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FOLLOW THE SMART MONEY

Like a lot of other sayings on how to invest successfully, this old hoary chestnut is easier said than done. Before applying it in practice, we need to answer two questions: who is the smart money, and what, exactly, is it doing?

In the distant past, large institutional asset managers were regarded as the smart money. They had the informational advantage; they employed the smartest brains in the industry and, above all else, they had what it took to move markets: size. However, in their push for profitability, they forgot about one thing that gave them their advantage in the first place: delivering superior returns to their clients.

Over the past few years, these large institutions sacrificed performance for scale, with the result that their offering has become commoditised. Nowadays, they are not much more than passive, index tracking investors, despite vehement protestations to the contrary. For them, a stocks' market capitalisation is directly linked to its investment value – the bigger the stock, the more of it they want to own, regardless of the underlying investment value. No, this is no longer the home of the smart money!

This has created the perfect environment for the really smart money to emerge, in the form of the corporate sector, or businessmen and women. Over the years, these market participants have always had the upper hand – and all the while being ignored by the broad market!

Having defined who the smart money is, we need to look at what they are currently doing. Very simply, they are buying out companies that are listed on the public market (the JSE) and taking them private. They are doing this, because these smart business people recognise what the large institutional investors are unwilling (more likely unable) to see: that smaller, less liquid companies on the JSE are extremely cheap.

Again, to fully understand their actions, we need to take a couple of steps back in time.

Remember the IPO boom here in South Africa in 1997/98? Investors couldn't wait to throw money at the next new listing! Each company that came to the market could raise as much money as it wanted to: capital was effectively for free.

Let's think about this. If capital is free to the company looking for it (the seller of stocks), it must be infinitely expensive to the provider (i.e. the buyer of stocks), and so it was – most companies that listed during 1997 and 1998 ended up worthless – effectively costing their investors all their money. The only ones who made money out of the process were the corporates who were listing (i.e. selling) their companies. In other words the smart money.

Today, the roles are the same, but the process is working in reverse. The corporates are taking the good businesses private – and being actively encouraged by the large institutional investors. The companies being delisted are too small, too illiquid and generally just too insignificant for these giants of the investment world. No matter that the corporates are buying out the minorities in these companies for a song, according to the large fund managers, if it's not in the top 40, it's not worth owning.

So, the same institutional investors who were willing to buy rubbish from the smart money at infinite prices are now willing to sell good assets to the smart money at bargain basement prices.

It is a very simple exercise to calculate the return from stocks from periods when there were a lot of new listings (clue: a very low number) and compare it with the return from stocks from periods when there were a lot of delistings, such as the current period (clue: a much bigger number). So far from getting despondent about the shrinkage happening in the JSE, investors should take heart from the actions of the smart money, and do the same: buy equity!

In managing your money, we are responding to the current situation in two ways: one, we are actively investing in smaller, less liquid companies – because that is where the value is. And two, we have, and will continuously oppose those corporate insiders who wish to buy these companies from our clients for 50 cents in the Rand. In doing these things, we are of the opinion that we are aligning our clients' interests with the smart money, instead of the passive, index tracking activities of the large money managers.

One such event is taking place right now. Old Mutual, that London listed giant of the investment world intends to take its 51% owned subsidiary, Mutual and Federal private. To do so, it intends to offer R17,50 to the minorities (which include our clients)

We think Mutual and Federal is worth up to twice as much, and we are using all avenues at our disposal to persuade Old Mutual to come up with a higher price.

A side comment: It is sad that a company which has emigrated to London, and has wasted so much shareholder value in overpriced acquisitions offshore, is finally doing it's first smart transaction back in it's previous home country. Along with persuading Old Mutual not to delist Mutual and Federal, perhaps we should petition them to domicile themselves in SA again, where it seems they have a far better chance of doing the right things for their shareholders!

Piet Viljoen, February Market Commentary