

# The Investment Analysts Journal

Number 17 April 1981

# Die Beleggings- Navorsers Tydskrif

Nommer 17 April 1981

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## Inhoud

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## This issue in brief

### **The case for equities**

Winston Floquet's address to The Association of Pension and Provident Funds of South Africa on 24 March 1981 contains a detailed examination of the relative performance of equities and fixed interest investments in South Africa since 1960. Although not without an interest in the equity market, as a leading stockbroker, Mr Floquet goes to considerable length to preserve the objectivity of his study even though he comes to an expected conclusion. Of particular value to investment analysts will be the comprehensive statistical illustration he provides to support his argument.

### **Rational expectations – the challenge to economic stabilization policy**

John D. Paulus is an economist with a leading firm of investment bankers in New York and prepared the address reproduced here for a conference sponsored by the Federal Reserve Board held in September 1980 in Boxborough, Massachusetts. The address is a fine example of clear analysis and description employing very little mathematical illustration to achieve its objectives. In this respect it should appeal to a large number of readers who find the mathematical illustration of many statistically based articles discouraging or excessively time consuming. The theory of rational expectations, like the efficient market hypothesis, is a source of much controversy. However, even those who reject it will concede its importance to the whole debate on the rightness, or otherwise, of monetarism.

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#### **Reserve Bank accommodation and monetary policy**

With the final report of the De Kock Commission due to be published later this year, interest in the matter of monetary policy in South Africa is considerable. Although details of the Commission's recommendations can only be guessed at this stage, it is reasonable to expect that they will be broadly in line with recent official policy statements regarding the need for greater emphasis on market freedom. Dr A. P. Faure, formerly of the South African Reserve Bank, brings considerable authority to his discussion of the local banking system and the Bank's role in guiding and controlling it. His examination of complex and esoteric detail is meticulous and lucid, and will be indispensable reading for all those concerned with money market operations and their connection with general economic developments in this country.

#### **The market model and The Johannesburg Stock Exchange**

Brian Gilbertson is well known to readers of this Journal for his earlier articles on the efficient market hypothesis and its relevance in the South African context. On this occasion he teams up with Moshe Goldberg to examine the need for distinguishing between the performance of the industrial and mining sectors of the JSE when considering "market model" analyses of share price behaviour. They conclude that the fortunes of the two sectors are sufficiently influenced by quite different factors to justify special treatment which can be accommodated via standard multiple regression analysis.

#### **Return on investment – an integrated measure of profitability and performance**

This is the eighth article in our "Investment basics" series and is written by Mr A. C. Valsamakis, lecturer in the Department of Business Economics at the University of the Witwatersrand. Amongst other things, the article examines the well known "Du Pont" system of financial analysis and shows how it can be used to obtain a comprehensive picture of the return on an investment.

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Seventeenth issue  
April 1981

A considerable amount of hope presently focuses on the De Kock Commission which is due to present its final (?) report on monetary policy after Parliament assembles in August. We already have a good idea of the direction of the thinking of the Commission because of its initial findings, because of numerous statements by Dr De Kock himself and because of recent policy actions of the Reserve Bank of which he is now Governor, but we still do not know what, precisely, it is going to recommend. The direction of thinking, clearly, is towards a freer, more competitive and, hence, more efficient financial system.

In this issue of the Journal we include two articles which are of importance to the debate about monetary policy. Both discuss issues which financial analysts need to consider thoroughly because the issues in question touch the heart of the problem of asset valuation in a world of multi-dimensional risk and uncertainty.

The theory of rational expectations is currently a source of special controversy in the debate about the rightness or wrongness of monetarism. Broadly, the theory states that business, investor and other expectations about future economic developments are based on a correct general understanding as to how the economic system works and that such understanding is not subject to systematic error or bias. In its strong form the theory holds:

- (a) that money illusion (the confusion between real and nominal price changes) exercises little influence on decision making because it is real price changes that matter to both producers and consumers and other economic agents;
- (b) that only unexpected change can cause economic agents to alter their planned responses or action; and
- (c) that governments cannot influence the *real* economy through their policies because they, in formulating these, do not have better information than the general public about how the economy works or about the likely course of future economic events, and cannot, therefore, prevent their policies and their consequences from being anticipated.

In short, the strong form of the theory of rational expectations asserts that economic agents, and this includes, amongst others, financial analysts and portfolio managers, are not misled by inflation and cannot be fooled by fiscal and monetary authorities attempting to implement policies through various means. For example, attempts by such authorities to increase employment through a manipulation of domestic demand will fail because they will generate, in the end, an increase in the price level that offsets any increase they encourage in nominal spending. Similarly, attempts to sell government stock to the private non-banking sector at rates insufficient to yield a positive real return will fail because this will be resisted by financial institutions.

All this is of the greatest importance to South Africa in present circumstances. The upswing in the economy has

Sewentiende uitgawe  
April 1981

Heelwat hoop word tans gevestig op die De Kock-kommissie wat sy finale (?) verslag oor monetêre beleid ná die Parlementsitting in Augustus gaan voorlê. Ons het reeds 'n goeie aanduiding van die denkrigting van die kommissie, gegrond op sy oorspronklike bevinding, die talle verklarings deur dr De Kock self en onlangse beleidsoptredes van die Reserwebank, waarvan hy nou die President is, maar ons weet nog nie presies wat die kommissie gaan aanbeveel nie. Dié denkrigting behels ongetwyfeld die ontwikkeling van 'n vryer, mededingender, en gevolglik doeltreffender, finansiële stelsel.

In dié uitgawe van ons Tydskrif het ons twee artikels opgeneem wat van belang is vir die debat oor monetêre beleid. Albei dié artikels is 'n bespreking van aangeleenthede wat deeglik deur finansiële navorsers oorweeg moet word omdat dit die kern van die probleem van batewaardasie in 'n wêreld van veeldimensionele risiko en onsekerheid aanroer.

Die teorie van rasonele verwagtinge is tans 'n bron van groot meningsverskille in die debat oor die aanvaarbaarheid al dan nie van monetarisme. Dié teorie kom in breë trekke daarop neer dat besigheids-, beleggers- en ander verwagtinge ten opsigte van toekomstige ekonomiese ontwikkelinge gegrond is op 'n juiste algemene begrip van die werking van die ekonomiese stelsel en dat dié begrip nie aan stelselfoute of vooroordeel onderworpe is nie. In sy uiterste vorm voer die teorie aan—

- (a) dat geldillusie (die verwarring tussen reële en nominale prysveranderings) min invloed het op beslissings omdat dit reële prysveranderings is wat vir die vervaardiger sowel as die gebruiker en ander ekonomiese agente van belang is;
- (b) dat slegs onverwagte verandering kan meebring dat ekonomiese agente hulle beplande reaksies of optrede verander; en
- (c) dat regerings nie die *werklike* ekonomie deur middel van hulle beleid kan beïnvloed nie omdat hulle by die formulering daarvan nie beter as die groot publiek ingelig is oor die werking van die ekonomie of die waarskynlike ontwikkeling van toekomstige ekonomiese gebeure nie en derhalwe nie kan voorkom dat hulle beleid en die gevolge daarvan voorsien word nie.

Kortom, die uiterste vorm van die teorie van rasonele verwagtinge beweer dat ekonomiese agente, en dit sluit onder andere finansiële navorsers en portefeuljebestuurders in, nie deur inflasie mislei word nie en nie gefloos kan word deur monetêre owerhede wat probeer om beleidsrigtings op verskeie wyses te implementeer nie. Pogings deur dié owerhede om werkverskaffing deur middel van manipulasie van binnelandse vraag te verhoog sal byvoorbeeld misluk omdat hulle uiteindelik 'n styging in die pryspeil sal kweek wat enige toename wat hulle in nominale besteding aanmoedig, kanselleer. Net so sal pogings om staatseffekte aan die nie-bankwese-privaatsektor te verkoop teen koerse wat ontoereikend is

reached an advanced stage. Demand inflation is now asserting itself. Money supply growth is by any historical standard extremely high and most economic forecasts anticipate the emergence of a significant deficit on the current account of the balance of payments in 1981 after four years of unbroken and substantial surplus. Given the March year-on-year increase in the CPI of 16,2 per cent, what support is a long-term Government stock issue pitched even at around 13,0 per cent, likely to attract?

This is an open question and a great deal of attention is likely to centre on the results which will be announced next month. Suffice it for us to note here that success on the Treasury's part at such a rate would imply one of two possibilities, namely:

- (i) that the March year-on-year increase in the CPI is not considered by the investment community as being a fair average measure of inflation over the life-span of the stock in question, i.e. that the current high inflation rate is likely to subside;

or

- (ii) that the South African capital market is inefficient either because it can be fooled or because its attempts at being efficient are undermined by official interference associated, inter alia, with official requirements pertaining to institutional holdings of gilt and semi-gilt stocks.

While it is not our function to take sides in unresolved issues of controversy, it is not out of place for us to draw attention to such matters. Opinion may be divided about whether our money and capital markets meet adequate standards of efficiency but for all those concerned with the survival of free enterprise and the minimisation of the waste of scarce resources, there cannot be any doubt that market efficiency is a desirable objective worthy of further promotion. What the rational expectations issue causes one to question is whether all who proclaim their adherence to the ethic of economic freedom are really aware of what all the implications of its full realisation would be.

Given the special nature of the South African situation — the duality of our economy, the co-existence and overlapping of its modern and mediaeval sectors, the unique socio-political problems that we face, and the rigidity of our existing financial structure, are we truly prepared to go all the way down the free enterprise road? Can we afford to scrap the many restrictions and controls, including exchange control, upon which the authorities continue to rely in their economic management? Alternatively, can we afford *not* to scrap such restrictions and control if we are to check inflation and survive competitively in the long run?

These are questions of profound importance to us all for which answers need to be honestly and urgently sought, and not only by an official Commission of Inquiry.

#### The Editor

om 'n positiewe reële opbrengs te lewer, misluk omdat dit deur finansiële instellings teengestaan sal word.

Al dié dinge is in die huidige omstandighede van die grootste belang vir Suid-Afrika. Die opgang in die ekonomie het 'n gevorderde stadium bereik. Vraaginflasie laat hom nou geld. Gemeet aan enige historiese standaard is die geldvoorsieningsgroeï besonder hoog en die meeste ekonomiese voorspellings voorsien die verskyning van 'n belangrike tekort op die lopende rekening van die betalingsbalans in 1981 na vier jaar van 'n ononderbroke en aansienlike surplus. Met inagneming van die Maart jaar-na-jaar-styging in die VPI van 16,2 persent, is dit onwaarskynlik dat 'n langtermynuitgifte van staatseffekte, selfs teen 'n hoë koers van ongeveer 13,0 persent, enige noemenswaardige steun sal geniet.

Dit is 'n onuitgemaakte saak en die resultate wat volgende maand aangekondig gaan word, sal waarskynlik heelwat aandag geniet. Dit is voldoende vir ons om hier daarop te wys dat as die Tesourie teen dié koers slaag, dit een van die volgende twee moontlikhede sal inhou:

- (i) dat die Maart jaar-na-jaar-styging in die VPI nie deur die beleggingsgemeenskap as 'n billike gemiddelde maatstaf vir inflasie oor die lewensduur van die betrokke effekte beskou word nie, d.i. dat die heersende hoë inflasiekoers waarskynlik sal afneem;

of

- (ii) dat die Suid-Afrikaanse kapitaalmark ondoeltreffend is, òf omdat dit om die bos gelei kan word òf omdat dié pogings van dié mark om doeltreffend te wees ondermyn word deur inmenging van ampsweë wat onder andere verband hou met amptelike vereistes ten opsigte van instellings se besit van prima en semi-prima effekte.

Hoewel dit nie ons funksie is om kant te kies by onopgeloste geskilpunte nie, voel ons geregverdig om die aandag te vestig op dié aangeleentheid. Daar is miskien meningsverskil oor die kwessie of ons geld- en kapitaalmark aan behoorlike doeltreffendheidsstandaarde voldoen, maar by almal wat by die voortbestaan van bedryfsvryheid en die minimalisering van die verspilling van skaars hulpbronne betrokke is, kan daar geen twyfel bestaan dat markdoeltreffendheid 'n wenslike doelstelling is wat verdien om verder bevorder te word nie. Die vraag wat die kwessie van rasonale verwagtinge opeer, is of almal wat hulle steun aan die etiek van ekonomiese vryheid toesê werklik bewus is van wat al die implikasies van die volle verwesenliking daarvan sal wees.

Gesien die besondere aard van die Suid-Afrikaanse situasie — die tweeledigheid van ons ekonomie, die saambestaan en oorvleueling van sy moderne en middeleeuse sektore, die unieke sosio-politieke probleme waarmee ons te kampe het, en die onbuigsamheid van ons bestaande finansiële struktuur — is ons werklik voorbereid om die weg van bedryfsvryheid end-uit te bewandel? Kan ons die skraping bekostig van die talle beperkings en beheermaatreëls, met inbegrip van deviesebeheer, waarop die owerheid steeds staatmaak ten opsigte van sy ekonomiese bestuur? Aan die ander kant, kan ons dit bekostig om *nie* dié beperkings en beheermaatreëls te skrap nie, as ons inflasie wil beteuel en op die lang termyn mededingend wil bly voortbestaan?

Dit is uiters belangrike kwessies vir ons almal; kwessies waarop antwoorde op eerlike en dringende wyse gesoek moet word, en nie net deur 'n amptelike Kommissie van Ondersoek nie.

#### Die Redakteur