Why we had African Bank holdings in our Value Fund

15 August 2014

As with any investing, the goal is to buy when the asset is cheap and sell when it is expensive. Investing with a value bias means picking out stocks that are priced by the market at below their true value.

This may include companies that are distressed. In these situations, when the market sentiment is at extreme pessimism, it begins to price in a permanent decline in returns to shareholders. The market-makers do not believe that the decline is cyclical and therefore price such companies at or below their book value. The opportunity for investors who are unemotional and able to look through the cycle can be enormously rewarding.

Some recent examples of such mispricing include Investec trading below their Net Asset Value (NAV) in 2012, Old Mutual in 2009 and Anglo American in 2009. The returns for investors, who believed the decline in returns to be cyclical rather than permanent, were exceptional. Old Mutual, Anglo American and Investec subsequently returned 87%, 94% and 53%, respectively, within an 18 month period from their lows.

Value investing, however, is not without its risks. There will be times when return assumptions are wrong and distressed situations can go against you.

With regard to ABIL, we believed that the market had priced in a structural decline in returns on equity. However, the ABIL management team has over the years established a good track record of pricing and underwriting unsecured credit. It was therefore our belief that the decline in returns was cyclical and would improve with time.

ABIL was trading at below its book value in 2013. The management team completed a R5 billion rights offer in 2013 and significantly strengthened their capital position. Core equity tier 1 capital increased to 26%, back to 2007 levels and well above the statutory minimum. At the same time management continued to bolster the business case by adopting a more conservative provisioning and write off policies. The valuation of the stock looked compelling on a through-the-cycle basis even if we recognised that the long term historical average returns on equity would not be reached again.

Last week's events were unfortunate and not part of our valuation model for African Bank. Our assumptions were proven wrong by the extreme nature of the events.

It is important to recognise that value investing carries an aggressive risk profile for investors. Achieving long-term performance often comes with periods of significant shorter-term underperformance.

Regards

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