the past 30 years are clearly unlikely to be repeated. Rates are either beginning to shift direction (FED) or have little room to fall further. In some countries they are already negative (EU, Japan and Switzerland). Rising nominal yield and therefore capital losses due to rising yields will also play a bigger role in reducing returns.

Changes in profit margins of corporates are a key driver of the difference between returns of a growth-recovery scenario and the "new normal" growth scenario. Margin differences directly account for about 0.5 percentage points of the difference, affecting profit growth. Margin differences also have a strong indirect impact on PE ratios and pay-out ratios.

Investment returns affect policy makers both directly and indirectly and this is particularly relevant in an era where policy decisions currently trump economic fundamentals. Currency plays are motivated by differences in interest rates which tend to impact movements in the longer-run. But in this current policy driven market, speculation on "carry trades "in this era should be avoided as policy decisions are notoriously difficult to predict relative to economic fundamentals.

One of the trends of the past few years, in particular through defined-contribution pension plans, is that financial risk has been transferred from institutions to individuals. The latter's investment horizons tend to be relatively short term and have been largely informed by hyped financial news; as a result they are often sitting on cash positions. As we have highlighted, a future of low returns potentially create even larger gaps in public pension funding and put millions of households under financial and economic pressure.

This is against a background of technology advances particularly in healthcare resulting in people - predominantly in developed countries- living longer after they retire. A prolonged era of low returns could be a toxic mixture, and potentially leave government at both national but also at local level facing rising demands for social services and even income support at a time when public finances are already under massive pressure.

Sadly many of the baby boomers have not saved sufficiently for their retirement. Even the small minority of those who have saved sufficiently under historic rates of return could find themselves vulnerable in a world of lower returns on savings. Thus the baby boomers in particular place continued constraints on consumer demand as households reduce debt. In a world locked in the first phase of deleveraging, households when consumers do spend, are more likely to focus on value for money and shifting consumer preferences toward value; as the weak economy continues to constrain budgets and precautionary saving persists. This is seen in the continued demand for bonds in spite of the FED talk of raising interest rates.

Growing concern about inequality between the “haves and have nots” will also require action, as the rapid diffusion of technologies such as mobile phones to low-income consumers has given the masses a stronger political voice. This has opened them to the potential of being provided with and demanding universal access to basic services; pushing “EM” Emerging Market governments in particular to deliver or face growing protests.

How does this “new normal” of low total returns impact on long term investment strategies and impact on one’s retirement savings?

We see the global economy entering a new era in which the need to invest exceeds the desire to save ultimately pushing real interest rates higher; constraining investment and unfortunately ultimately slowing global growth – “the new normal”.

The new normal condemns the global economy to sluggish growth, resulting in risk assets caught between competing forces. On the one hand, the prospect of continued low but rising real interest rates should still favour equities over cash and bonds. On the other, the profit outlook is uninspiring in a world of low nominal growth where it has become harder to reduce labour costs. Equities will outperform bonds and cash over the medium term, but absolute returns will be a pale shadow of their former performance and volatility is likely to remain strongly elevated.

How then do we as investors respond? We believe that the most successful investors in the next decade will be those who have developed a well-defined strategy and who align their portfolio with this strategy – and are constantly testing the strategy’s robustness. This strategy revolves around an underlying “Thematic Approach” and therefore correct asset allocation; it must address three broad questions relating to both developed markets “DM“ and emerging markets “EM” investments:

a. What is the portfolio aiming for and why?

b. How will it get there?

c. What resources will it need to achieve the desired outcome?

Thematic investing requires a fundamental understanding of the impact of long-term economic, political, and social trends on regions and sectors, which reveals investable opportunities. Thematic investors develop proprietary views on how the second- and third-order effects of structural trends will create hot spots or discontinuities in certain sectors and regions where value and risk will be concentrated. I will highlight some drivers in the article that I see influencing the essence of a thematic strategy. Importantly this investment strategy implies moving away from the current obsession of quarterly performance and meaningless benchmarks and implementing sound long term strategies matching one’s risk profile.

A driver of the thematic approach, for example, is that investors should not ignore commodities, as environmental issues move further centre stage the cost implication for commodities is profound. Bear in mind and contrast that new mining discoveries have been broadly flat despite a quadrupling in spending on exploration over the last couple of decades. Increasing demand for scarce resources, such as water, exacerbated by urbanisation could mean that some countries will face significantly higher marginal costs for adding new supplies of resources. Supply now is becoming increasingly inelastic; as a result of this is evidence that points to the long run marginal costs of many resources increasing in the future.

The supply of resources could well run into logistical and political difficulties, making adding capacity vastly more costly. Regulation that might well hamper the implementation of projects is another barrier, including concerns about land and water rights or tenure. It is a scenario that would impose potentially the most onerous barrier to new mine development; one of the most difficult to overcome; as it is likely to see collaboration internationally to establish some form of linked carbon-pricing mechanism or penalties, and/or efforts to generate cooperation on commitments on abating carbon intensity.

Energy is another driver; from an electricity-access point of view, sub-Saharan Africa's situation is the world's worst. It has 13 percent of the world's population, but 48 percent of the share of the global population without access to electricity.

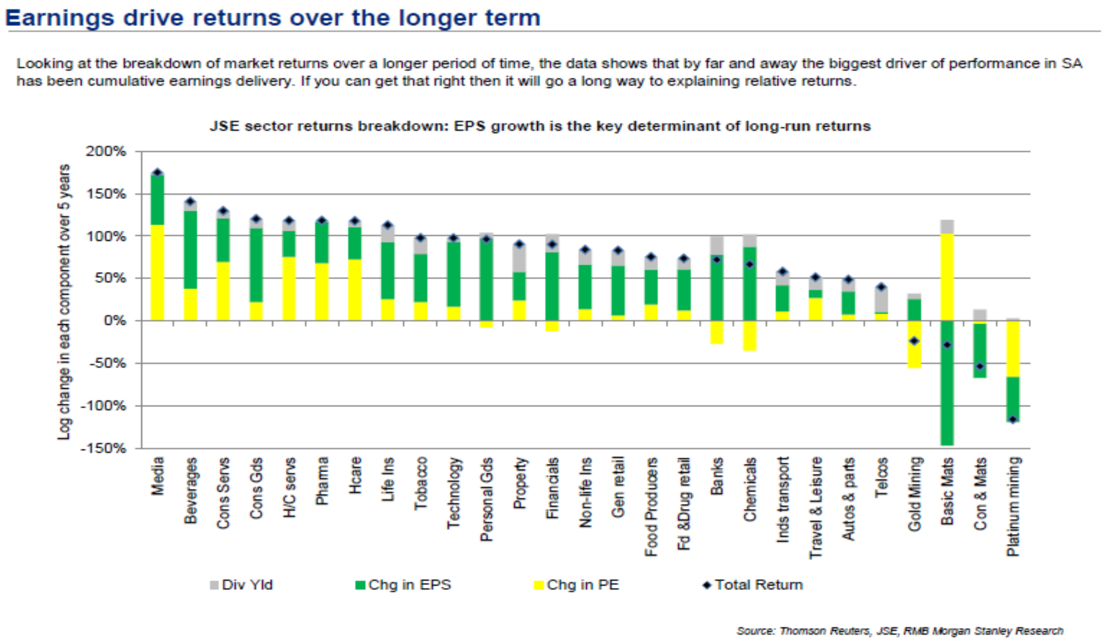
The reality is that Southern Africa will continue to build coal capacity, but its overall importance in the continent's fuel mix will diminish from 51 to 23 percent. Accordingly, if humans must make dramatic cuts in their carbon emissions while old coal fired power plants are still running, and before other technologies can be rolled out. Back-fitting carbon capture and storage (CCS) is a vital way of cutting the world's overall emissions in the medium term when it matters most. Part of the solution will be Renewable and Clean energy, such as Hydrogen Fuel Cells (HFC) and their use of Platinum Group Metal's as a catalyst, as the global climate environmental response accelerates.

Given that Africa and South Africa in particular, needs to focus on ensuring the financial viability of the power sector, what should drive a monopoly like Eskom is whether people can access electricity or not and how much they are able to affordably consume. These are the two most important measures that indicate the degree to which ESKOM is supporting national development.

Further good news from a thematic perspective is demographics, but it requires a long term perspective, in that OECD forecasts that three billion more middle-class consumers (the research defines middle class as having daily per capita spending of $10 to $100 in PPP terms) will emerge in the next 20 years compared with the current 1.8 billion today. This would drive up demand for a range of different resources. This growth and importance is underlined by urbanisation and the growth of the middle class in India and China. This is historically unprecedented and is happening at about ten times the speed at which the United Kingdom improved average incomes during the Industrial Revolution and at approximately 200 times the scale. Urbanisation is therefore an important driver of economic growth, and for it to be occurring on such an unprecedented scale is one of the decisive reasons for China's rapid economic transition.

Clusters are essential – it is important given the disruptive forces of creative destruction, to identify Business clusters that leverage off and nurture one another, as once formed these clusters are often difficult to replicate i.e. natural barriers to entry. Therefore, where they exist, clusters are valuable because they represent defensible advantage in a competitive, globalising world. However, clusters can also be fragile because they are delicate, interwoven ecosystems; it is precisely because they depend on their connectivity that they can be vulnerable. Therefore all actors within a cluster, large corporations, small and medium-sized enterprises (SMEs), universities, further education colleges, investors and associations, can benefit from finding ways to work together to nurture the success of the cluster. i.e. Tech = Silicon Valley.

Another driver could be to embrace and engage active asset management capabilities. For example, while average returns in the next 20 years could be lower, our prior research reveals that corporate profits are increasingly shifting from asset-heavy sectors to idea-intensive ones such as pharmaceuticals, media, and information technology, which have among the highest margins. Total returns given this low growth will assume ever greater import. Within these sectors too, firms are developing a winner-takes-all dynamic, with a wide gap between the most profitable firms and others. (See below)



The state and public / private sector partnerships are another driver in that reviving GDP growth is absolutely essential for starting the second phase of deleveraging, in which public-sector deleveraging begins. But growth in times of deleveraging requires more than a cyclical upturn in demand. It is important that structural changes are made to shift economies from relying mostly on consumption to a new growth model in which exports, investment, and consumption are more balanced. Governments have an arsenal of measures at their disposal to raise productivity and GDP growth, ranging from removing barriers to competition, especially in service sectors, “helicopter money”, investing in physical and digital infrastructure, incentivising innovation, and boosting labour market participation among women, older people, and other groups.

In conclusion over the past few years, there have been a number of structural economic changes, as highlighted above. A persistent bout of historically low interest rates, the polarisation of growth between developed countries and emerging economies, and the required global deleveraging, all have had an impact on how investors deploy capital. The overlay and the “metabolic rate” of the economy is also accelerating, with industry dynamics evolving faster than ever and profit pools shifting across value chains in many industries, thanks to unprecedented technological innovations.

Therefore given that the current starting point is very different from previous recovery cycles, predicting short-term market movements is inherently difficult if not impossible, making it vital to remain focused on one’s long term strategies. No one nor any rational investor should exclude that the future, too, may bring with it a new set of exceptional circumstances given the fast pace of disruptive technologies.

The return to the long term mean, viewed with a long-term perspective, implies that stock and bond returns cannot entirely divorce themselves forever from the underlying business and economic fundamentals that drive them. Inflation and interest rates are unlikely to decline further; corporate profit margins are more likely to decline than rise from current elevated levels; equities offer fair value and are therefore not cheap; given that portfolios already have relatively high equity allocations and the credit game is over. It is hard, therefore, to be overly bullish about long-run financial market returns in this cycle.

A thematic investment approach coupled with a long term investment horizon enabling effective asset allocation (90% of investors returns) both on a geographic and sector basis would lessen the forecast impact of a sustained period of lower returns that would potentially have severe implications for a wide swath of society. Governments will certainly have to rethink retirement policies, but not by usurping market mechanisms and free market policies, and more importantly they will need to identify fiscal strategies to boost growth!

Mark Huxter, May 2016