

RE:CM

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THE new *NEW* ECONOMY: CHINA

The price of Billiton shares is up by 60% over the past year. The Nasdaq is up 33% and the Dow Jones index is up by 15%. Oh, yes – those are all US\$ numbers! For us here in SA, that is meaningless, as the Rand has appreciated by over 40% over the same period. What's going on?

For many years, the weak Rand was seen as a very safe one way bet to riches. Very many companies prided themselves on their highly efficient operating practices, when all they were doing was betting shareholders funds on a weak currency. Management (as well as the investment community) spent more time guessing the direction of the Rand, than managing their businesses (or investments). Not surprisingly, these so-called Rand hedge shares became the flavour of the day with the investment community. Now it is all change – the roost has been well prepared and the chickens are coming home!

How long can the Rands' strength continue? And what are the prospects for so-called Rand hedge shares?

In an attempt to answer this, one needs to understand the dynamics taking place in global markets. Needless to say, we can't say we understand it, but as usual we have a strong opinion, and as usual, we are more than willing to share this opinion with whoever will listen!

In short, we think the consensus looks something like this:

1. The US\$ prices of commodities are increasing rapidly, and will continue to do so.
2. This is because of two reasons: strong demand from China, as well as a very weak US\$.
3. At the same time, the current prices of commodities are, in most cases, well below their long term average, when expressed in real terms.
4. The combination of these factors is causing not only physical commodity prices, but also the US\$ price of commodity related shares, currencies and other assets to increase substantially.
5. Due to the incessant decline in the US\$, and an increase in global risk appetite, the SA Rand has risen to very overvalued levels, and will decline in the years ahead.

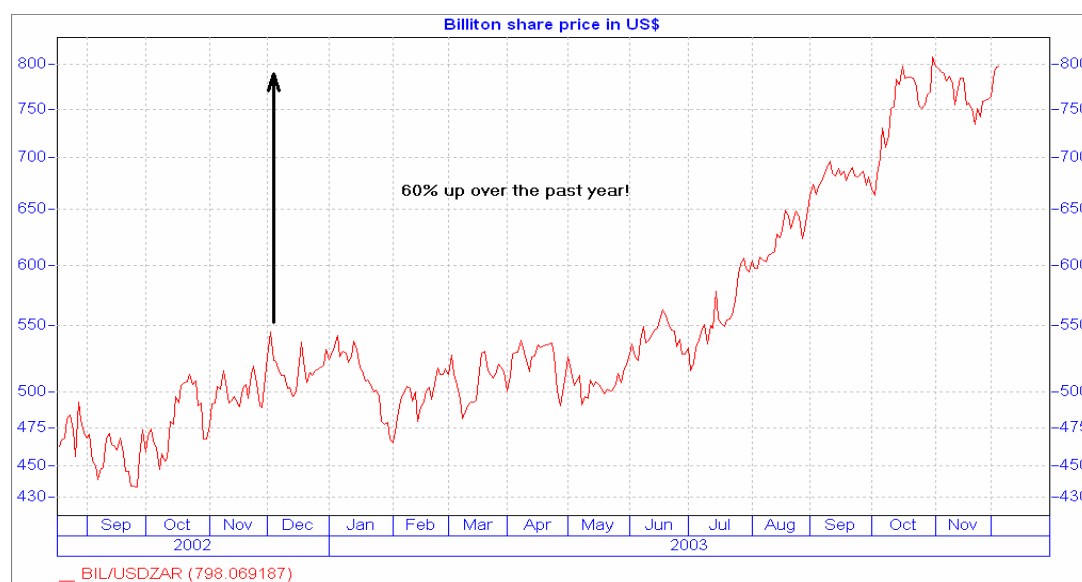
Investors are thus quite justified in enquiring why the exposure to resource stocks is low in portfolios managed by RE: CM. With exactly which points in the above (admittedly very superficial) analysis do we not agree?

Here's the thing: we agree wholeheartedly with all the points above!

We think China is exerting an inexorable force on the demand for certain commodities, and this step change that has taken place, serves to drive commodity prices higher. It could ultimately serve to drive commodity prices well above their long term average levels in real terms. In our opinion, there could be quite a boom in commodity prices (expressed in US\$, of course). The weak US\$ is another trend that we expect to continue going forward. The US administration, cheered on by Alan Greenspan, is debasing their currency consistently, by running the (monetary) printing presses non-stop. This is being done to ensure an economic recovery, and, some cynics would add, a re-election for George Bush. As long as this carries on, coupled with the huge “twin deficits” in the form of the budget and trade account, the US\$ will continue to weaken. In fact, if it were any other country’s currency, it would have collapsed by now.

The main support for the US\$ comes, ironically enough, from China, and the rest of Asia. They are running a huge trade surplus with the U.S. – and are recycling their surplus into US\$ denominated bonds. This ensures a consistent inflow on the capital account for the U.S., which balance out their current account deficit. If this recycling, stops, for any reason, the US\$ could be in even more trouble than it already is.

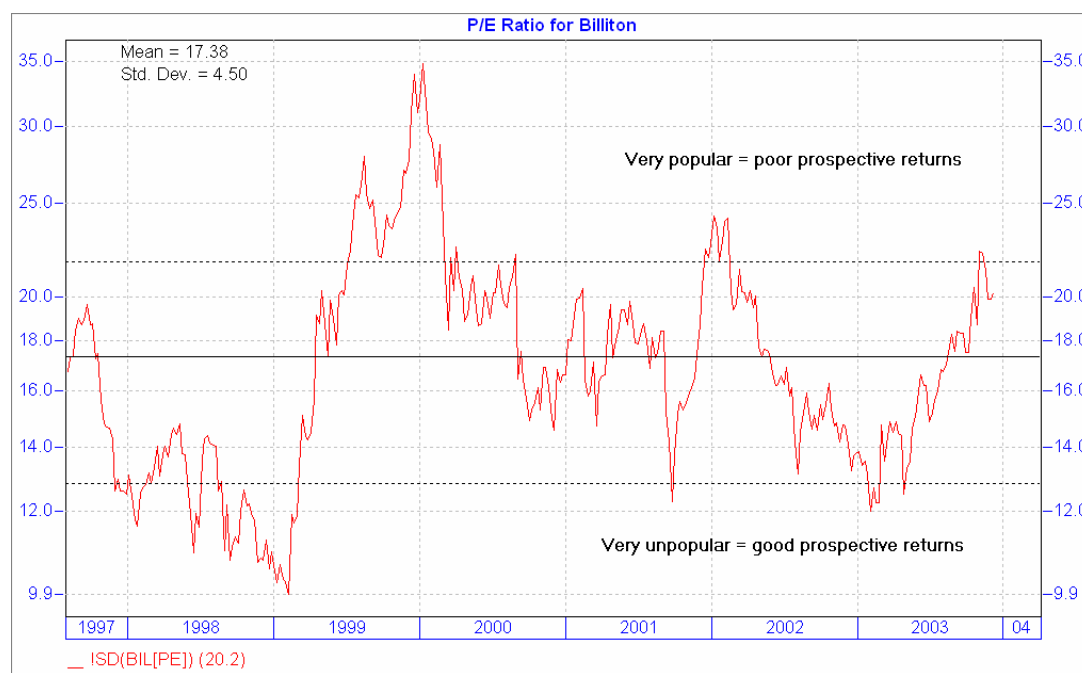
So far, so good. The reason we are not that positive on “Rand hedge” shares at this point is two-fold. The first is that our clients are SA based, and demand competitive Rand returns. It is no use investing in an asset that gives superior returns in a consistently devaluing currency. Remember when nobody wanted to buy SA assets, because of exactly this reason? Well, the shoe is on the other foot now! For instance, Billiton has outperformed the US market in \$ terms by at least 40% over the past year! The following chart shows how high the Billiton share price has risen, denominated in US\$ terms.



This phenomenal increase has not helped SA based investors. Billiton has gone sideways in Rand terms over the last year, and underperformed the local market! But that is history: we need to know where things will go from here.

Of course, a share price that has gone up by 60% means nothing, in itself. What is important – at least to investors who like to know the value of what they are invested in – i.e. is it cheap or expensive. The answer to this guides our actions, not the fact that the price has gone up a lot.

Billiton is currently priced on a P/E of 20. This, to say the least, is a very high P/E ratio. Investors are willing to pay R20 for R1 worth of earnings. This is not the sort of price that exceptional long term returns are made of! Although this is not a valuation tool as such, P/E ratios do contain good information about prospective returns. Very simply: high P/E, low prospective return. This is because high P/E's indicate a high level of popularity with the investing community. Now, once a stock becomes very popular, one would expect all the best news to have been priced in. The result: limited upside, with large downside risk. The following chart shows just how popular a stock like Billiton has become:



It seems to us, that commodity stocks in general have priced in the scenario we described earlier: high and rising commodity prices due to the combination of low current real price levels and strong Chinese demand. If anything were to happen to upset this scenario, there could be a lot of disappointment out there. We would prefer to avoid this potential disappointment. Not because we are forecasting it to happen, but because our clients are not being paid (i.e. in terms of a low share price) to take this risk. This is the classic suckers bet: If everything works out as expected, there is little upside. If there is any disappointment, there is big downside.

The “yes-buts” can chime in now, please! Ah, there they are - they are saying, yes, but what if the Rand depreciates to some sort of fair value (which we happen to believe is around R8,40 to the

US\$). In fact, the shares are already discounting a Rand of around those levels. Companies that are listed offshore, and use the US\$ as their reporting currency, should be valued in those terms. Once the appropriate US\$ valuation is determined, it can then be translated into Rand, using whatever the fair value level that one considers appropriate for the Rand.

In short, the Rand **needs** to depreciate to justify current share price levels, and does not provide additional upside if it were to actually do so.

It might also be useful to consider under which circumstances the Rand would depreciate. In our opinion, it would probably be some combination of US\$ strength, weak commodity prices or problems in China – none of which look highly likely at present.

The funds we manage on behalf of clients are very light on resource orientated stocks: justifiably so, in our view.

Piet Viljoen, December Market Commentary