Portfolio Update – 10th March 2020

At this time of extreme anxiety in the world where some of the leading stories on major news networks are about "how to wash your hands properly", we want to reiterate that while most stock markets are falling spectacularly, great buying opportunities are emerging.

Most successful portfolio managers are positive people and they attribute their best ever investment decisions on buying in when things have been very cheap. This is fast becoming one of those times. As fast as markets are falling, so will they rebound because most investors hate sitting on cash and losing out on cheap deals. To this end, we have remained invested and have not gone to cash.

You have not lost money until you sell out:

It is natural to look at one's investments at times like these and despair on how much one has lost. This however is NOT TRUE. This is not a loss; it will only be a loss IF you sell out of the investment. If you sell out of the investment, then the loss is LOCKED IN. Almost no one could have predicted the current fall in markets, but we can all predict that the markets will recover.

Missing the best days can be catastrophic:

January 4, 1999 to December 31, 2018	Dollar value	Annualized Performance
Fully invested (S&P 500 index)	$29,845	5.62%
Missed 10 best days	$14,895	2.01%
Missed 20 best days	$9,359	-.33%
Missed 30 best days	$6,213	-2.35%
Missed 40 best days	$4,241	-4.2%
Missed 50 best days	$2,985	-5.87%
Missed 60 best days	$2,144	-7.41%

SOURCE: JP MORGAN.

The chart above shows how detrimental it can be to miss the best days in markets. By remaining fully invested in the US equity market for 20 years, $10,000 would have grown 3 times. Missing just 10 of the best days in the market would have resulted in less than HALF THE RETURN. This 20-year period includes both the dot.com and Great Financial Crisis. The biggest up days typically FOLLOW the biggest down days. So, the moral of the story is that if you are invested, STAY INVESTED.

<u>Assets are very cheap; this is a buyers' market:</u>

While most investors are anxious, the best long-term investors are currently jumping for joy. No matter what investment style you prefer, we all know that the best returns are made when an asset is bought cheaply. We can well imagine how excited Warren Buffet and Charlie Munger are now. This could be the last great buying opportunity of their lives.

<u>What we have been up to in the last month:</u>

- We added to our offshore allocation in the portfolios when the rand was less than ZAR15 to the USD and are now quite fully allocated to offshore.
- In late February, we switched from the All Share Index Capped SWIX to the All Share Top 40 Index in Core parts of our portfolios and funds. This has exposed the portfolios to more dual listed rand hedge stocks which will benefit from when global markets recover first. We believe that investors will return to the equity markets starting with developed and then come back to the emerging market.
- We sold down all our domestic property holding in the Core portfolios and allocated this to domestic equity and domestic bonds.

<u>What we are working on:</u>

- We will be adding further active managers to the Satellite portfolios of the funds. The managers to be added will further diversify the funds and portfolios.

This is a time of high anxiety for all. While there is the propensity to become the proverbial "deer in the headlights", we continue to read extensively and push aside all the noise, fake news, and conspiracy theories, to instead focus on the opportunities that are becoming available. The virus will pass, we may get sick, but almost all of us will recover and the world will carry-on and markets will go up again as they always do after corrections.

Cinnabar Monthly Insight: All that Glitters

Amid the panic caused by the coronavirus investors have been hammered by the uncertainty and volatility flooding markets worldwide, and in reaction to the dismal numbers that stocks have been showing there's been a resurgence – as there is almost every market dip – in gold.

There has been a persistent belief over time (usually precipitated by market nervousness) that gold makes a good safe haven based primarily on the assumptions that it is a good inflation hedge, that it is less volatile (and therefore safer) than risky asset classes like equity, and that it makes a good equity hedge. We will tackle those assumptions below as well as address the recent gold performance in a coronavirus world.

Gold as an Inflation Hedge

Although we have been in a low inflation environment for some time, and look to be for some time more, there are those that are concerned with the return of rampant inflation and the effect on their investments and thus their purchasing power in the future. The theory that the price of gold will maintain pace with CPI (our measure of inflation) and thus prevent the loss of purchasing power has been tested and proven to be true in the long run – the long run being about 100 years. In the shorter run however – 20 years – gold has been outed by studies as a "poor" inflation hedge.

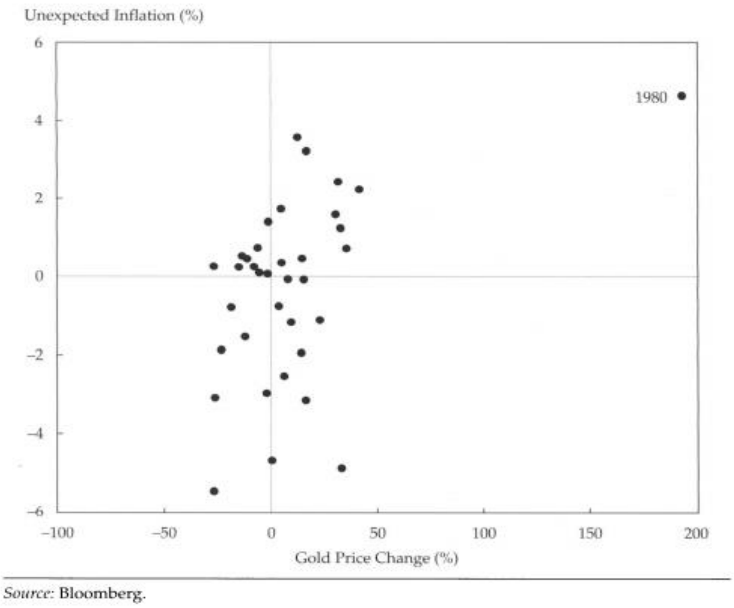

Figure 1: Gold Price Change and Unexpected Inflation, 1975-2011

Figure 1 shows that there is no real pattern between the change in gold prices caused by changes in inflation.

Gold as a Safe, Attractively Returning Asset

Looking at the swings the market has taken since the beginning of the year you may be forgiven for thinking that a solid commodity like gold would provide a more stable return and better peace of mind for the next time someone decides to eat a raw bat and let loose a viral calamity upon the world.

In fact, when we look at the return and volatility numbers we see that gold (proxied by use of the largest gold ETF in the world) has, over 5, 10, and 15 years always registered higher volatility than global stocks – as high as over 20% more volatility. Gold has also returned less, especially on a risk-adjusted return basis, with an exception over the 15-year period which encompassed the Great Financial Crisis of 2008/9. Even then, gold only slight outperformed, but with 20% more volatility. Hence gold still did not beat global stocks on a risk-adjusted return basis.

In addition, gold as an asset is different to stocks, bonds, and even other commodities in that it is a unproductive asset – we don't count jewellery – because it doesn't lend money to a company that can use the capital to grow and therefore benefit the economy, and it cannot be used to make anything else that would provide a means of production itself (e.g. platinum is used in car exhausts). The only growth in gold's value depends entirely on the belief that someone else will pay more for it eventually, or as Warren Buffet puts it, the motivation to buy gold is the "belief that the ranks of the fearful will grow".

Gold as an Equity Hedge

Regardless of the performance of gold over the long period, some investors are still attracted to the asset because they believe that the "ranks of the fearful" pile into gold under equity market distress, driving the price of gold up and therefore providing a decent return to counteract falling equity markets. The reality is rarely that clean cut.

There are times during market downturns when gold sees a return better than equities, but the negative correlation (when one asset goes up, the other goes down) is not consistent, and even when present, it is quite short lived.

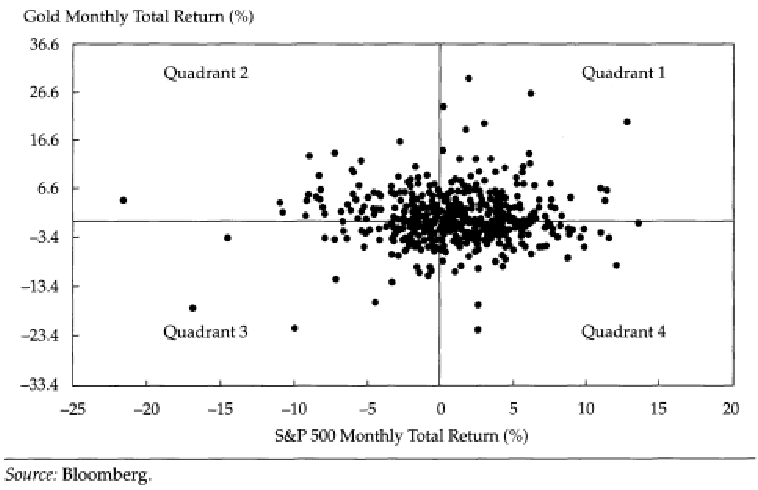

Figure 2: Gold and the S&P 500 Index, 1975-2012

Figure 2 shows monthly returns for gold and US equities. If gold was a perfect hedge, there would be no observations in quadrant 3, where both equities and gold had negative returns.

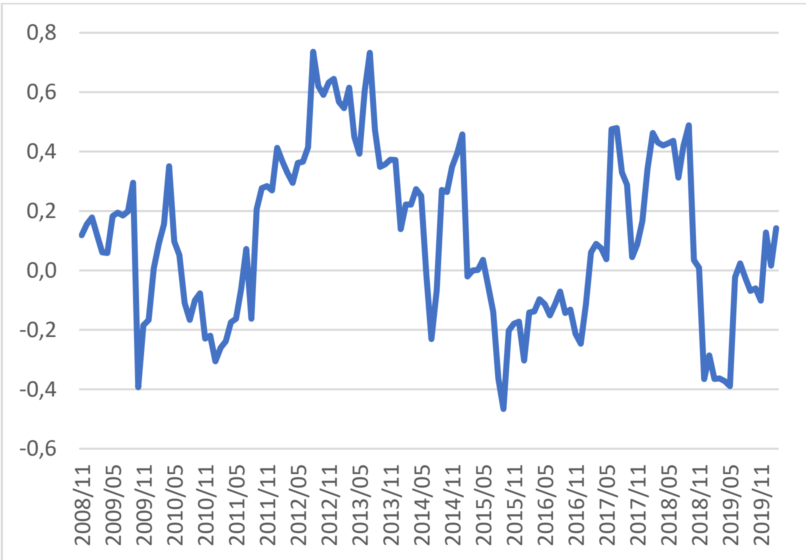

Figure 3: Gold Correlation to Global Equities

When we look at gold's correlation to global equities over time, we see numbers all across the board, and in fact the average correlation of gold to global equities over 10 years is actually a positive 0.13, meaning that gold moves on average slightly WITH stocks instead of against them.

Another concern with gold as a hedge is its relationship to the dollar. The greenback has also historically been a "safe haven" asset that investors flee to during market turbulence, and a strong dollar is bad news for gold. Why? Because international gold is dollar denominated, so when investors buy the dollar and it strengthens, less dollars buy the same amount of gold and therefore the price of gold decreases.

Gold in a Coronavirus World

Despite long-term data, we have seen gold outperforming in short spurts of down markets, and the coronavirus represents one such time – gold has returned 8.9% since the beginning of the year whereas equities at points reached 'correction territories'. If you were holding gold before the virus hit then you probably looked quite prophetic, but investors who bought in after the news hit would have seen significantly less return (as of this writing), and with every piece of news whipsawing markets it's difficult to identify the price at which gold will peak during this particular disaster. As a prudent long-term investor, the coronavirus should represent not the opportunity to make large additions of alternatives in the strategic asset allocation of your portfolio, but rather a buying opportunity for the more traditional asset classes that are seeing a disruption and have become cheaper.

Conclusion

Hindsight is 20/20 and if an investor is able to get in at a low gold price and is able to sell before the switch back to "riskier" assets, especially in a market downturn such as this, then we applaud them.

For the long-term though, as a strategic part of a portfolio, gold's main contribution would be the diversity it can provide as a commodity, held with a low weight to mitigate the volatility it adds to returns.

Sources: Morningstar, Erb, Claude, and Campbell Harvey. "The Golden Dilemma." Financial Analysts Journal, 2013. JSTOR.