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SA BANKS: WHAT'S DRIVING THE VOLATILITY?

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It is fair to say that SA banking shares have been on a roller-coaster ride over the last few years. Take Standard Bank, for example. It was trading at R175 in April 2015, fell by more than 40% to R98 in January 2016 and subsequently recovered, rallying by more than 120% to more than R220 earlier this year before retreating somewhat over the last few months. In contrast to this, the earnings of Standard Bank have been quite resilient. It has grown its earnings per share and dividend per share by 15% per annum over the last three years.

So why the apparent disconnect between the very volatile share prices of our banks on the one hand, and the relatively resilient profit stream on the other hand? In our view, the wild investor mood swings in South Africa in general disproportionately impact our banking shares. The reasons for this are: our banks are directly exposed to the health of industries in South Africa, they are leveraged businesses, and they are prone to confidence crises because there's a mismatch between the length of the assets and liabilities, making them more vulnerable to changes in investor sentiment.

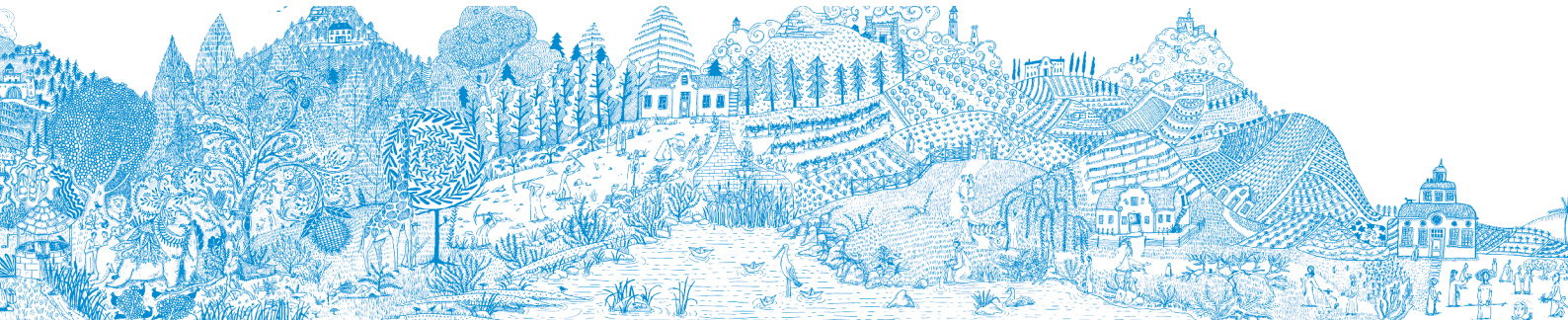
So let's talk about the sentiment drivers of the volatility in banking shares over the last few years. Firstly, we had quite a lot of political noise. Back in December 2015, there was the unexpected firing of then Finance Minister Nene by President Jacob Zuma. He was replaced by Des van Rooyen. At the same time, commodity prices were under pressure, which put the rand under quite a lot of pressure. And also we had severe droughts in the northern parts of this country which raised food prices and put certain farmers under pressure.

Another factor at that time was the looming credit downgrade for the South African government. This would have automatically had the impact that our banks' credit ratings would have been downgraded to non-investment grade ratings, which would have had a negative impact on their funding cost.

These factors obviously created a lot of negative sentiment around our banks, and we were fielding a lot of calls from clients regarding our exposure to banks. During this time, our response was that although we are aware of these concerns that may have a negative impact on the underlying profitability of banks, these risks were already priced into the banking shares. They were attractively valued and if there would have been any improvement in the environment, there should be good value unlock for shareholders.

So during this time, despite the very negative sentiment around the banks, we found them compelling on a valuation ground and we added to our banking exposure during 2016. With the benefit of hindsight, there have been a few improvements since then. We know about the political change, the rains have come in which broke the drought, and we had a bumper maize crop the next year. Also, commodity prices recovered well.

Understandably, the banking shares responded quite well and while they were trading well below our estimate of the intrinsic value in 2016, during the earlier part of this year they for the first time started trading above our fair value. Hence we started trimming our exposure to banks.



Let me just spend a few moments on why banks' earnings are so resilient relative to the macro environment. In contrast to, say for example, a typical retailer who has to go out every financial year and generate revenue from scratch, a bank has quite a big portion of its revenue coming from annuity sources. So for example, they've got a very big loan book which generates net interest revenue, and they also have a large number of fee-paying accounts.

The general economy does impact their earnings. We have a natural credit cycle. But even there you've got different drivers that would offset the impact. For example, you've got an interest rate cycle that works very much against the credit cycle, and you also have provisions that banks are releasing and raising to soften the impact on earnings. So despite the amount of noise impacting banks, the key take-away is that the earnings streams are a lot more resilient.

So how do we handle this volatility in our portfolios? We acknowledge that in the shorter term, volatility is very uncomfortable for the investor to stomach. But in the longer term, volatility is actually the friend of an active manager as it allows us to take opportunities of mispricing when sentiment removes the value of a share price away from its intrinsic value.

In summary, banks actually have a more resilient income stream than one may expect. Despite this, there's quite a lot of volatility in the market that affects the share prices, which gives us opportunities from time to time. At the moment we are quite neutrally positioned on banks after taking some profits off the recent rally in banks, but we know that there will be noise in the future, which will give us the opportunity to add long-term value for our clients.

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