INTUITION
15 SEPTEMBER 2023

It doesn't always work the way you think.

Life has become complex. For example, we use a significant number of devices that we cannot easily explain how they work. It astounds me that I can send a picture from my phone via e-mail to my laptop and within seconds have it on my screen on a secondary device. All that has been transmitted is a series of on and offs (ones and zeros) which defines every aspect of the picture to reproduce it. It went from my cellphone to a tower and then somehow found its way to my internet service provider who sent it to my laptop along a fibre cable. Unbelievable! But we all do it every day.

Similarly, we all rely on the stock market to produce our returns. It feels like some arbitrary person decides whether we make or lose money on any given day. In the face of complexity, we retreat to the simple. If we cannot explain it, then any well-constructed simple story with a plausible rationale satisfies our desire to understand, but more importantly, be in control. This is where we fall in the hole of being driven by news headlines. Those dreadful appeals to our limbic system (the part of your body that controls your fear response) that are so well couched to make us click an article so that we can be exposed to the advert that is the revenue stream of the news portal. South Africa is done for; GDP is dead; infrastructure is failing; the future is hopeless. Yet this is where the potential opportunity lies.

Robin Gibson

If you have spent any time listening to market commentators, then you will have heard the term "PE" bandied about. It stands for Price/Earnings Ratio, but what does it mean? Simply, a share can be valued on its historic or future earnings. PE is merely how many times the market values either of those earnings. An example will illustrate it best. Let us assume ABC (Pty) Ltd, a listed company, has earned R1 in profit per share in the last financial year and is expected to earn R1.20 in the next financial year. Let us also assume that the shares are currently trading at R8.50 per share on the market. We would then say that ABC is trading on a historic PE Ratio of 8.5 times (R8.50 share price divided by R1 profit) and on a forward PE of 7.08 times (R8.50 share price divided by the expected profit of R1.20).

SPEED READ

- **Everyone hopes that something miraculous will lift our GDP growth rate out of the doldrums. This surely will lure investors back from overseas and we can finally make money on our shares.**
- **There are in fact two ways in which share prices can rise. One is from a sentimental outlook perspective that makes everyone want to share part of a perceived more lucrative future (we call this a change in rating). The second is by lifting profits ahead of inflation on a consistent basis, without any change in sentiment.**
- **South Africa has been systematically derated (a perceived unprofitable future) to almost historic lows. However, there are diligent and resilient companies that continue to service a vibrant economy that still offer opportunities to lift their profits ahead of inflation.**
- **There is unlikely to be much change in sentiment for some time (and consequently the rating) but that doesn't mean that these resilient companies cannot produce respectable returns with sentiment just a potential future bonus.**

PE ratios are an indication of sentiment. Another way to describe them is the number of years of current profit you are prepared to pay to own the company. If you are prepared to pay many years of its current profit, it is because you believe the company's growth will be exceptional. A low PE ratio is an indication of poor sentiment. Many South African companies are trading at PEs that reflect a very negative sentiment towards their future earnings. This does not mean, however, that you cannot make money from them. Au contraire! They can be rather lucrative. A significant number of SA inc. stocks are trading at high dividend yields and relatively low PE's (see table 1). This implies a dismal future, yet most are trading quite successfully and, in some cases, showing the ability to grow strongly despite the poor environment in which they operate. So how can an investor enjoy a good return from such stocks without a sentiment change?

"A low PE ratio is an indication of poor sentiment. Many South African companies are trading at PEs that reflect a very negative sentiment towards their future earnings."

The other 5% can be made in one of two ways - either by an improvement in sentiment (an increase in the PE ratio) or by increasing earnings with an unchanged PE ratio. This means that if sentiment remains unchanged and doesn't deteriorate further, then even a modest 5% growth in earnings with the same PE plus the 5% dividend yield can yield a total return of 10%.

Obviously, it is always possible that shares can get cheaper should sentiment erode further, but we would argue that recent corporate results are demonstrating that sentiment is probably at its limit or even overdone, albeit for understandable reasons. This leaves the possibility that a positive result in earnings which exceeds expectations could result in good returns for investors with little risk to the downside as well as the potential for enhanced returns if there is even a small uptick in sentiment.

Sample of SA Inc Companies

Company	Dividend Yield (%)	PE Ratio	Last years Earnings Growth	Potential Total Return with 10% improvement in Earnings and the same PE Ratio
AECI	6.2%	8.3x	15.3%	16.2%
Famous Brands	5.7%	13x	37.0%	15.7%
Hudaco	5.9%	7.7x	22.3%	15.9%
JSE	8.0%	9.8x	4.4%	18.0%
Reunert	5.1%	10.2x	8.6%	15.1%
Standard Bank	7.5%	7.7x	30.3%	17.7%

The total return of a share in any year is comprised of the dividend payout plus the movement in the share price. If a share is offering a 5% dividend yield, it is halfway to a double-digit total return.

Interestingly, it is possible that American stocks face the opposite scenario. Should earnings decrease or remain flat due to recessionary headwinds, sentiment will deteriorate (a decline in the PE ratio) leading to an overall decline in the total return of a share or the broader market. This is an increasingly possible scenario, not because America is facing unique circumstances, but rather because their sentiment is priced for a far more optimistic scenario. It's a case of "Sentiment Retreat" in the US versus "Earnings Recovery" in SA. Don't give up on SA just yet, it has a place! It is still too early to tell, but maybe the Bokke can get the sentimental recovery underway with a lift of a little golden trophy…

Topic:	Stats vs Facts
Natal Midlands	
Date:	21st of September 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	19th of September
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	n/a
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

Our next Insight seminar will take place in September in Howick and Johannesburg. This seminar will delve a little deeper into our economic statistics to challenge some common misconceptions."

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