

After recording losses in Q2, bonds rebounded somewhat to show a positive performance in Q3. The All-Bond Index (ALBI) returned 2.1% for the quarter. Longer-dated bonds performed better than shorter-dated ones. Again, inflation-linked bonds (which are not included in the ALBI) were the best performing fixed interest asset class, returning 3.7% for the quarter.

Bond and Money Market (local currency returns)

Name	September 2006	3 months	6 months	12 months	Year-to-date
All Bond	1.36%	2.1%	-1.6%	5.0%	-0.1%
GOVI	1.39%	2.1%	-1.6%	4.9%	-0.2%
OTHI	1.17%	2.0%	-1.1%	5.2%	0.7%
Bonds 1-3 Years	0.66%	1.6%	1.4%	6.0%	3.2%
Bonds 3-7 Years	0.92%	1.9%	-0.3%	5.5%	1.5%
Bonds 7-12 Years	1.61%	2.4%	-2.6%	5.0%	-1.1%
Bonds 12+ Years	2.45%	2.3%	-5.4%	3.2%	-4.8%
Cash	0.67%	1.9%	3.8%	7.5%	5.6%
Barclays BESA Govt Inflation-Linked Bonds	1.16%	3.7%	4.3%	10.3%	7.1%

Source: Deutsche Securities

Bond market performance was perhaps surprising for many market-watchers, given that we entered the quarter just following the first interest rate increase in this cycle in June, and ended it amid a volatile and much weaker rand. Even as expectations cemented around further rate rises – and despite a poor performance by the rand – bond yields generally moved in a sideways range over the quarter. However, shorter dated bonds were affected by expectations about further repo rate rises, and by the end of the quarter the yield spread between the R157 and the R194 had moved to a small inversion as the latter, shorter-dated bond yield rose above that of the longer-dated one.

There are a number of possible explanations as to why longer-dated bond yields did not respond more negatively, especially later in the quarter when the rand broke important levels again and at one point seemed close to breaking \$/R8.00. We believe one of the reasons was that the sharp reaction in the bond market to, in quick succession, the announcements of the June rate hike and the large Q1 current account deficit effectively “priced the cycle” within a few weeks. As can be seen from the chart below, there had been a very close relationship between moves in the rand and bond yields for the preceding year. In late June, bond yields broke higher and stayed at higher levels – pointedly ignoring the later rally seen in the currency in July and August. It thus seems feasible that the reason that longer-dated bonds largely ignored the weakening in the rand during September was that they had effectively already discounted it.



Going beyond simply looking at what bonds might have discounted, we can also discuss the reasons why. The most likely explanation seems to be that the credibility of the SARB had been established through the 50 basis points rate hike in June, and the follow-up of similar magnitude in September. In other words, the bond market has confidence that the SARB will respond appropriately to ensure that any inflationary impact of the rand's weakness (and there will be an effect) will be short-lived. We can perhaps look to 2001/2002 as a precedent in this instance. Following the sharp weakening of the rand through R10 to the dollar in 2001 Q4 and its subsequent move to close to R14, bonds sold off in dramatic fashion; at that stage there were many in the market who did not believe that the SARB would raise rates. However, when the SARB did indeed start raising rates (beginning with an “emergency” hike at a special, non-scheduled MPC meeting in January 2002) the bond market relaxed somewhat and bond yields generally moved down over the course of 2002 despite rising repo rates and rising inflation. In other words, the bond market looked through the spike in inflation as being temporary, and we expect that this type of thinking is probably supporting the market at present as well.

However, it is also important to note that the downward move in bond yields over 2002 was generally accompanied by a strengthening rand as well; and the rand probably remains the key risk at present. Hovering in the high R7's in the midst of very volatile moves at the time of writing, the shorter-term path seems somewhat unclear at present. But with the sharp adjustment in the rand that has been seen this year (it is currently down around 25% on a trade-weighted basis so far this year) combining with the interest rate rises the SARB has delivered already and more to come, it is just a matter of time before the principal imbalance in the economy – the current account deficit – starts to correct. It is this that has been at the root of concerns about the rand. Thus, while the shorter term path may be murky and the risk always remains of further negative sentiment affecting the rand, we are pretty confident that looking 12-18 months out will put us in a situation where the current account deficit has started adjusting towards more manageable levels, and inflation will have pushed past its peak and begun returning to trend levels.

While much of our discussion this time has centred on domestic developments, the international backdrop remains of critical importance. The rand's reaction to the news of the current account deficit should be seen in the context of jitters in emerging market currencies – especially of countries with high current account deficits – around the same time. Furthermore, the restraint in local bond yields, while probably largely due to the reasons we outlined above, would probably not have been possible in the absence of two important global factors: namely, that US Treasury yields and emerging market bond spreads (as measured by the EMBI) both remained at relatively low levels during the quarter.

Mark le Roux
Portfolio Manager

Fund category	Domestic Fixed Interest Bond
Launch date	1 August 1997
Portfolio manager	Mark le Roux
Fund size	R111 million
NAV	1312.35 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 Sep 2006
0 – 1 year	12.56%
1 – 3 years	13.41%
3 – 7 years	17.00%
7 – 12 years	34.85%
12+ years	22.19%

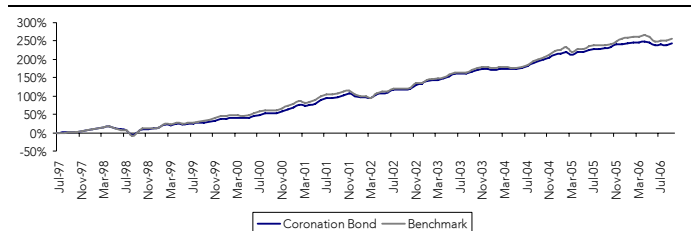
PERFORMANCE AND RISK STATISTICS

	Fund	Benchmark
Year to date	1.10%	-0.07%
Latest 12 months	5.95%	4.96%
Latest 36 months (annualised)	9.47%	9.47%
Latest 60 months (annualised)	12.09%	11.49%
Since inception (annualised)	14.64%	14.86%
Annual deviation since inception	8.12%	9.76%
Sharpe ratio	0.36	0.32
Maximum gain	26.21%	26.36%
Maximum drawdown	-19.02%	-22.26%
Positive months	77.27%	76.36%

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
30/09/2006	01/10/2006	35.92	35.92
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

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%	0.63%	-0.18%	1.43%			
B'mark 2006	0.96%	0.78%	-0.23%	1.16%	-1.12%	-3.61%	0.68%	0.04%	1.36%			
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%