

PORTFOLIO MANAGER COMMENTARY

The fund began the year with a strong quarter. It has outperformed its benchmark by 1.1% p.a. over a rolling 3-year period (7.2% versus 6.1% p.a.) and 1.3% p.a. over a rolling 5-year period (17.7% versus 16.4% p.a.). The fund is one of the top performing funds in its sector over all meaningful periods.

Equity market returns have been excellent, with the All Share Index returning 19.9% and 17.1% p.a. over the last five and ten years respectively. Put differently, investors have earned approximately 2.5 and 5 times their capital over the five and ten year periods. While many have become accustomed to earning such handsome returns, it truly has been an exceptional period where both global and local markets (more so) benefitted from a very asset-friendly environment. Given this context, we believe the next few years will be more challenging and returns more muted. This environment should favour the patient, long-term investor who is disciplined and valuation-driven.

We reduced our aggressive overweight equity position towards the latter part of 2009 on the back of strong market returns and now hold what we consider a neutral equity exposure. Despite this profit-taking, equities remain our preferred asset class for producing inflation-beating, long-term returns. We continue to believe that global equities are more attractive than local equities and given the continued strength of the rand investors are currently afforded an excellent opportunity to diversify their portfolios. We have taken full advantage of this opportunity across client portfolios.

The All Share Index returned 4.5% for the first quarter of 2010. Financials led the market with a 9.9% return, while industrials returned 4.4% and resources 2.1%. We remain underweight resources with the view that the upside to long-term valuations, based on mid-cycle earnings, is not attractive enough to justify higher exposures. Notwithstanding this view, we believe Sasol presents a good opportunity given its long-life assets, low cost base and the favourable long-term fundamentals of oil as a commodity. We have started adding to our AngloGold position. While gold and platinum producers are experiencing enormous cost pressures (labour and electricity), we believe that this is adequately discounted in the AngloGold share price. Further, one is not currently paying for the optionality of a weaker rand and future growth projects, which if successful, could be company transforming.

Banks led the financial index upwards returning 12.2% for the quarter. Despite the recent run banks remain attractive, trading at price-to-book ratios of 2 and forward price earnings ratios of 10. South African banks remain well-capitalised and offer good earnings growth prospects driven initially by an unwinding of the impairment provision and followed by advances growth as consumers respond to lower interest rates.

While the rand remains very strong in the short term, we continue to believe the risks are heavily skewed to the downside. Industrial South Africa is not competitive at these levels. Also, at some point, the excessive global financial stimulus has to be withdrawn and global interest rates will have to be raised. This will reduce the attractiveness of the carry trade currently on offer, placing further pressure on the rand. The portfolio remains skewed towards rand-hedge counters that we consider to be attractively valued, such as MTN, Naspers, SABMiller, Richemont and Bidvest. These companies are globally diversified with best-in-class business models that should benefit from a depreciating rand.

Within industrials, we believe it will be a challenge for the average domestic company to defend its real earnings. Consequently, we remain defensively positioned with holdings in the Spar Group, Shoprite Holdings and AVI. The earnings of these companies are more bankable than the average industrial company and while one does pay for this certainty, the premium is not excessive. As highlighted in previous commentary, we continue to find value in small caps. Although small caps have recovered significantly off the lows of March 2009, many quality companies with good franchises can be acquired at 6 times our assessment of normalised earnings.

MTN remains the largest individual position in the fund. Almost two years have elapsed since we started building the position in 2008; disappointingly the share price is around the same nominal level. Sometimes the market takes time to assess the long-term fundamentals of an investment; in such a case it is the job of the rational investor to remain focused and patient. The news flow surrounding MTN has been poor. First there was the uncertainty and subsequent collapse of the Bharti deal. We were not in favour of the proposed transaction as the indicative price range undervalued MTN and payment was partly in Bharti shares, a company we consider to be fairly valued. Secondly, post the failed transaction Bharti acquired Zain's African operations, allowing it to enter the lucrative Nigerian market. Bharti is well-capitalised and presents a credible competitor to MTN. We believe concerns over MTN's ability to defend its earnings in Nigeria has been more than adequately discounted in the current share price and remain convinced that the competitive advantages this group enjoys remain intact.

The bond market had a good quarter with a return of 4.4%, outperforming cash which returned 1.8%. We remain underweight bonds as we believe that current yields do not compensate investors for upside risks to inflation and the yield pressure from heavy issuance expected in the future. We currently own corporate bonds where spreads are still above our assessment of normal levels. We also find value in inflation-linked bonds given our view that there is upside risk to inflation expectations over the next few years given the significant cost pressures being experienced by the average South African company (high wage settlements and electricity price increases). Listed property enjoyed a very strong quarter, returning 9.9%, despite de-rating relative to bonds. At current levels, property offer reasonable value with good prospects of real distribution growth over the medium term.

In conclusion, markets are likely to remain volatile and challenging for some time to come. As a long-term investor, this is not bad news as volatile markets often create opportunities when emotion trumps reason. We look forward to capitalising on these opportunities.

Portfolio managers

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