SIMEKA CONSULTANTS & ACTUARIES

INVESTMENT NOTE

3 of 2015

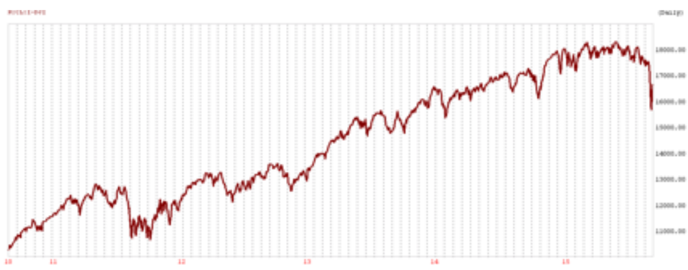
What to make of volatility in share prices

Pundits called it Black Monday when share prices around the world tumbled on 24 August 2015

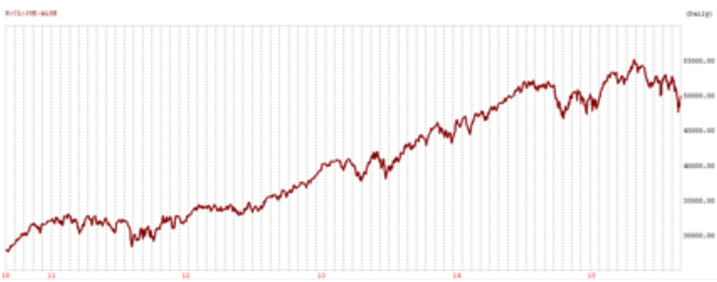
The Dow Jones Industrial Index closed at 15 871, down 3.85% from the previous day. During August 2015, it lost 5.9% of its value and in 10 trading days it lost 5.1% of its value.

By comparison, the FTSE/JSE All Share Index closed at 47 631 on 24 August, down 2.85% from the previous day. The very next day, it closed at 48 981, up 2.83%. Two weeks earlier, the index closed down 3.16% in a single day and up 1.59% the next day. Clearly, the mood on the JSE is not so much black as it is difficult to understand.

Dow Jones Industrial Index



FTSE/JSE All Share Index



Here's what we think.

A valuation gap developed in equity markets since monetary authorities started increasing money supply in response to the global recession in 2008/9. Banks had access to cheap money and became subject to the stringent requirements of the Basel III agreements. Instead of advancing loans into the real economy, these financial institutions invested the surplus liquidity in financial markets. With interest rates at a historic low point, banks avoided bond and money markets and invested in shares, particularly in emerging economies, which offered growth opportunities. Share prices increased as these investors and others normally investing in bonds ("bond refugees"), invested in shares.

The Federal Reserve Bank of New York is widely expected to announce increases to interest rates in 2015, ending an era of cheap money that supports share prices worldwide. Investors are now reducing exposure to shares, particularly to reasonably expensively priced emerging markets, to make better use of investment opportunities anticipated in developed markets, thus instigating the great emerging market sell-off of 2015. The weakening currencies of the commodity producing BRICS-countries reflects the sell-off of shares – in particular for Russia, Brazil and South Africa.

Exchange rate of “emerging” resource producing countries

When money piled into markets from global sources, the price to earnings ratios in emerging markets such as South Africa increased substantially, creating a **hothouse effect** in share prices. Investors who in normal course of business would invest in bonds, avoided low yields and invested in shares in emerging markets in search of yield.

FTSE/JSE All Share Index Price-Earnings ratio

As markets recovered from the 2008-crash, the FTSE/JSE All Share Index increased from 18 120 in 2009 to 31 986 in 2011. This 77% increase essentially COMPLETED the recovery from the 2008-crash.

More importantly, since 2012 the FTSE/JSE All Share Index increased from 32 000 to 55 000, an increase of 72% while economic growth around the world was lacklustre and frankly in South Africa uninspiring. This increase occurred despite falling prices of commodities, which our producers export.

Commodity prices (platinum, iron ore, Brent Crude oil)

In summary, in 2015, share prices in emerging markets came under pressure because of anticipation of reduced liquidity, falling share prices in developed markets and because of falling commodity prices.

WHAT IS GOING TO HAPPEN NEXT?

At present, share prices are affected more by macro-economic factors such as interest rates and exchange rate movements and less by the financial results of individual companies. This trend cannot continue indefinitely and we expect that at some stage fundamental value considerations will once again determine share prices. The macro-economic considerations that prevail presently are distorting the true value of shares and result in the extreme levels of volatility in share prices.

The experience of markets falling by 3% and going up by 3% in a week is disconcerting. The macro-economic factors driving share prices (and volatility) are not going to disappear overnight and investors are expected to continue paying for the 2012- 2014 excesses.

However, it is during the period of volatility that the quest for fundamental value is likely to re-assert itself as the basic driver of share prices. Index tracking or passive investment strategies performed well in 2012 – 2014, but we expect the performance attributable to this theme to slow in favour of active investment managers seeking outperformance based on fundamental value factors.

WHAT SHOULD RETIREMENT FUND MEMBERS DO?

Investment markets are fickle presently and any steps taken by members may as soon add as destroy value, both from a substantive and timing perspective. Members are advised to take great care when selecting investment managers to manage their retirement savings and to focus on their long-term investment objectives.

Younger members’ greatest asset is their future service during which they are expected to contribute to their retirement savings. They should be concerned typically with achieving sufficiently high investment returns, rather than managing volatility (risk). Conversely, closer to retirement members’ greatest asset are the value of past contributions to retirement savings, as reflected in the value of their current retirement savings portfolio. These investors should typically eliminate unnecessary price risk from their retirement savings portfolios.

Members who are uncertain about what to do should approach an accredited financial adviser for assistance.

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