

Bonds extended their losses into the second quarter, with the All-Bond Index (ALBI) down 3.6% for the quarter. This brings the year-to-date loss on the ALBI to just over 2%. A defensive, short-duration position in the Bond Fund proved the right move as the fund handsomely outperformed the ALBI as the market sold off. Year-to-date the fund produced a negative 0.77% return versus the negative 2.1% of the ALBI. The longest maturity area of the ALBI was down some 6.4% in the quarter and 7.0% for the year so far.

Bonds are the worst-performing asset class for the year to date, with the negative performance being trounced by equities – the All-Share Index was up 4.9% for the quarter, despite the jitters seen in May and June, and still up a smart 18.8% for the year-to-date. Bonds also trailed cash (3.6% year to date) as well as inflation-linked bonds, 3.3% for the year so far.

Poor bond index performance in the second quarter was led by a number of factors, principally the reduction in risk appetite for emerging market assets that we had expected would eventuate sometime this year. The trigger point seemed to be the US Federal Reserve raising interest rates beyond where many had expected, coupled with expectations of further monetary tightening by both the European Central Bank and the Bank of Japan. In addition to these major central banks, many other central banks have been in, or have begun a, tightening mode as well, including a majority of emerging markets. Rising interest rates both reduce general liquidity available in the markets – usually meaning a fall in risk appetite – and raise the relative return required by other assets if they are to continue to remain attractive relative to “home” interest-bearing assets.

Although the JPMorgan Emerging Markets Bond Index (EMBI) has held up quite well, it is significantly weaker than its best levels of earlier in the year. Local bonds were affected by this as well as by the fall in the rand that accompanied the risk reduction. The trade-weighted rand has lost some 18% since late April. The cherry on top for the bond market was the SA Reserve Bank’s move to raise the repo rate by 50 basis points to 7.5% at the June Monetary Policy Committee meeting. While the FRA market had discounted some probability of a rate rise, it seemed that the bond market was to a large extent caught unawares by the move. The initial response by many economists was to dismiss the rate move as a one-off, but a negative current account number for the first quarter saw a widespread revision of rate forecasts. We have for some time expected that interest rates would enter an upcycle this year and thus fortunately had been positioned for the market moves.

Of course, the big question is what happens next. Readers will recall that we have been relatively bearish on inflation for some time, as we had been negative on currency and food price prospects, in particular. While we thus are not implementing any material adjustments to our inflation forecast in light of recent developments, some factors have moved worse than we had expected and thus upside risks remain. At present we expect the SARB to raise interest rates another 100 basis points by February 2007.

While inflation-linked bonds have outperformed conventional bonds over the past year, we believe that an overweight in this asset class is no longer justified. Real yields had fallen to levels that do not look sustainable, while breakeven inflation rates have risen to levels that no longer offer value. Looking forward, it seems it will be very difficult for inflation linkers to outperform cash.

Another interesting development in the domestic market was a change in sentiment towards credit, where the previous “no-brainer” attitude towards new corporate issues received a shock when a couple of new issues struggled to find a decent reception in the market. We have for some time believed that credit spreads in general were too tight (i.e. they did not offer value) and that it made sense to be defensive in credit (i.e. both underweight credit and within that, to remain in high-quality issuer names). Any risk aversion that enters markets is likely to make its way down the credit curve, and this is what we saw in the past quarter.

While we had been defensively positioned in the run-up to the repo rate hike, we feel that the bond market is now closer to fair value. Still, the call between bonds and cash remains close over the next 12 months – especially on a risk-adjusted basis.

Mark le Roux
Portfolio Manager

Fund category	Domestic Fixed Interest Bond
Launch date	1 August 1997
Portfolio manager	Mark le Roux
Fund size	R116.9 million
NAV	1288.09 cents
Annual management fee	0.75% (ex VAT)

Benchmark	BEASSA ALBI Index
Fund description	Seeks to provide investors with a well-diversified exposure to the SA bond market.

ASSET ALLOCATION

Maturity Band	30 June 2006
0 – 1 year	25.41%
1 – 3 years	10.03%
3 – 7 years	10.73%
7 – 12 years	36.52%
12+ years	17.31%

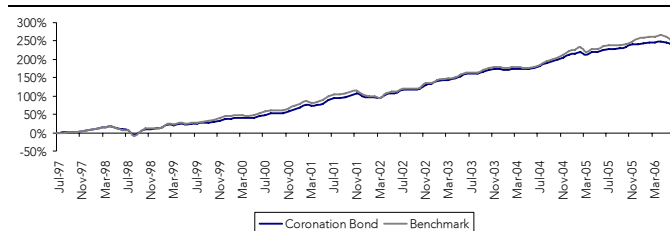
PERFORMANCE AND RISK STATISTICS

	Fund	Benchmark
Year to date	-0.77%	-2.12%
Latest 12 months	5.14%	3.94%
Latest 36 months (annualised)	9.71%	9.68%
Latest 60 months (annualised)	12.62%	11.88%
Since inception (annualised)	14.84%	15.04%
Annual deviation since inception	8.22%	9.89%
Sharpe ratio	0.37	0.33
Maximum gain	26.21%	26.36%
Maximum drawdown	-19.02%	-22.26%
Positive months	77.57%	75.70%

ANNUAL RETURNS SINCE INCEPTION

	Fund	Benchmark	Active Return
2005	10.96%	10.80%	0.16%
2004	13.94%	15.25%	-1.31%
2003	17.47%	18.07%	-0.60%
2002	16.32%	15.96%	0.36%
2001	22.36%	17.84%	4.52%
2000	19.43%	19.44%	-0.01%
1999	23.05%	28.73%	-5.68%
1998	5.00%	5.04%	-0.04%
1997	6.08%	7.12%	-1.04%

CUMULATIVE PERFORMANCE SINCE INCEPTION



INCOME DISTRIBUTIONS

Declaration	Payment	Amount	Interest
31/03/2006	01/04/2006	50.61	50.61
30/09/2005	01/10/2005	49.05	49.05
31/03/2005	01/04/2005	59.42	59.42
30/09/2004	01/10/2004	83.29	83.29

MONTHLY PERFORMANCE RETURNS

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Fund 2006	0.72%	0.93%	-0.26%	1.02%	-0.76%	-2.38%						
B'mark 2006	0.96%	0.78%	-0.23%	1.16%	-1.12%	-3.61%						
Fund 2005	1.04%	1.38%	-2.11%	2.01%	0.35%	2.02%	0.62%	0.16%	0.32%	0.70%	2.12%	1.91%
B'mark 2005	1.45%	1.99%	-3.67%	2.06%	-0.12%	2.69%	1.00%	0.02%	0.08%	0.63%	2.37%	1.97%