ELECTUS
EQUITY SPECIALISTS

Neil Brown &
Richard Hasson I Boutique Heads

Quarterly Strategy Note | August 2011

Total Returns to end of July 2011	1-month	3-month	6-month	1-year	3-year p.a.	5-year p.a.
JSE SWIX (J403)	-1.5%	-3.8%	2.5%	13.1%	8.9%	12.3%
JSE All Share (J203)	-2.0%	-4.7%	0.7%	13.1%	7.0%	11.3%
JSE Resources (J258)	-4.5%	-10.1%	-7.0%	9.0%	-2.2%	7.6%
JSE Financial (J580)	0.1%	-0.3%	7.9%	21.3%	16.6%	17.3%
JSE Industrial (J257)	-1.6%	-3.2%	1.9%	4.5%	9.7%	7.3%
USA S&P 500 (ZAR)	-3.1%	-3.2%	-5.5%	9.4%	-0.4%	1.3%

Economic Indicators	31-Jul-11	30-Apr-11	31-Jan-11	31-Jul-10	31-Jul-08	31-Jul-06
R/$	6.71	6.59	7.18	7.30	7.30	6.93
Prime Interest Rate	9.0%	9.0%	9.0%	10.0%	15.5%	11.0%

Sources: Deutsche Bank and Morningstar

EXCESS RETURN IS WHAT HAPPENS WHEN PREPARATION MEETS OPPORTUNITY

As you will recall from previous Strategy Notes and interactions with ELECTUS, we construct focussed portfolios – picking the best shares on a bottom-up and an unconstrained basis to build well-diversified portfolios that offer the best risk-adjusted returns for our clients. In this Strategy Note we explain why we are seeing great opportunities emerging for additional excess returns, and how we have positioned our client portfolios to benefit from these opportunities.

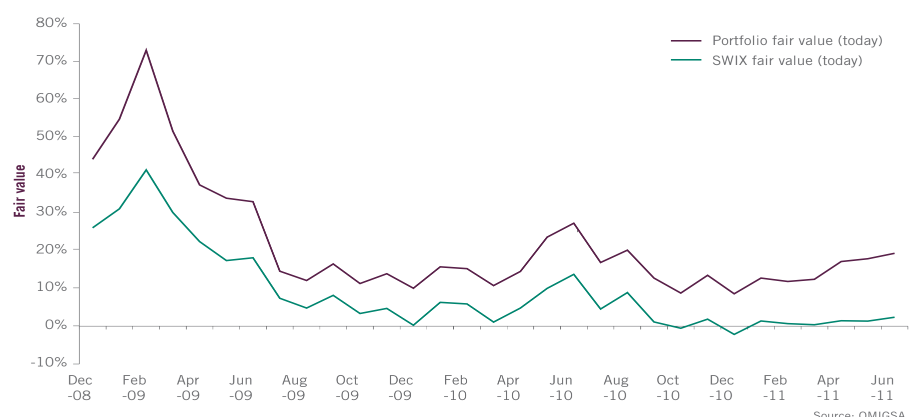
As a starting point, it is fair to say that there are not always opportunities in the market to generate large levels of additional excess return. During these periods in the market cycle it is not worth taking additional portfolio risk if there is not a reasonable likelihood of getting additional risk-adjusted returns. Therefore, for us at ELECTUS, ***opportunity*** leads to appropriate ***risk-taking*** in client portfolios, which leads to ***excess returns*** (assuming we get it right).

The key method that we use to try and understand the potential excess-return opportunities in the market is first to understand what each company is worth and then to rank the particular opportunity set. First, our 15 equity analysts build detailed financial models forecasting profitability and cash-flow generation for almost all of the largest 160 companies that make up the FTSE/JSE Shareholder Weighted Index (SWIX). We use these cash-flow forecasts to value each of these companies, arriving at an absolute value (termed fair value) per share today. Using this methodology we believe that MTN, for example, is currently worth R150.

To improve certainty to these valuations, we cross-check them by using other measures, such as Return on Equity versus Price:Book value. Applying each of these company valuations to the weight of each share in the SWIX allows us to build up a fair value for the SWIX today.

Based on these valuations, Chart 1 shows that the best opportunity to buy the SWIX was at the end of February 2009, when we believed the SWIX had 40% immediate upside. Interestingly, if you grow this 40% upside at the end of February 2009 by 13% per annum (which is the approximate discount rate of return that you would have expected), it would result in an expected return of around 85% by the end of June. If you compare that to the 80% that the SWIX actually returned over the period from February 2009 to 30 June 2011, you get a return that is reasonably similar, in aggregate, to what we were forecasting back in February 2009.

Chart 1: Calculating fair value reveals opportunity (31 December 2008 to 30 June 2011)

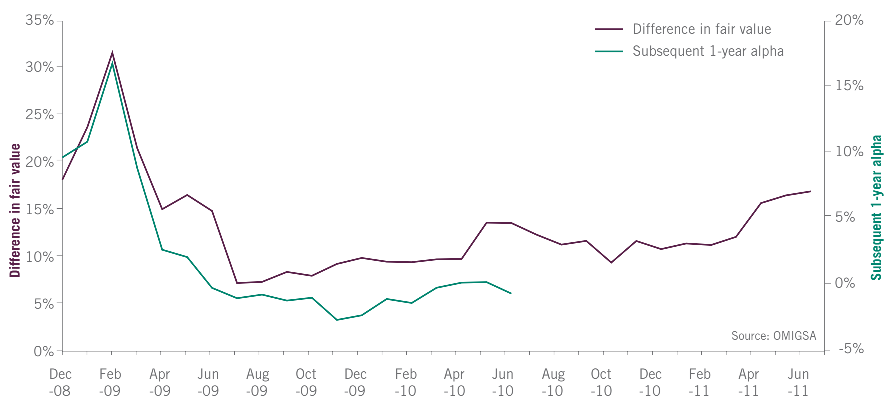


What is also interesting from Chart 1 is the difference between our own portfolio's upside to fair value and the benchmark's (SWIX) upside to fair value. This difference is again shown in Chart 2, essentially highlighting how divergent the valuation of each share was through that period, and hence our ability to position the portfolio for potential excess returns compared to that of the market, as represented by SWIX.

Difference in fair value reveals opportunity

As you can see from this chart, there are times when the market offers investors lots of additional opportunity for excess return from a fundamental bottom-up valuation perspective. We believed that this was the case in February 2009 and positioned the portfolio accordingly. As the green line in the chart shows, we managed to extract excess returns compared to the market of 16% from 1 March 2009 to 28 February 2010. However, in capturing this excess return over time, many of the shares that we felt were undervalued increased relative to SWIX (like Anglo American, BHP Billiton, Richemont), while many that we felt were overvalued decreased relative to SWIX (for example, SABMiller and British American Tobacco). What this showed us is that by the time we got to the end of 2009, there were significantly fewer opportunities for excess return compared to the market (SWIX) than there were in March 2009. The chart also shows why we believe that numerous opportunities for generating excess returns currently exist – as this is the highest difference in fair value (portfolio less SWIX) since early 2009.

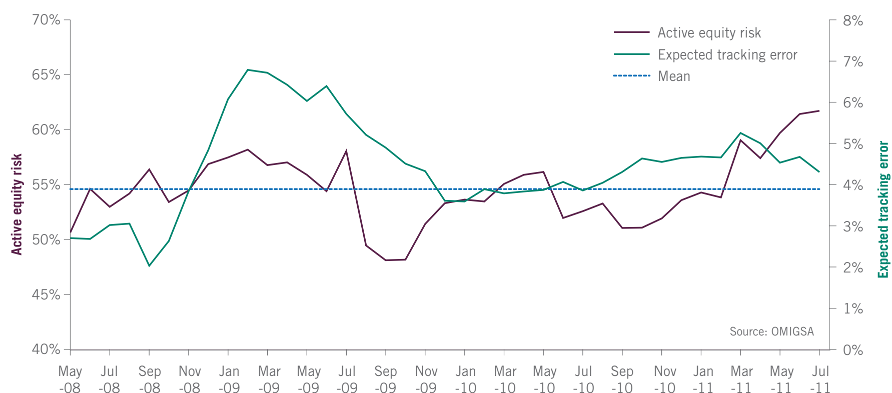
Chart 2: Percentage difference in fair value (portfolio less SWIX) and subsequent realised 1-year alpha



Opportunity leads to risk-taking

One measure that we use to measure the level of risk in our portfolio relative to the market, is tracking error. Chart 3 shows how our tracking error increased to 7% in February 2009, following our belief that since there was the potential for large excess returns, we were happy to position our client portfolios to take on the additional portfolio risk. Keep in mind there is no free lunch in equity markets – you have to take additional risk to earn additional returns. From the chart you can also see that from late 2009 we decreased the high level of tracking error – remembering that it is only worth taking additional portfolio risk if there is the opportunity for additional portfolio returns, and we saw less opportunity for massive excess returns during that period.

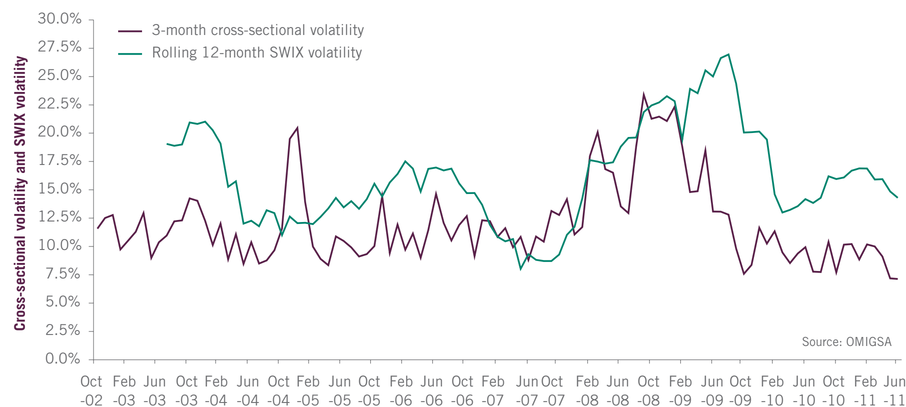
Chart 3: Active equity risk has increased as we are finding more opportunities for excess return, but tracking error has declined due to lower market volatility



Another way we measure portfolio risk is to look at the active equity risk in the portfolio. We define this measure by taking the weight of each holding in the portfolio less the weight of that share in the benchmark. This essentially shows us our overweight or underweight position in each share compared to the market. We then add up all of the overweight positions to get the active equity risk in the portfolio. You can see from Chart 3 that our current active equity risk has now risen to a higher level than that in early 2009, which was the last time we saw large opportunities for excess returns in our market.

What is interesting from Chart 3 is that despite our taking on more active equity risk over the last few months, the expected tracking error has actually been declining. The answer to this lies in Chart 4, which looks at volatility.

Chart 4: 3-month cross-sectional volatility (alpha relative to the SWIX) and rolling 12-month SWIX volatility



The final measure of risk/return potential is market risk behaviour. For this we look at two drivers: Firstly, equity market volatility (we use SWIX volatility to show this) and, secondly, cross-sectional volatility. For cross-sectional volatility we have taken the 65 largest shares in the SWIX (which account for 90% of the index) and then calculated the three-month excess return relative to the SWIX for each of these shares at each date. At each date we calculated the standard deviation of the corresponding excess returns on that date. This gives us an indication of the spread of excess returns, and of the potential excess return for a portfolio: The greater the cross-sectional volatility the greater the opportunity of excess return.

Interestingly, we are now at the lowest cross-sectional volatility point to date, suggesting that in recent times there has not been a good opportunity for large excess (or large negative) returns. The various asset consulting surveys also show a similar excess-return profile over the 12 months to the end of June 2011. Of the 36 equity non-benchmark cognisant funds, only three earned excess returns against the benchmark above 4%, while 24 funds were within 4% of the benchmark and nine funds underperformed the benchmark by more than 4%.

The key message from Chart 4 is that there may be times when portfolio managers believe that additional excess returns are available but, in the short term, the market does not allow this to occur due to low cross-sectional volatility, i.e. shares are moving together more closely with fewer major winners/losers. We believe that over the last 18 months we have been through a period of lower opportunity to earn excess returns (based on fundamental valuations) and also lower cross-sectional volatility – hence our portfolios have shown returns in line with the overall market despite our taking on some additional risk (in the form of a tracking error at around 4% and active risk greater than 50%).

In conclusion, we believe that we are starting to see some very good opportunities to earn returns in excess of the SWIX for our clients – evidenced by the difference between portfolio fair value and SWIX fair value in Chart 2. For this reason, we have started to take on additional risk in our portfolios, shown by active equity risk in Chart 3, and we expect market volatility and cross-sectional volatility to increase off the current low levels seen in Chart 4, allowing excess returns to be earned for our clients over the medium term.

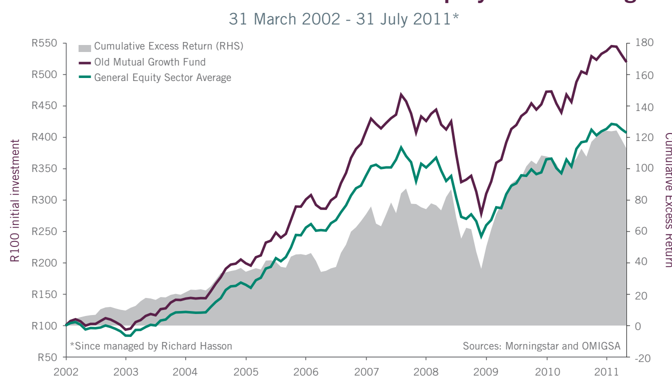
Opportunity leads to appropriate risk-taking which leads to excess returns

Portfolio strategy and recent fund activities

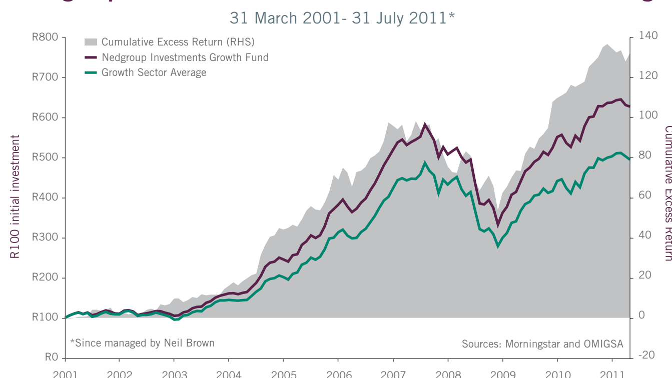
- We are currently positioned with large weightings in **mining** shares. Our preference is for the lower-risk diversified miners, as well as for single commodity companies that have long-life, high-quality reserves, and that are also low-cost producers within their peer group globally. In the last quarter, we continued the recent switch by buying more Lonmin and reducing Impala Platinum.
- Within the **industrial** sector, we have selectively reduced our exposure to the more defensive industrials, but remain underweight to cyclical industrial companies, such as the credit retailers. We also have a preference for taking rand hedge exposure through quality shares, such as MTN, Naspers and Trencor, rather than through the more expensively priced Richemont and SABMiller. In the last quarter, we added to our holdings in Netcare as we believe the market is placing a very low valuation on their UK business. We funded this by selling out of Life Healthcare, which has added value to the portfolio since its listing last year.
- Within **financials**, we have increased our weighting in banking shares as we believe they are high-quality businesses that are once again offering value. Old Mutual is our preferred holding in the life assurance sector as we believe it will unlock substantial value through its restructuring initiatives. In the quarter, we added to the more attractively valued ABSA, Standard Bank and Investec plc and sold the fully valued FirstRand.

Our portfolios are even more focused than their previous positioning and currently hold between 25 to 35 shares, with the top 10 shares contributing over 60% of the fund value. We believe our portfolios are well positioned relative to the market should there be a volatile global economic period ahead, similar to that experienced in the second half of 2008. The companies held in the portfolios have significantly lower levels of financial gearing and our holding in the NewGold ETF, a proxy for the rand gold price, provides a very useful portfolio diversification tool. As mentioned earlier, an increase in volatility should create opportunities for excess returns. As per our policy, the funds continue to maintain low effective cash levels.

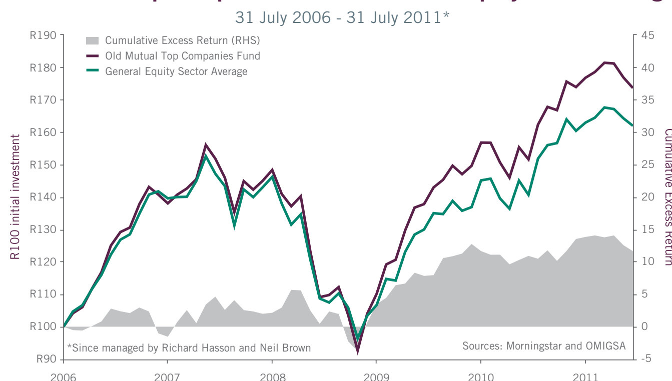
Old Mutual Growth Fund vs General Equity Sector average



Nedgroup Investments Growth Fund vs Growth Sector average



Old Mutual Top Companies Fund vs General Equity Sector average



For more information on ELECTUS or to read previous editions of our Strategy Notes, visit www.electus.co.za.

Figures sourced from Morningstar, OMIGSA and I-Net. Products do not provide any guarantees against capital losses. Market fluctuations and changes in rates of exchange or taxation may have an effect on the value, price or income of investments. Since the performance of financial markets fluctuates, an investor may not get back the full amount invested. Past performance is not necessarily a guide to future performance. Unit trust figures are based on a lump sum, using NAV-NAV prices with income distributions reinvested. Unit trusts are generally medium- to long-term investments. The value of your units may go down as well as up and past performance is no indication of future growth. Unit trusts can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from the management company, Old Mutual Unit Trust Managers Ltd. You can easily sell your investment at the ruling price of the day (calculated at 15h00 on a forward pricing basis). Old Mutual Unit Trust Managers Ltd is a member of the Association for Savings & Investment SA.

Old Mutual Investment Group (South Africa) (Pty) Limited is a licensed financial services provider, FSP 604, approved by the Registrar of Financial Services Providers (www.fsb.co.za) to provide intermediary and advisory services in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. Old Mutual Investment Group is a wholly owned subsidiary of Old Mutual South Africa Limited. Reg No 1993/003023/07.

August 2011

ELECTUS
MUTUALPARK, JAN SMUTS DRIVE, PINELANDS 7405
PO BOX 878, CAPE TOWN 8000, SOUTH AFRICA
TEL +27 (0)21 509 5022, FAX +27 (0)21 509 5025
WWW.ELECTUS.CO.ZA

ELECTUS
EQUITY SPECIALISTS