

Some like it hot

By Jeremy Gardiner, Director, Investec Asset Management

9 June 2008



“Never buy on credit what you can afford to pay for with cash.” Sage advice from previous generations, but unfortunately too often ignored in today’s relentless pursuit of instant gratification.

Equally ignored are words such as prudence and diversification. Unfortunately, the time to plan appropriately from a diversification perspective is when times are good, and diversification by definition involves cutting back a bit on what is hot and diversifying into what is not! Which is always less fun and therefore not nearly as popular!

Human instinct being what it is, most people find this approach impossible. They either stay over invested in what is hot, ignoring what is not, and worse still, some borrow or leverage to buy more of what is hot than they can afford. Of course, this inflates returns while what is hot remains hot, but when that which was hot, becomes not hot, it can exaggerate downside returns as well!

At the moment, unfortunately, not much is hot, and with rampant fuel and food prices fuelling further rate hikes, much out there looks set to remain cool for a while. The consumer is likely to remain financially challenged until rate hikes peak and at least show some promise of relief, which looks unlikely for another year. Equally, financials will remain under pressure while consumers struggle to repay loans and while subprime works its way through the system. This will probably take another six months, however the after-effects of the shock, i.e. how long it takes before banks loosen up on credit provision or until consumers feel sufficiently confident to borrow money and spend it may take longer! In addition, with the listed property index down 28% from its peak in November, ABSA’s residential property report telling us median house prices are down 13.5% year on year and with 82% of properties selling at less than asking price, property also is struggling.

Commodities have enjoyed an extended period of “time in the sun”. Cash has not. However, due to higher interest rates cash is now showing reasonable post tax returns (although with inflation where it is, real returns are unimpressive). Nevertheless, there are great bargains out there for those with cash, who are prepared to take a longer-term view, although there is no rush. Like cash, commodities are also hot, and Asia (even with a likely slowdown in western demand in the short term) will ensure that commodities remain hot for some time to come – for 10 years, possibly even 15 years.

Increasingly therefore, investors are now trying to position their portfolios excessively (and imprudently) towards cash and commodities. While both play an important part in a diversified portfolio, there are risks associated with both.

Firstly, sitting too heavily in cash could see you miss the rise in asset prices when it comes. Equities (aside from commodities) are reasonably priced, and when the world recovers (which it will) prices will rise.

Secondly, although commodity demand should remain fundamentally strong over the longer term, commodity shares (and prices) are not going to maintain a smooth gradually rising trajectory. They will run ahead of themselves and at some stage they will pull back, possibly as much as 40% or even 50%, and when it happens it will happen fast. They will recover thereafter, but it will take some time.

Of course, one must remember that tough times are a global phenomenon. The world is struggling with high fuel prices, food prices and inflation. Globally, cash and commodities are hot, and most other sectors are not. But, the wheel turns and when it does, what is hot becomes not, and what is not once again becomes hot. While prudence and diversification are not the most adrenaline-fuelled concepts, it is at times like these that when those who are diversified enjoy a far more peaceful sleep at night.