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## Why we like retail

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Nick joined Foord in 2005 from Stern Stewart and currently holds the position of portfolio manager. Nick is also responsible for research, with a focus on retailers and financial shares.

### Foord's portfolios continue to hold a sizable allocation to South African retail shares. Nick Balkin explains why.

Foord has continuously held an allocation to retailers in client portfolios over the last 7 + years. The allocation to the retail sector has varied over time, and the exposure to names has changed as cycles and valuation change, but the presence has consistently been there. Central to Foord's investment philosophy is getting the big calls right. At a macro-economic level, we feel that there are logical arguments for the inclusion of retailers in portfolios. Selective companies continue to be attractively priced.

There are a number of factors supporting the continued improvement in the spending capacity of the SA population. Above-inflation wage growth is expected to continue, albeit at a slower pace than in previous years. This is a direct result of a highly regulated labour market and union bargaining pressure. Additionally, banks are expanding into the largely untapped unsecured loan market, despite reducing their appetite for secured loans such as home mortgages. Finally the current low interest rate environment and the consequent lower debt servicing costs have allowed people to stabilise and even decrease their debt burdens. Each of these factors has a direct bearing on the spending capacity of the population, which favours retailers.

Another supportive factor for the retail sector is evidence of changing spending patterns. The continuing development of a rising middle class has shifted buying behaviour from the informal retail sector to the formal retail sector. Given the extent to which this demographic change can continue, it is likely that this trend will persist for the foreseeable future.

The formal retail sector is protected to certain degree – barriers to entry remain high as insufficient mall space is being built to accommodate new entrants to the market. As a result, any new entrants will find it hard to achieve sufficient scale to compete with the larger retail chains. This means that high margins and returns on equity should be sustained by the existing players.

A fundamental qualitative characteristic of companies favoured by Foord is the calibre of the management teams that steer them. In our view, the South African retail sector is blessed with some of the best management teams in the country. An excellent management team improves the stewardship of shareholder funds.

Investment selection also requires a pragmatic consideration of the price of an investment. You don't have to be an investment professional to understand that buying a share at the right price can determine the extent of long term returns. Although South African retailers have enjoyed a significant re-rating over the last two years, they remain at a discount to emerging market peers. This is an important consideration as foreign investors, with their global perspective, have significant holdings in South African retail shares.

Importantly, having enjoyed two good years of above-market returns, the re-rating of retail shares over the last two years should not be a reason to sell. A share should not be sold merely because it has performed well. Whilst the historical perspective provides context, of greater importance is an understanding of where the sector and the companies in that

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sector are headed. Our analysis suggests that earnings and dividends in the retail industry will continue to grow at a robust pace, and given the sector of the economy they are exposed to, perhaps with less volatility than companies exposed to other sectors of the economy. Consequently, returns from such investments should be acceptable.

Finally, retailers offer scope to apply another key tenet of Foord's investment process: to diversify and manage risk. Although our view is that the rand should depreciate over time (in line with fundamentals) the risk of being wrong in this view is too high to remain unmitigated. Resource companies and industrial companies sourcing the majority of their earnings abroad may perform very well in a weaker rand scenario - in the absence of falling commodity prices. However, were the rand to appreciate sustainably, retailers will be able to import supplies more cheaply and so make their products even more attractive to buyers. Within the sector itself, the risk to be managed is that of inflation. If inflation is higher than expected - Foord's exposure to defensive food retailers will offset the risks of exposure to more cyclical clothing retailers.

In a nutshell, holding retail shares is entirely consistent with Foord's proven investment philosophy – both from a “top-down” macro-economic perspective and a “bottom-up” fundamental perspective on the sector and the companies listed in it.

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*Glacier Research would like to thank Nick Balkin for his contribution to this Week's Funds on Friday.*