ELECTUS

EQUITY SPECIALISTS

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Quarterly Strategy Note | December 2011

Total Returns to end of November 2011	1-month	3-month	6-month	1-year	3-year p.a.	5-year p.a.
JSE SWIX (J403)	2.0%	6.1%	3.5%	12.5%	19.6%	10.1%
JSE All Share (J203)	1.6%	7.1%	2.5%	11.7%	18.8%	9.5%
JSE Resources (J258)	2.1%	8.3%	-1.0%	6.6%	14.5%	6.9%
JSE Financial (J580)	1.5%	7.6%	6.3%	17.1%	24.7%	14.5%
JSE Industrial (J257)	0.8%	3.6%	1.3%	10.3%	15.8%	4.8%
USA S&P 500 (ZAR)	2.0%	18.7%	10.7%	22.3%	5.6%	1.8%

Economic Indicators	30-Nov-11	31-Aug-11	31-May-11	30-Nov-10	30-Nov-08	30-Nov-06
R/$	R8.10	R7.00	R6.83	R7.09	R10.07	R7.18
Prime Interest Rate	9.00%	9.00%	9.00%	9.00%	15.50%	12.00%

Sources: I-Net and Morningstar

WHEN DOES A QUALITY DEFENSIVE BUSINESS NOT OFFER VALUE?

At ELECTUS, our desire is to own quality businesses. Why then do our client funds currently not hold quality defensive companies like SABMiller, British American Tobacco and Shoprite, but rather invest in quality cyclical companies like Anglo American, Trencor and Italtile?

Since the ELECTUS boutique was established in August 2006, we have always been very clear that we invest in a disciplined and focused manner based on our well-defined investment philosophy of **"striving to buy into high quality businesses at prices that are low compared to their long-term investment value"**.

In our August 2010 Strategy Note, we explained in detail how we define a quality company and why we always want the vast majority of our client funds to be invested in these shares.

With these positive "quality" characteristics being so rewarding, we have a strong bias towards quality businesses. However, the question could be asked: "Why then does ELECTUS not only hold quality businesses in their client funds?"

The price factor is key for future returns

The simple answer is that if all the quality companies (as set out in the criteria alongside) were very attractively valued, we would only buy quality companies. However, equity investing is not that simple and a key part of long-term equity returns lies in the price you pay when buying shares. If quality shares are overpriced and expensive when you buy them, it is very difficult to achieve good medium to long-term returns.

In South Africa, we believe that the current uncertainty in global economies and markets has led to the position where the best quality defensive businesses are so sought-after that their share prices have been pushed to levels that we believe are unsustainably high. This situation is remarkably similar to late 2008 when, post the global financial crisis, shares in quality defensive companies became very expensive. In late 2008 we switched (possibly a few months too early) into more quality cyclical companies, such as Anglo American, BHP Billiton and Richemont, where we believed the valuations were very attractive. We subsequently had excellent performance for the year following February 2009.

In this Strategy Note, we discuss why we do not own certain high quality, defensive businesses like SABMiller, British American Tobacco and Shoprite, but rather prefer to own high quality, but slightly more cyclical businesses like Anglo American, Trencor and Italtile.

It's important to pay the right price for quality defensive businesses

Three of the very best defensive industries are beer, tobacco and food. No matter how well, or badly, local or global economies are performing, people are predictable and consistent regarding their drinking, smoking and eating habits. Therefore, whenever there is economic and market uncertainty, as we currently have in developed economies and mainly in Europe and the USA, investors have a very strong desire to own good quality

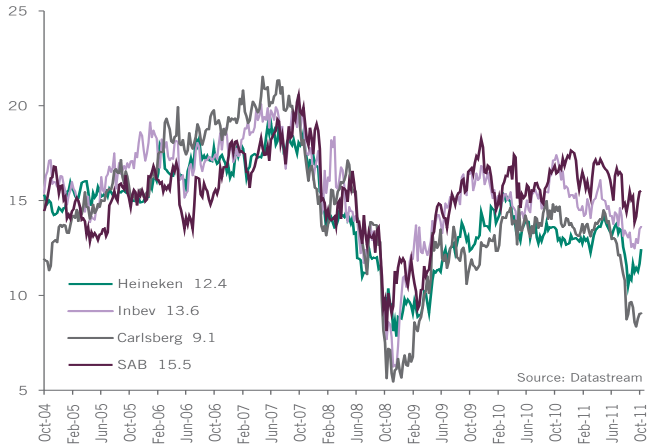
Characteristics of a QUALITY company

1. The ability to generate a return-on-capital that is above its cost of capital;
2. Above-average long-term profit, cash flow and dividend growth rates;
3. The ability to self-fund their normal growth path and possibly do value-accretive acquisitions through a suitable level of debt funding;
4. High-quality management teams with proven track records and good capital allocation skills; and
5. Above-average barriers to entry in their industries, with sustainable competitive industry advantages, for example, SABMiller in South Africa.

beer, tobacco and food businesses. This herding of investment behaviour has led to quality beer, tobacco and food companies (like SABMiller, British American Tobacco and Shoprite) being pushed to expensively-priced share levels, which we believe are overpriced and offer no value.

SAB Miller considered expensive vs peers

European brewers 12-month forward P/E



In the case of Shoprite, the management have done a superb job over the past 10 years, and it has been a far superior share to Pick 'n Pay. However, Shoprite's margins are at an all-time high and they have sweated the business as hard as possible – leaving very little room for the future positive surprises that we believe would be necessary to justify the current share price.

Shoprite P/E ratio relative to the FTSE/JSE All Share Index P/E ratio

Weekly data: June 2005 to December 2011

These companies have proven to have all the "quality" characteristics that we look for and, if attractively priced, we would love to own a great deal of them in our client funds. However, the above charts show how expensive these companies are relative to their own history, their peer groups and their markets.

Diversifying and buying undervalued quality cyclical businesses

We believe that equity fund management requires diversification of macro drivers such as commodities, currencies and interest rates and therefore, by not owning these overpriced beer, tobacco and food businesses, we need to find some attractively priced businesses that are of a high quality and can give our client funds this necessary diversification. There are many quality shares that we own in our client funds that offer good value, but a few of these warrant further discussion: Anglo American, Trencor and Italtile.

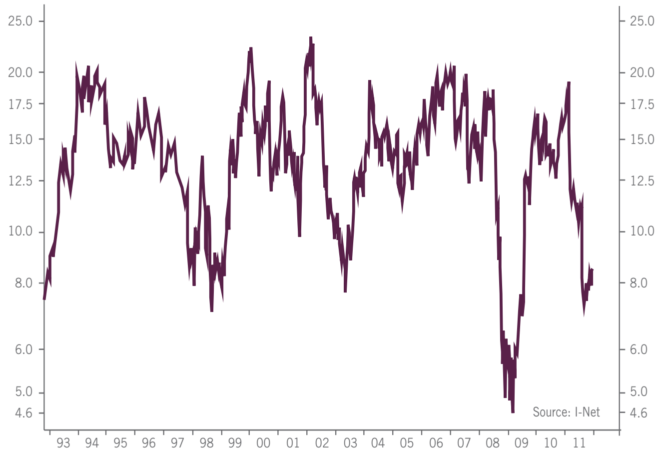
We have, for some time now, been suggesting that Anglo American is undervalued. It displayed poor capital allocation from 2006 to 2008, overpaying for acquisitions and buying back shares when they were too expensive. However, over the past few years it has improved in many areas, including:

- appointing a highly competent new chairman and restructuring the mix of board members (through retirement and adding appropriate skills);
- identifying those commodities that are "core" and well-positioned on the "cost curve" and those commodities that are "held for sale";
- cutting costs and moving down the production "cost curve" at Anglo Platinum, the global leader in platinum production;
- cutting down the size of the head office team in London and ensuring that the Exco members in charge of the different commodities are operating nearer to the mines;
- improving procurement and asset optimisation, each by a sustainable US$1bn per annum; and
- clearly defining the project pipeline with tough, but realistic timeframes.

As one of the very best diversified mining houses, Anglo American has exposure to several commodities, such as iron ore, manganese, copper, platinum, diamonds, coal and nickel, and it operates in various geographies, including South Africa, Botswana, Brazil, Chile, Columbia and Australia. With the share price currently around 31500 cents per share (cps), we believe that Anglo American is worth 44000 cps. It therefore provides our clients with exposure to a leading mining house diversified by commodity and region and, importantly, it trades at a sizeable discount to its fair value.

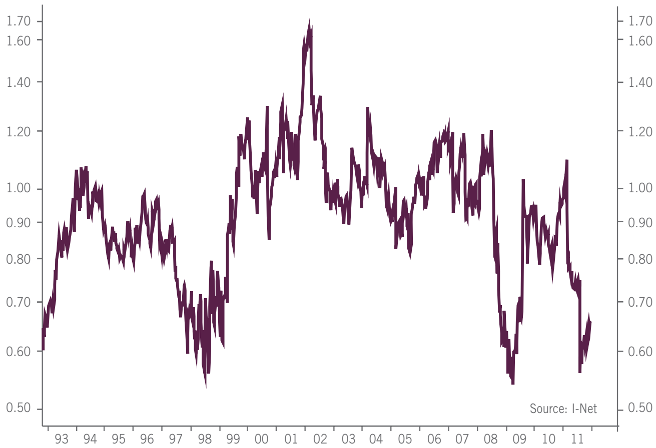
Anglo American P/E ratio

Weekly data: October 1992 to December 2011



Anglo American P/E ratio relative to the FTSE/JSE All Share Index P/E ratio

Weekly data: October 1992 to December 2011



Another rand-hedge share that is not nearly as well-known as Anglo American, but is in the top 10 shares in our client funds, is the low-profile steel container business, Trencor. Originally a road transport company in the Northern and Western Cape, Trencor's history goes back 80 years. Over the years, it has evolved into a global leader – owning, managing and leasing steel containers through its 61% owned stake in the New York Stock Exchange-listed company, Textainer. On the back of ever increasing global trade, these 20 to 30 foot steel containers are used to move goods around the world and are seen daily on the back of trucks and in all harbours where ships load and unload containers. Founded in 1979, the key attractions of Textainer's business include:

- Being one of the world's largest owner, manager and lessor of steel containers;
- A fleet of almost 2 million steel containers, of which about 50% are owned and 50% are managed for third parties;
- Long-term (±7 year) leases on 78% of its total fleet, to about 400 shipping lines and other lessees;
- An average fleet utilisation of more than 98%;
- Bad debt expenses have average around 1% of revenues over past three years;
- A conservatively-managed and under-geared business;
- They have consistently generated returns well above their cost of capital; and
- Trading on a price/earnings ratio of 7.4 times and a dividend yield of 5.7% (as at December 2011).

Over the past five years, Trencor has become increasingly focused; selling non-core businesses, listing Textainer in the USA in October 2007 and unbundling its pyramid/holding company, Mobile in February 2011. This means that Trencor has become much easier to accurately value, with its 61% listed stake in Textainer, a long-term debtor's book (receivables from container sales and leases, with an extremely low level of bad debts) and a small amount of cash.

The table below shows why we find Trencor, currently priced at 3625 cps, to be such an attractive investment. It shows our "sum of the parts" valuation of Trencor – indicating a value for Trencor of 4682 cps, based on the current ZAR/US$ exchange rate of 8.07 and the current market price of $26.11 for Textainer; and a value of 5695 cps, when valuing Textainer at our analysts' value of $33.56.

TRENCOR Sum of Parts (SoP) calculation	Value of Trencor's portion (Rm)	% of total Sum of Parts	Value (cps)
Textainer	6 272.8	75.8%	3550.6
Total listeds	**6 272.8**	**75.8%**	**3550.6**
Present value of the Debtors Book, less provisions	1 420.1	17.2%	803.8
Cash at the centre	579.0	7.0%	327.7
Total debtors and cash	**1 999.1**	**24.2%**	**1131.6**
Total Sum of Parts (SoP)	**8 271.9**	**100.0%**	**4682.2**
	Tex Price	**ZAR / US$**	
Trencor valued with Textainer at spot price	**$26.11**	**R8.07**	
Trencor valued with Textainer at analyst price	**$33.56**	**R8.07**	

Discount calculation	
Total Sum of Parts	**R8 271 934 572**
Trencor market cap	R6 404 215 399
Trencor net shares in issue	176 668 011
Trencor spot SoP (cps)	4682
Trencor share price (cps)	3625
Discount per share (cps)	1057
Discount % of spot SoP	**-22.6%**
Trencor SoP (cps) (analyst price)	5695
Trencor share price (cps)	3625
Discount per share (cps)	2070
Discount % of analyst SoP	**-36.4%**

Source: OMIGSA

An undiscussed, high quality, family controlled retailer

The final share we wish to discuss is Italtile, the largest retailer of tiles in South Africa through its top-end brand, Italtile, middle-market brand, CTM, and entry-level brand, TopT. Italtile is held in our client funds and is one of very few South African retailers where we can find a market-leading quality business that is not overpriced. While we believe that businesses like Shoprite and the clothing retailers are overpriced, our quality holding in the fairly-priced Italtile provides us with diversification and exposure to the South African consumer.

Italtile was founded over 40 years ago by Giovanni Ravazzotti, who is still the largest shareholder in the company. As discussed in our April 2011 Strategy Note, we have a positive bias towards companies where founders, key directors and management are large (personal) owners of shares (and not just through share options). We believe that if the founders, directors and management hold large stakes in the companies where they work, their capital-allocation decisions will be good and aligned with our clients, as shareholders. This gets back to one of the points we listed upfront as a characteristic that quality companies should have.

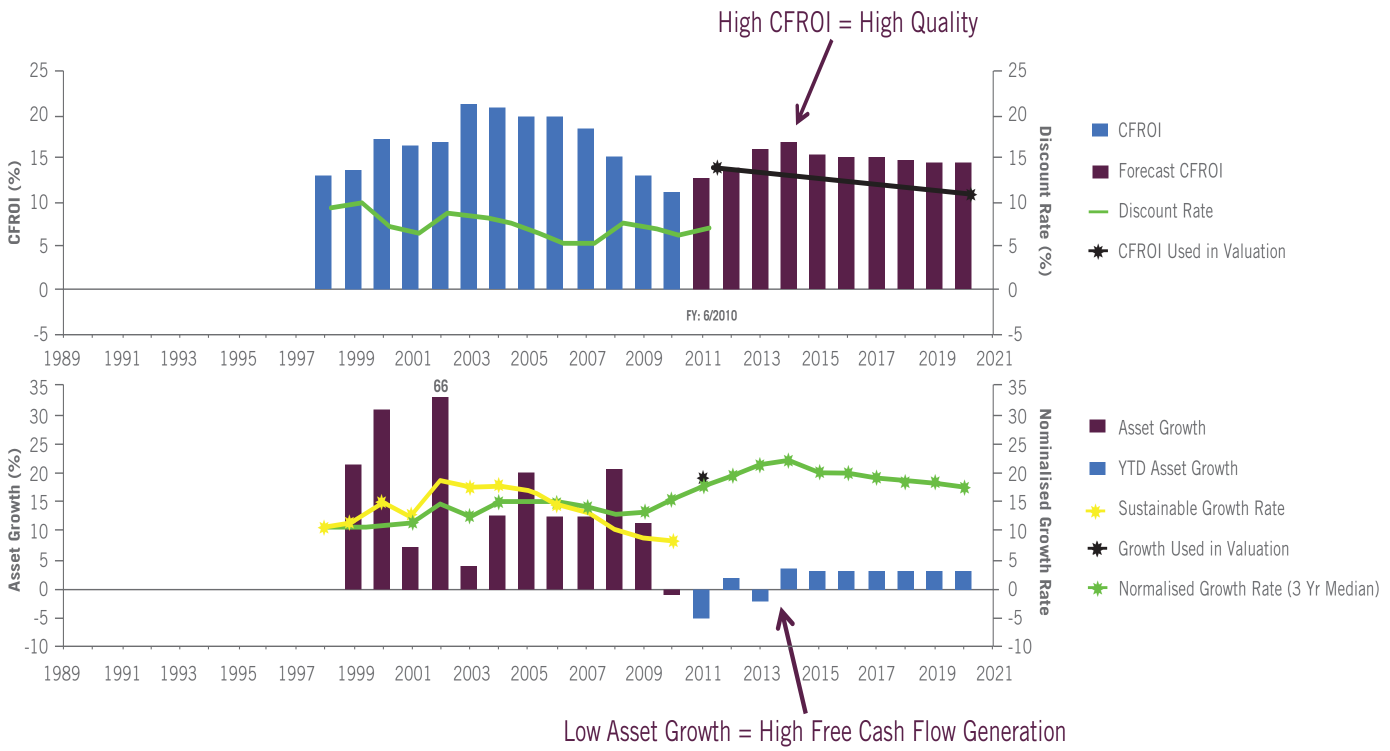
Besides the ownership by the founders, directors and management; there are many other reasons why we like Italtile and have it as an investment in clients' funds:

- They have 35% of the tile market and 18% of the sanitary market.
- Italtile has a niche focus compared to more generalist listed competitors.
- They have a very strong relationship, through their common shareholder, with the listed tile manufacturer Ceramic, enabling them to manage their supply chain exceptionally well.
- The franchise portion of the business allows them to spread the operating costs over a larger sales base without taking on all the investment.
- All of the above translates into high and stable operating margins.
- Their stock turns are best-in-class.
- Italtile's cash flows are particularly good, resulting in a large cash balance of around 80 cps.
- The book value of their properties is around R860m, but the estimated value is R1.3bn.
- They have consistently generated returns well above their cost of capital.

The following chart demonstrates Italtile's best-in-class positioning in the South African market.

The fact that companies not held in our client funds (namely, SABMiller, British American Tobacco and Shoprite) are quality defensives, and those that our clients do own (Anglo American, Trencor and Italtile) are quality cyclicals, does not mean that we invest in a thematic or style basis. Our disciplined ELECTUS investment philosophy, which we have written about in previous Strategy Notes, leads us to buy or sell shares based on their long-term valuations. Currently the shares that offer the best value just happen to be quality cyclicals, while the quality defensives are generally overpriced. In summary, a quality company must be priced right in order for it to generate appropriate long-term equity returns for our clients.

ITALTILE: trading close to fair value of 490cps



Source: HOLT

Portfolio strategy and recent fund activities

Resources

- We are currently positioned with large weightings in mining shares, with a preference 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 reduced our holding in BHP Billiton as it approached our fair value and we also halved our exposure to the NewGold ETF, which is effectively the rand/gold price. The defensive holding in the gold ETF has contributed very strongly to both absolute and relative returns and we have invested the proceeds into AngloGold Ashanti, which we believe offers value for the first time in many years.

Industrials

- Within the industrial sector, we have selectively reduced our exposure to the more defensive industrials, but remain underweight 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 both the existing positions in Trencor and Netcare, which offer good value, as well as introducing a new holding in AECI, a diverse South Africa industrial business that is very undervalued.

Financials

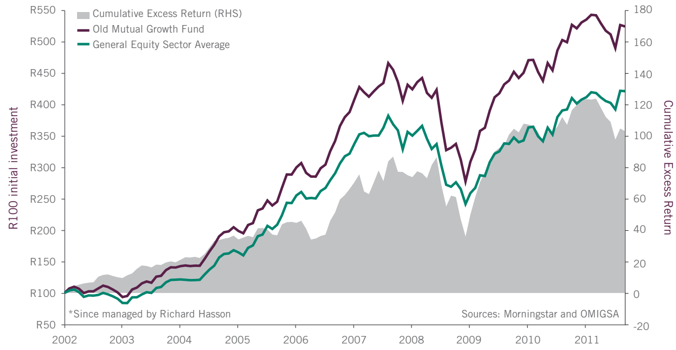
- Within financials, we reduced our weighting in ABSA as it approached our fair-value level. Following a period of underperformance and a re-focusing of the business, Standard Bank is now our preferred bank. We continue to favour Old Mutual in the life assurance sector, as we believe it will unlock substantial value through its restructuring initiatives.

Current Fund Positioning

Due to our increasingly high conviction regarding the attractiveness of our preferred shares the portfolios are even more focused than their previous positioning. The funds currently hold between 25 to 35 shares, with the top 10 shares contributing over 60% of the each fund's value. As per our policy, the funds maintained low effective cash levels throughout the period.

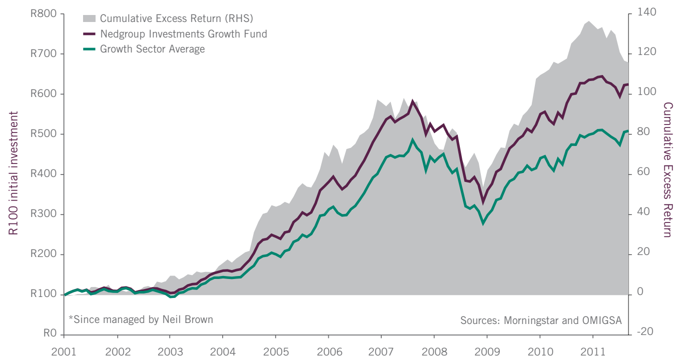
Old Mutual Growth Fund vs General Equity Sector average

31 March 2002 - 30 November 2011*



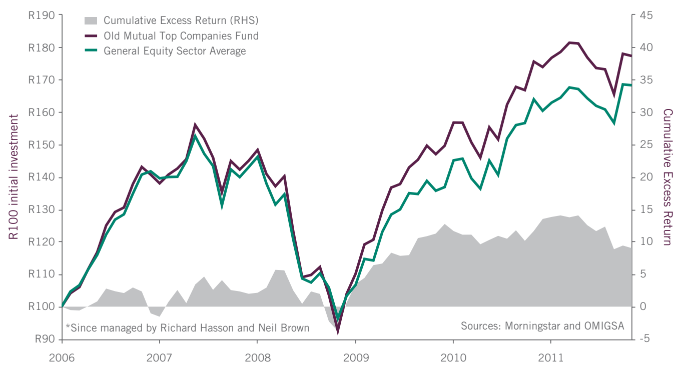
Nedgroup Investments Growth Fund vs Growth Sector average

31 March 2001 - 30 November 2011*



Old Mutual Top Companies Fund vs General Equity Sector average

31 July 2006 - 30 November 2011*



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

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