OASIS ASSET MANAGEMENT HIGHLIGHTS THE HIGH CONCENTRATION RISK FACED BY SOUTH AFRICAN INVESTORS

OASIS

The recent collapse in the Steinhoff International share price has provided the opportune time to reflect on the fundamental pillars of portfolio construction and the effects of concentrating your portfolio in a few positions. Stocks which may appear diverse can have unexpected similar price movements if there is a significant common source of risk. Between the 5th and 7th of December 2017, Steinhoff International share price plummeted by 78%, leading to losses of up to 9% across certain portfolios of South African asset managers. During that period, the share also impacted negatively on other companies through shareholding (STAR, KAP Industrial and PSG) and through a common shareholder (Shoprite, Brait, Tradehold and Invicta). To date, Steinhoff International has lost more than 84% of its market value. Such a market event highlights the inherent risk faced by many investors and how the neglect of fundamental portfolio construction principles can have a profound impact on the savings and wealth of investors. At Oasis, we think that portfolio managers should not only worry about the implications of high volatility (implying high stock price fluctuations from the average price), but should also think of risk as the likelihood of permanent loss of investor capital. Such a view is important in investment management as it implies that it is not enough to only assess/consider the risk of a share based on the actual movement of the share price from its average price (as is done in measuring volatility), but it is important to also consider the fundamental value of a stock and see risk as the magnitude of loss to the investor from the fundamental value. The following discussion does not question investment managers' stock selection capabilities but more focuses more on wealth management and the fundamentals of portfolio management.

EQUITY

Diversification is a key pillar of any equity portfolio construction. According to Markowitz's modern portfolio theory, combining assets that are imperfectly correlated with one another, meaning the performance of assets does not move in tandem, lowers the risk (volatility) of a portfolio and opens an opportunity for higher risk-adjusted returns. Thus, in theory investors need to (i) consider the optimal exposure they subject their investment to a single stock and (ii) how that exposure could be impacted by other positions taken in other stocks.

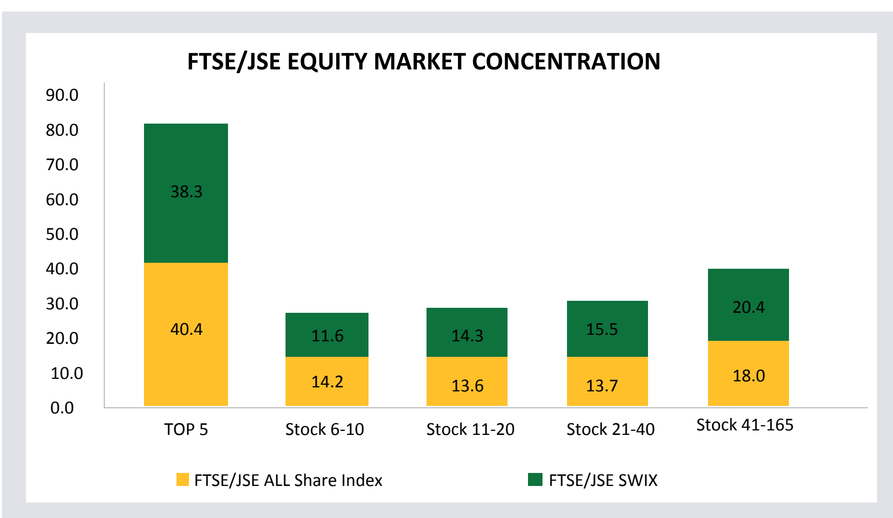


Figure 1: FTSE/JSE Equity market concentration (Source: IRESS, Bloomberg)

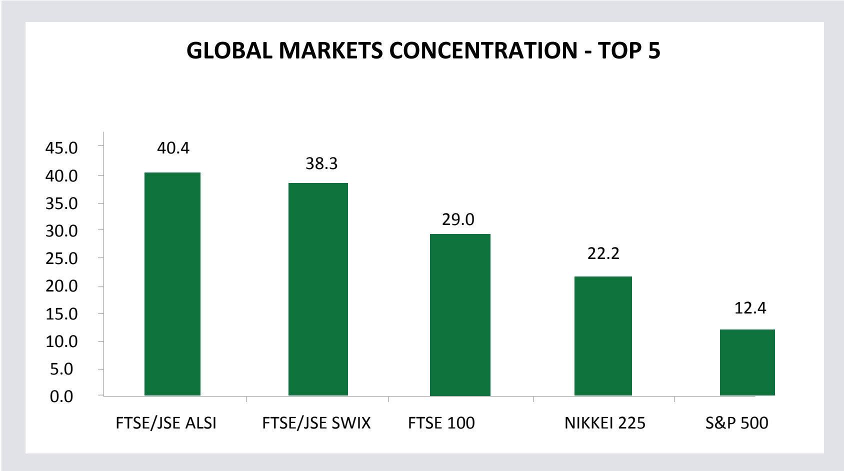


Figure 2: Global Markets concentration (Source: IRESS, Bloomberg)

By construction, the South African equity market is highly concentrated in a few stocks. As shown in Figure 1, the top 5 stocks in the FTSE/JSE All share Index (ALSI) constitute 40.4% (FTSE/JSE Shareholder Weighted index (SWIX)-38.3%) of the total market capitalisation. This implies that the South African equity market inherently exhibits a high level of concentration risk as only a few stocks have a greater chance of influencing the direction of the whole equity market. In portfolio construction, a manager's view on the future direction of the market is reflected in the choice of the active weights assigned to different stocks making a portfolio relative to a certain reference benchmark. South African equity Managers' performance is usually assessed relative to the FTSE/JSE ALSI or FTSE/JSE SWIX. Given the high concentration of the local benchmarks (ALSI and SWIX), to achieve outperformance whilst ensuring that a portfolio is well diversified is a challenge for the South African Manager. In periods where the market is largely trending up, Managers as well as Investors tend to overlook how portfolio returns are generated, focusing more on absolute returns (typically generated by overweighting the 'current winners'. Taking Steinhoff International as an example, Table 1 shows some of the largest exposures South African funds took on the stock:

TABLE 1: STEINHOFF EXPOSURES			
	Portfolio	Date	Portfolio Weighting %
1	Ashburton Low Beta SA Composite Tracker	2017/09/30	12,5
2	Baobab BCI Flexible Opportunity	2017/11/30	9,4
3	SMM Institutional Positive Return 2	2017/10/31	8,8
4	Momentum Industrial	2017/09/30	8,7
5	Anchor BCI Worldwide Aggressive Flexible	2017/11/30	8,6
Source: Morningstar			

As shown in Table 2, Steinhoff International has been an important stock in the major South African indices in recent years, achieving a peak weighting of 3.5% and 4.4% in the ALSI and SWIX respectively in March 2016.

TABLE 1: STEINHOFF WEIGHT IN ALSI & SWIX &						
	Dec-12	Dec-13	Dec-14	Dec-15	Mar-16	Dec-16
ALSI	0,9	1,4	2,3	2,9	3.5	2,8
SWIX	1,3	1,9	3,0	3,8	4,4	3,4
Source: IRESS						

However it is not the largest stock in these indices as that position is held by Naspers with a current weight of 19.4% in the ALSI and 23.3% in the SWIX. As Naspers has delivered strong share price performance in recent years, it has become a much larger component of the Indices and various funds and in that process has raised concentration risk significantly for investors (see Table 3 below).

TABLE 3: NASPERS EXPOSURES		
Portfolio	Date	Portfolio Weighting %
NewFunds NewSA ETF	2017/09/30	38,1
Satrix Indi ETF	2017/09/30	34,7
NewFunds SWIX 40 ETF	2017/09/30	26,8
Satrix Swix Top 40 ETF	2017/09/30	26,5
SMM Equity Index	2017/10/31	23,6
Nedgroup Inv Rainmaker	2017/09/30	20,5
Allan Gray Optimal	2017/09/30	20,5
Sygnia Active Equity	2017/09/30	20,0
SIM General Equity	2017/10/31	19,8
STANLIB SA Equity	2017/09/30	19,7
ALSI	2017/12/29	19,4
SWIX	2017/12/29	23,3
Source: Morningstar/IRESS		

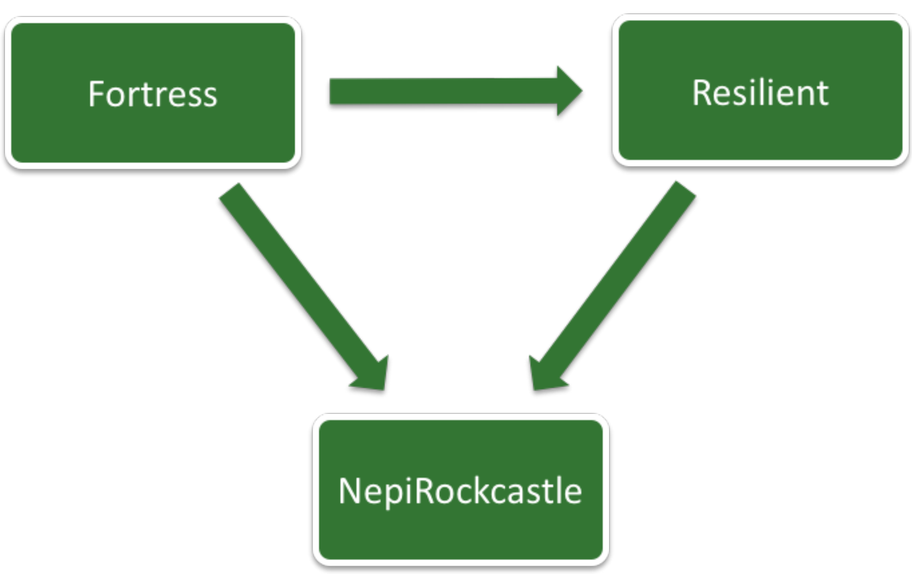
We are not questioning the quality of the Naspers business but strongly believe that investors who are looking for long term sustainable returns should consider the following two questions:

1. Are you prepared to have >20% of your wealth exposed to a single stock?
2. What happens if Naspers suffers a share price shock?

We believe these two questions to be pertinent as investors should be concerned when a high proportion of their savings and wealth is exposed to a few position in a market that is concentrated and driven by many market agents on the same side of the canoe.

PROPERTY

The South African listed property market also exhibits a high level of concentration risk with few stocks representing more than 50% of the indices. The primary example is the Resilient Group of companies, which consist of Resilient, NepiRockcastle and Fortress. These three companies are connected through common management teams and cross shareholding and as per the latest published annual financial statements, Fortress owns 10% of Resilient and per the NepiRockcastle prospectus, Resilient and Fortress owns 13% and 25% of NepiRockcastle respectively.



Together these three related companies represent close to 40% of the SAPY Index and 35% of the PCAP Index. Similar positions have been taken by certain property unit trusts, as listed in the Table 4 below.

The cross-holding effect between these companies further increase the concentration risk for investors as significant value can be destroyed if a major negative event impacts any of the companies within the Resilient stable. An additional risk is the multiple levels of debt due to the cross holdings and the investment of NepiRockcastle in listed securities which add another layer of debt. This cumulative effect of multiple levels of debt and the cross holdings create the potential for significant downside risk and value destruction which will affect the entire South African property market. Again we are not questioning the quality of these companies but as recent experience has shown us, having such large exposures create significant risk to investors' wealth.

"At Oasis we have consistently applied the basic principles of portfolio management and our asset allocation strategy has been developed to ensure we can deliver stable returns to investors over the long term. This is achieved by ensuring that that our portfolios are well diversified in terms of asset class, sector, instrument, geography and currency. Our investment strategy and philosophy has proved its resilience throughout the various economic cycles that have occurred during the last 20 years", Oasis Chief Investment Officer, Adam Ebrahim said.

Adam Ebrahim
Chief Investment Officer