

Richemont and 80/20 in the stock market – Market Commentary – July 2022

Markets were in buoyant mood in July with the MSCI World Index up +7.9% in USD terms. This provided some support to the SA market but at +2.5% in USD terms it lagged by a somewhat wide margin. It still outperformed Emerging Markets as a group though.

The MSCI World was led by the US with the S&P 500 returning +9.2% and the Nasdaq +12.6%. The MSCI Growth Index strongly outperformed at +11.5% as well, with Value rising but at a more muted +4.6%.

The various market returns for the month are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for July 2022*

	Jul-22	YTD 2022
FTSE/JSE ALSI (ZAR)	4.2%	-4.4%
FTSE/JSE ALSI (USD)	2.5%	-8.4%
MSCI World	7.9%	-14.2%
MSCI EM	-0.2%	-17.8%
MSCI Value	4.6%	-8.1%
MSCI Growth	11.5%	-20.6%
S&P 500	9.2%	-12.8%
Nasdaq 100	12.6%	-20.3%

*Total return indices, Source: Factset

The strong returns appear to have been driven by declining US interest rates. The US 30-year yield declined from 3.1% to 2.9% in July. While small, this was part of a trend from mid-June when this yield achieved a short term high of 3.4%.

US yields declined as better US inflation data materialised and the US market now appears more concerned with prospects of a slowdown especially following the Fed Chair's most recent pronouncements.

Richemont

Closer to home Richemont returned +14.5% in July, far outpacing the ALSI return of +4.2%. Richemont's weight in the ALSI in June was close to 12.5%, rising at the time of writing in August to 13.5%, suggesting an ALSI ex-Richemont return for July closer to +2.8%.

Nothing unusual about the above. Except it was a repeat, in somewhat less dramatic fashion, of Q4 in 2021. Then Richemont returned +55.2% vs the ALSI's +15.1%, inclusive of Richemont's strong return.

Contrast also with the returns of the SWIX, where the Richemont weight is suppressed to close to 2% of the index. The SWIX returned +8.3% in Q4 of 2021 vs the ALSI's +15.1%, and +2.8% in July 2022 vs the ALSI's +4.2%. More significantly, the average equity fund in Q4 of 2021 returned +9.5%, as calculated by Profile Data, and +2.7% in July of 2022 i.e. closer to the SWIX, with both underperforming the ALSI by wide margins.

The point of this brief performance review is that at times when Richemont, now the largest share in the index, performs well, the average fund struggles to keep up and underperforms the ALSI. This is either pure underperformance or underlying funds benchmark to the SWIX. In either case however the result is the same – the average fund underperforms the ALSI.

SWIX and Capped SWIX

The reason the SWIX was introduced was, in theory, to benchmark against shares traded in the South African market – shares trading in London, for example, for large, international, South African-listed companies were inaccessible, and should therefore not be in the benchmark. It just so happened that Richemont was a share whose weight would be suppressed.

While the SWIX successfully dealt with offshore-listed companies, Naspers, a wholly-South African company, performed well and became large in both the ALSI and the SWIX. This again became problematic and the Capped SWIX was launched to address this new and hitherto unanticipated problem.

Richemont and Naspers outperform

While the creation of these benchmarks is couched in the supposedly sound theoretical arguments of including only an accessible universe of shares and limiting concentration risk for investors, we suspect the underlying reason is the difficulty these shares cause, and have caused, in outperforming the ALSI.

In 2017, Richemont comprised 1.7% of the ALSI. Today, as mentioned, its weight stands at 13.5%. Naspers, for all its negative press this year was close to 20% of the ALSI not too long ago. It is only through corporate structure contortions that its weight in the indices was brought down, only to decline further from negative sentiment towards Chinese Tech shares this year and last. Even this year, however, along with plenty negative press, the share was down nearly -35% before the company announced a share buyback program. The shares then re-rated rapidly and are now positive for the year, while the ALSI Price Index is down close to -5% (Prosus, notably, is still down -18% for the year-to-date).

The point being made is that it is no accident that Richemont and Naspers have become large in the index – this is primarily due to superior long term performance relative to other assets in the universe. To suggest that large size somehow poses a problem for investors in terms of concentration risk is to ignore the enormous benefit these same investors would have gained while Richemont was rising from 1.7% to 13.5% of the index. Further, with apparently more limited scope for growth in South Africa, the possibility of Richemont continuing to outperform other listed assets is not necessarily small i.e. a large exposure embracing the concentration risk could well turn out to still be justified.

This leads to a further point.

The Pareto distribution and the 80/20 principle

Adrian Gore, a prominent and increasingly internationally-recognised business personality, published an article earlier this year commenting that all too often a normal distribution is assumed in the occurrence of particular outcomes – a mean, the most common occurrence, and a bell-shaped curve of possibilities with extremes towards the edges. Instead, a Pareto distribution may apply. This probability distribution essentially suggests that, for example, 20% of “inputs” are responsible for 80% of outcomes. Mr Gore’s article provides examples e.g. the sickest 20% of Discovery clients are responsible for 80% of health costs. Also, 80/20 need not apply – 1% of the population might hold 99% of the wealth for example, or 99/1.

Could the same apply in the stock market? This is not the forum for an exhaustive academic-style study. cursory empirical evidence – not least Richemont and Naspers - would however suggest this might be so. Internationally, notwithstanding the US Tech

declines this year, there has been consistent media commentary of how a small number of stocks is responsible for most of the market's gains. The FANG stocks are well-known to the investing community.

Some statistical analysis would reveal a normal-type distribution of monthly or daily returns. Yet the long term picture reveals clear winners. Naspers and Richemont have been mentioned. To these we could add Capitec in South Africa.

What to do?

We feel that changing the goalposts is not the answer to the problem. Concentration is not an arbitrary outcome but arose from success which could well persist in the future. We feel that recognising the world as it is serves investors better. Theoretically sound as the SWIX and the Capped SWIX may be, investors still have the alternative of investing in a better-performing low cost passive ALSI or ALSI 40 ETF (Richemont's weight in the ALSI 40 is even higher). To this end we feel the ALSI, with its high weights in Richemont and Naspers, remains an appropriate benchmark. It is up to the fund manager to devise ways to outperform in a small market with high exposure to individual shares.