MONEY MARKETING
31 Mar 2012, p.10

Look for diversified alternatives to expensive defensive shares

Equity investors looking to add high-quality, defensive stocks to their portfolios in 2012 in order to ease some of their anxiety after a rough ride in 2011 are facing a dilemma, as many of South Africa's best-known defensive companies started off the new year valued at very expensive levels, according to fund manager Neil Brown, co-head of ELECTUS, a boutique in Old Mutual Investment Group (OMIGSA).

"A key part of investing for the long term lies in the price you initially pay when buying shares," explains Brown. "Even if the company concerned is a high-quality one, if its shares are overpriced and expensive when you buy them, it is very difficult to achieve good medium to long term returns."

In the local equity market, he says, the uncertainty in global economies and markets has led to the best quality defensive businesses being so sought-after that their share prices have been pushed to unsustainably high levels.

"Three of the very best defensive industries are beer, tobacco and food," he notes. "No matter how well, or badly, local or global economies are performing, people are predictable and consistent in their drinking, smoking and eating habits. Therefore, whenever there is economic and market uncertainty, investors have a very strong desire to own high quality beer, tobacco and food businesses. This herding of investment behaviour has led to companies like SABMiller, British American Tobacco (BAT) and Shoprite being pushed to expensive levels by the end of 2011, so that they offer no value."

He points out that by year-end SABMiller was trading on a 12-month forward P/E of 15.5 times, much higher than its European peers like Carlsberg (9.1 times) and Heineken (12.4 times), while Shoprite's P/E ratio was at approximately twice the level of the FTSE/JSE All Share Index.

So what are those investors who want more defensive portfolios to do? Brown says that in managing the Old Mutual Top Companies and Growth Funds, he and co-boutique head Richard Hasson have instead sought to buy shares in high-quality, undervalued, cyclical businesses that can offer diversification through exposure to macro drivers such as commodities, currencies and interest rates.

To illustrate this, he highlights three high-quality counters that they own in their client funds, among many, that offer good value as well as the necessary diversification: Anglo American, Trencor and Italtile.

"Although Anglo American displayed poor capital allocation from 2006 to 2008, among other contentious issues, in recent years it has improved in many areas," explains Brown. "It was trading around 33,010 cents per share (cps) at year end, while we believe that it is worth 44,000 cps. As one of the very best diversified mining houses, Anglo American has exposure to many commodities and diverse geographies. It therefore provides our clients with exposure to a leading mining house diversified by commodity and region and, importantly, it has been trading at a sizeable discount to its fair value."

Trencor, the global steel container group, is a conservatively managed and undergeared business trading on a price/earnings ratio of 7.4 times as at end 2011, with a dividend yield of 5.7%. "Its exposure to global trade and 61% ownership of the NYSE-listed container group Textainer make it an excellent rand hedge share," Brown elaborates. "And importantly, it was trading at 3,959 cps as at year end, but our analysis indicated a value for Trencor of 4,682 cps, making it substantially undervalued."

A third counter held by Brown is Italtile, the largest retailer of tiles in South Africa. "This is one of the very few SA retailers where we can find a market-leading quality business that is not overpriced," he says. "This high-quality business provides us with diversification and exposure to the SA consumer. Plus we have a bias toward companies like Italtile where founders and management are large owners of the shares (not just through options), as we believe their capital allocation decisions will be sound and aligned with other shareholders. This is just one of the reasons why we like it as an investment in the current climate."

So while it may be difficult for investors to find well-known, top- quality, defensive shares at a price that offers value, they can be assured that, with careful analysis, other shares can be found that will help to diversify their portfolios to lower risk in what are likely to be still-volatile conditions ahead.

Neil Brown: Careful analysis reveals good buys