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Investing for a
world of change

Changes in earnings to be key driver of SA equity returns

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Global economies have undergone monumental change in recent years. The COVID-19 pandemic triggered one of the most significant monetary and fiscal expansions, followed by the fastest monetary contraction in modern history. To top this off, heightened geopolitical tensions over the last two years have hamstrung global supply chains. The key driver of stock market performance in 2023 was undoubtedly artificial intelligence (AI), manifested in an extraordinarily narrow number of companies. This enigmatic backdrop has not favoured stockpickers.

As we look ahead, we believe the potential for returns will be driven much more by resilient companies that have adapted best to this turbulence. At the same time, many have yet to wake up to the changes the volatile macro situation has wrought on their businesses. With economic growth expected to be slow in the first half of 2024, we believe markets will likely reward the companies thriving in this environment and punish losers ferociously. In other words, this might finally be a year in which the market focuses on winning and losing companies, thus creating a much friendlier environment for stockpickers.

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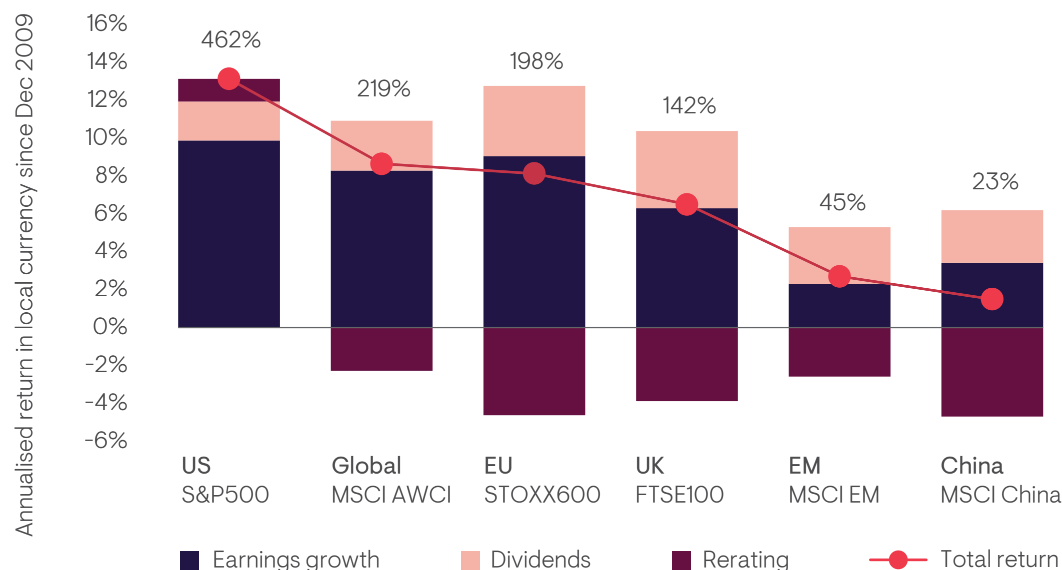
This year will see countries with half the world's population, many of whom are in emerging markets, head to the polls. We agree with Churchill, in that "Democracy is the worst form of government except for all those other forms that have been tried from time to time." Elections are a wonderful spectacle but also a rich source of event risk for investors. It should come as no surprise that 2024 is likely to be full of surprises if the last decade is anything to go by. Thus, careful risk management will be essential in 2024.

With so much uncertainty, how should one think about investment?

Equity investors make money in two basic ways - through capital gains and current income. A capital gain is a change in the market price of the stock from the time of purchase to the date it is sold (or the current price if it is still owned) - profits, in other words. Another way is when companies pay out a portion of the profits in the form of dividends (current income) to shareholders as a reward for their investment.

To calculate the total return to a shareholder, we use a formula that considers growth in earnings per share (EPS), changes to valuation (price to earnings multiple, or PE), and dividend paid.

Figure 1: Global indices total returns since 2009



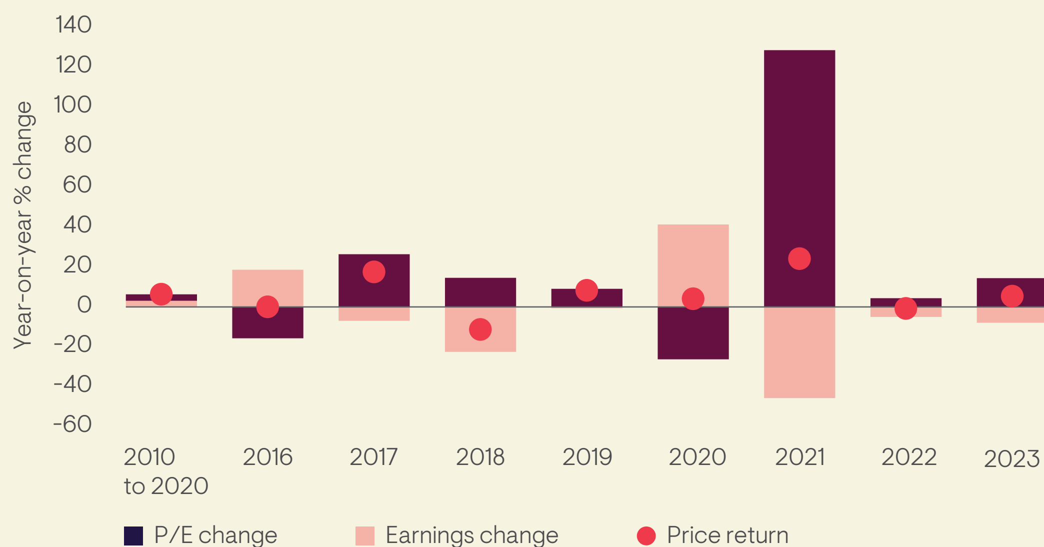
Source: Bloomberg, Ninety One as at 31 December 2023; All returns are in local currency terms.
Bars show annualised returns while numbers indicate total cumulative return over the period.

Defining our philosophy

> As an investor, the aim is to maximise the total shareholder return to comfortably beat inflation and generate real returns over the long term.

Our investment philosophy aimed at maximising total shareholder return focuses on the growth in EPS and the change in PE, the capital return component of the Total Shareholder Return formula. This involves selecting companies that experience positive earnings revisions and offer reasonable value. We believe that blending earnings revisions (a shorter-term, trending, or behavioural factor) with valuation (a longer-term, mean-reverting fundamental factor) can result in a more consistent performance profile. In our opinion, there is tension between earnings revisions and valuation, and successfully navigating this tension ensures a more consistent return profile.

Figure 2: Price returns in the SA Equity Market



Source: Standard Bank Securities, January 2024.

These returns comprise only two components of Total Shareholder Returns: earnings (EPS) and valuation (PE). On average, over the last 13 years, a dividend of approximately 4% should also be added to calculate total shareholder returns. Figure 2 clearly illustrates how the 'blend' of earnings and valuation interact to deliver price returns over time.

Figure 3: Consensus EPS growth forecasts for the next two years

EPS estimates	January 2024	
	2024E	2025E
ALSI	12.1	13.1
SA Industrials	21.5	19.7
SA Financials	11.9	10.8
SA Resources	2.9	8.0

Source: Standard Bank Securities, Bloomberg; January 2024.

Expectations and consensus estimates predict low double-digit EPS growth from SA equities in 2024 and 2025. From a macro perspective, inflation has likely peaked, interest rates are set to decline, and South Africa's GDP growth, at a cyclical low, should accelerate from very depressed levels.

From a stock selection perspective, key contributors to EPS growth include Naspers and Prosus (>30%), beverages, personal care, drug, and grocery stores (>15%), as well as banks and retail (>10%). The EPS expectations for resources are distorted due to very bearish sentiment on some commodities and skepticism about the Chinese recovery and demand for commodities.

> We anticipate capital returns to benefit from EPS growth, attractive valuations, and decent current income (dividends).

It is important to state that not all commodities should be treated the same, as structural, and cyclical factors influence the supply and demand dynamics in different ways for different commodities. At any given time, therefore, the outlook for industrial metals such as iron ore, for example, may differ completely from the prospects for precious metals, oil and gas, or paper and packaging.

Over the next 24 months, we anticipate returns to benefit from EPS growth, attractive valuations, and decent current income (dividends). Strategic stock selection, focusing on earnings delivery and revisions, should help to deliver outperformance.

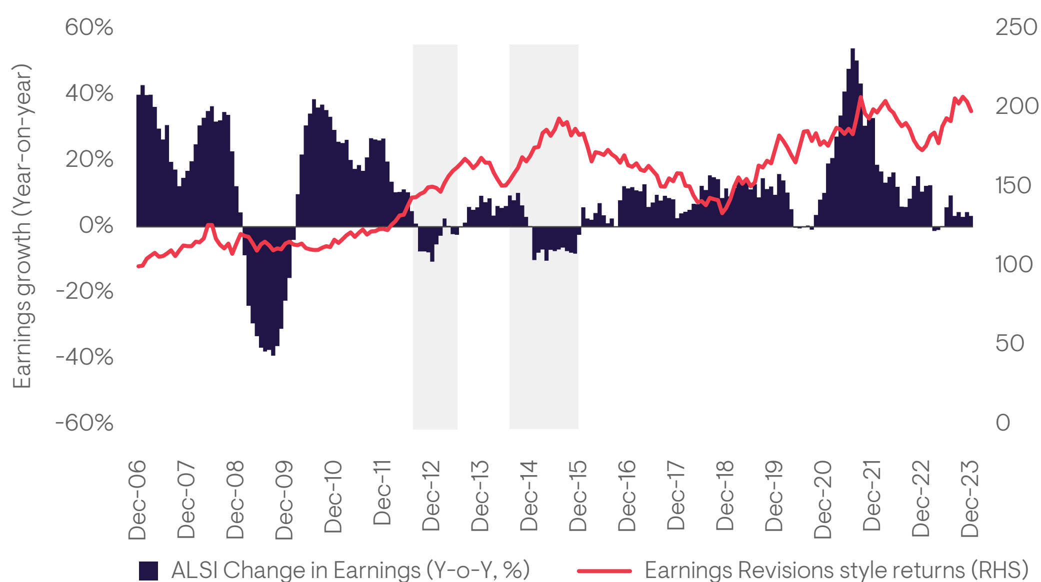
A core solution over time

As the strategies managed by the SA Equity and Multi-Asset team aim to deliver a consistent return profile, they are considered core solutions.

Considering the earnings focus of our investment approach, concerns have at times been raised that our return profile (alpha signature) is highly cyclical, as relative performance will be largely dependent on earnings growth cycles. The perception is that when earnings growth accelerates, earnings revisions as an investment style tend to do well and that the reverse tend to be true as well. This is however not the case.

The graph below compares the earnings cycle of the FTSE JSE All Share Index (rolling 12-month % change) with the return signature of Earnings Revisions (long/short factor model) over time. Notably, during previous periods of sharp earnings decline (2008/09), Earnings Revisions held up reasonably well. Similarly, during subsequent periods of earnings decline (2012 and 2015), Earnings Revisions accelerated, posting strong returns. It is also worth noting that from 2016 to 2018, Earnings Revisions struggled despite the market posting positive earnings.

Figure 4: Earnings revisions (investment style return) relative to the JSE earnings cycles



Source: Deutsche Research, Bloomberg, Ninety One as of 31 December 2023.
Shaded areas highlight recent periods of significant earnings declines.

Earnings revisions, as a behavioural school of thought, captures the change in sentiment towards a company. For instance, the expected earnings growth for a business can be negative, but if analysts start revising their earnings expectations based on an improvement in sentiment/expectations (even though actual expected growth can still be negative), the share price typically reacts positively. As followers of Earnings Revisions, we wouldn't hesitate to invest in these opportunities.

When do earnings revisions struggle?

Considering that this investment approach is dependent on following trends in analysts' expectations, in our experience, any sharp changes in market direction (inflection points) typically result in periods when Earnings Revisions could struggle[1]. Over the last 13 years, there have primarily been two distinctive periods on the SA market where Earnings Revisions struggled – between 2016 and 2018 and then again from 2022 to 2023.

For instance, in the 2nd quarter of 2022, the US central bank caught the market off guard with an accelerated approach to hiking interest rates, resulting in several inflection points across different asset classes worldwide. The US$ strengthened sharply, leading to weaker emerging market currencies (the rand lost more than 10% over the quarter), and commodity prices fell sharply. These macroeconomic events directly impacted asset prices across the domestic equity market. Over the 3-month period, Resources lost 20.6% and Financials declined 15.2%, while a share such as British American Tobacco gained 13.6%. Multiple inflection points followed over the last 18 months as markets continuously wrestled with the direction of inflation and the extent of monetary policy response from across the world. We believe we have entered the next phase of the economic cycle which should provide a backdrop for company fundamentals to drive returns rather than continuous economic speculation.

In conclusion, navigating the tumultuous and ever-changing stock market is challenging. Keeping a close watch on changing earnings growth expectations is key to identifying growth opportunities in the next 24 months. While the effects of tighter monetary and financial conditions will persist for a short while, this is reflected in the valuations of certain risk assets. It is our view that changes in earnings will again be a key driver of capital returns in the SA Equity market. Expectations are at extremely low levels. Any change in sentiment towards South Africa will provide additional return optionality.

> It is our view that changes in earnings will again be a key driver of capital returns in the SA Equity market.

Only time will tell how investors will fare, but careful analysis, informed decision-making, and a long-term perspective will undoubtedly play a crucial role in driving superior investment outcomes.

1. On a side, these 'inflection points' are typically when 'Value' does well which could explain the complementarity (lack of correlation) characteristics of these investment styles.

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