RE·VIEW

Investment Insights - Volume 16
April 2011

RE·CM

INVESTMENT INSIGHTS
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RE·CM

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INTRODUCTION

Dear fellow investor,

Over the past quarter, two of our funds have achieved significant milestones: Our global fund is now five years old, and was awarded its second "Raging Bull" award for best performing global fund in South Africa. Also, our Australia equity fund is now one year old, and it has outperformed the ASX by almost 4% since inception. Both these funds, although domiciled – and invested – outside of South Africa, use exactly the same philosophy and process we have been using here in South Africa. Unsurprisingly, the results are the same – strong long term returns for clients!

On the whole, RE:CM's clients have been very supportive, to the extent that our global assets under management now exceed R18bn (of course, the bulk of these are South African). We are grateful for the support, and continue to work hard to exceed our clients' expectations in every way.

Over the past quarter, most equity markets were up, with developed markets outperforming emerging markets strongly. The US equity market was one of the better performing markets globally, while the South African markets – in line with other emerging markets was broadly flat. The Japanese market, hit by the quake and tsunami, was one of the worst performing. The Rand weakened initially in January, but regained most of its losses against other currencies by the end of the quarter, ending only slightly down. Since quarter end it has continued to strengthen. Although we think the Rand is somewhat overvalued, we also think it is not such a 'slam dunk' as the consensus would have it. Very simply – many of the alternatives are in a much worse state!

In terms of our funds investment positioning, we continue to find more selling opportunities than buying opportunities, and as a result, cash holdings in all of our funds are building up. This has been a drag on our returns over the past year. But, we are of the opinion that risks in the system remain "undervalued" – i.e. investors are not being paid for the inherent systemic risks that result from years of excess debt creation. We have no idea how it all plays out; we just know from experience that when prices are high (as they are in most markets, with the possible exception of Japan) bad things tend to happen. And these bad things, despite the best efforts of our friends in the economics profession - are unforecastable. The best defense against these "known unknowns" is cash in the bank. Although it might feel like one is foregoing easy money, what is actually happening is that one is storing up the potential for good, low-risk future returns, while avoiding the possibility of deep losses in the interim.

One of the main events over the past quarter was the earthquake and subsequent tsunami in Japan. Markets initially responded by declining very sharply – lead by the Japanese market, but have subsequently regained all their losses. And this is despite the outcome of the reactor damage at Fukushima being regarded as on par with Chernobyl. Even the Japanese market has regained most of its losses. In our opinion, this illustrates two points: one; how precariously positioned global markets are in terms of their price/value relationship, and two; how large the appetite for risk is, driven mainly by excess money creation in many of the major global economies. We are of the opinion that risk appetite is a good contrary indicator.

With that summary of global markets, and our fund positioning as a backdrop, this quarter's batch of articles by our analysts is particularly interesting. First of all, it is a bit longer than usual – our investment team now consist of 18 analysts, and, as you can imagine, there is intense competition for a spot in the RE·VIEW! With this intense competition, the standard of writing has moved up a few notches, and the quantity of interesting ideas has jumped. As editor, it is becoming very hard to choose between submissions, but I enjoy every minute of doing so. I hope you enjoy these articles as much as I did when I first read them.

In the first article "The Illusion of Knowledge", our Managing Director, Lonn Potgieter deals with the almost existential question of what the nature of "knowledge" is. This is a question we have to deal with regularly when we analyse the financial statements of the companies we own and want to invest in. In this article, Lonn illustrates a few steps we use to improve the level of understanding in our analysis work.

In the second article, “Asset Allocation: Myths and Realities” Linda Eedes points out some of the flawed thinking behind the mathematics generally used to measure risk, and illustrates how we manage risk in practice. She also has some interesting insights into how we deal with the issue of asset allocation, given that our definition of risk is a much less theoretical one, and of much more relevance to real people, than that used by most market practitioners.

The third article, by our Investments Director Danie Malan and entitled “Regulatory Changes in South Africa” might strike one as a very dry topic, but Danie shows how significant some of the changes are, and what we are doing at RE:CM to deal with these changes. Being responsible for the investment team and its output, Danie has thought very clearly about how these changes affect our clients, and how to position the firm with regards to these changes. In this article he discusses his thinking.

In article 4, “Of Disguises, Delusions and Learning”, Danie shares another of his initiatives. This one has to do with our “tombstones” where we document and review the outcome of our long term investment decision making. In this article, he specifically looks at a stock - Simmer and Jack - we have owned in the past. It makes for fascinating reading, and contains some valuable lessons.

Articles 5 and 6, by Richard Court (one of our associate analysts) and Johannes Visser, deals with specific stocks we have recently looked at. In “The Chickens are Coming Home to Roost” Richard looks at the construction sector in South Africa, with specific reference to Murray and Roberts, and shows why we avoided companies in this sector during the boom, and – with the obvious benefit of hindsight – shows why it was right to do so.

In “Striking Oil” Johannes looks at BP and Sasol, and illustrates how our investment process forces us to remove emotion (as far as possible) from the investment decision. The article also contains some fascinating insights about the energy industry – a very topical industry at the moment.

Finally, in “Managing Management Actions” Wilhelm Hertzog takes a look at some recent corporate actions in some of our portfolio holdings. In this well written article, Wilhelm tries to outline our thinking in two very different cases where we, as shareholders had to exercise our vote.

As always, good investing!

Piet Viljoen
Executive Chairman, RE:CM

THE ILLUSION OF KNOWLEDGE

"It's tough to make predictions, especially about the future."

Yogi Berra (A variant of this has also been attributed to Niels Bohr)

"I am the wisest man in the world, because I know what I know and I know what I don't know."

Socrates

Since the early 1800's society has used the bicycle as a mode of transport and for recreational purposes. Most people have ridden a bike. But could you draw precisely how a bike works? Do you think that you could explain exactly how the modern day flushing toilet works or how a cylinder lock works? Many people believe they can, but when asked, more than two thirds of people are incapable of drawing or describing how these everyday objects work.

This failure is not limited to novices. In early 2000, shortly before Tony Blair and Bill Clinton announced the completion of the first stage of the Human Genome Project, expert geneticists began predicting the number of genes in the human genome. A betting pool was set up so that the geneticist who made the most accurate prediction could benefit financially. Over the three-year period of the competition, the highest prediction was 153,478 genes, the average 60,547 and the lowest 25,747. While the final number is still disputed, the most accepted value is 20,500 genes, significantly lower than the average prediction of 453 expert geneticists.

Computer scientists predicting when a computer might beat an expert chess player, ecologists predicting famine due to overpopulation and economists predicting commodity prices during periods of decreasing supply and increasing demand have made similar prediction errors. In each of these cases, the "experts" came up significantly short when they predicted future outcomes.

Regrettably, We Also Find Examples of the "Illusion Of Knowledge" in Financial Services

In 2005 Brian Hunter, a futures trader for Amaranth Advisors, was paid $75 million for making profits while trading energy futures. His strategy was to predict future energy prices and then buy or sell options. In mid-2005 he predicted that prices would rise sharply, buying $12 options when the ruling prices were between $7 and $9 per million BTU (British Thermal Units, a standard unit measure of energy).

Late that summer, a series of hurricanes damaged processing plants and oil platforms, which caused prices to climb beyond the $13 mark. These circumstances allowed him to make more than $1 billion for the Amaranth Fund that year. Less than a year later, with profits of almost $2 billion, he again predicted a rise in prices, this time of natural gas. However, after Hurricane Katrina, prices fell sharply to below $5. By September 2006 he had cost the fund some $6.5 billion, forcing it to liquidate. At the time it was the largest trading loss in history.

Since then Howie Hubler (from Morgan Stanley) and Jerome Kerviel (from Societe Generale) have each lost more in their trading activities. Ironically, Brian Hunter had lost money for Deutsche Bank prior to joining Amaranth and has since joined Peak Ridge Capital Group where his fund initially did well. He has since left Peak Ridge after Morgan Stanley sued them in October 2010 for a $40.6 million loss tied to natural gas futures trades.

The dot.com boom in 2000 and the sub-prime crisis in 2008 are similar examples of very bright experts getting their predictions horribly wrong.

You May Wonder Why We Often Over-Estimate Our Knowledge

Research has shown that the prime causes of the illusion of knowledge are the human tendencies to:

1. Over-simplify complex circumstances.
2. Confuse familiarity with deep understanding.
3. Assume that short-term information equates with deep understanding.
4. Fail to calibrate our understanding with reality.

"Everything should be made as simple as possible, but not one bit simpler."
Albert Einstein

Our World is Complex and the Mechanistic Metaphor Introduced with Industrialization Misleads Us

If one assumed a situation where each company, investor and industry were represented by a single dot, a world of only 4 dots would leave us with 6 potential links and 64 potential patterns of arrangement. A world of only 10 dots would yield 45 links and 3.5 trillion patterns. No human brain is capable of processing so many pattern relationships. How then can any human being ever expect to figure out a world where there are thousands of investors, hundreds of companies operating in tens of industries with an unknown number of configurations?

We Can't Predict Future Outcomes, But We Can Create Circumstances Where A Positive Outcome is More Probable

The best that any human can do is to create the circumstances where favourable future outcomes are more likely. Put differently, we try to create the circumstances where a positive outcome is more probable. To do this, it is vital to have a deep understanding of the complex system that we are dealing with and a process of surfacing flawed assumptions and blind spots in our thinking.

At RE:CM we recognise this human blind spot and need to be sure that we do not fall foul of a similar illusion when we manage our clients' investments. Essentially, we tackle the problem from two separate perspectives. The first is preventative and the second assumes that the first may not work and introduces a way of mitigating risk.

Anyone familiar with the study of Knowledge Management will understand the concept of building knowledge into processes wherever this is possible. This is precisely what we try to do when we design our processes within RE:CM. Of particular relevance to this article is the idea that we try to build three factors into our investment process that may assist in identifying or removing the illusion of knowledge.

We Follow Three Overall Steps to Improve Our Understanding and Avoid the Illusion of Knowledge

The primary aim of each of the steps below is to understand what we know about the investment case and what we do not know. As we have seen above, a key factor causing the illusion of knowledge is a tendency to overestimate what we know and underestimate what we do not know about a particular subject.

1. **We Document Our Analysis of the Investee Company in Detail**
   The very process of committing thoughts to paper requires our analysts to consider all aspects of the investment proposition and present them in a coherent way. The analyst provides all quantitative aspects that support the investment case in supporting schedules to allow fellow analysts the opportunity to understand the key value drivers and underlying financial information. Non-financial factors are also documented to ensure that the analyst has considered the competitive advantage of the investee company, the competitive landscape in which it operates and the manner in which the company allocates capital. Not only does this practice improve the rigour of our analysis but it also builds corporate memory if an analyst leaves the firm. While there is no guarantee, this process limits the likelihood of over-simplification and of short-term (mis)information.

2. **We Critically RE·VIEW Each Investment Proposition**
   We undertake this as part of our policy report RE·VIEWs. The analyst proposing a new investment is required to present the investment case to a panel of colleagues for critical RE·VIEW. The process is often iterative as we raise probing questions with the aim of finding any flaw in the investment case. This process helps the analyst calibrate their understanding with the real world and it surfaces any potential confusion between familiarity and deep understanding.

3. **Annually, the Full Team of RE:CM Analysts Critically RE·VIEW Each Investment Proposition**
   These RE·VIEWs are partially a post-mortem of the investment case but are also an opportunity to revisit any new information or insight. This step is a further way of calibrating because we do this with the luxury of a certain amount of historic evidence.

An Experienced Portfolio Manager then Assesses the Quality and Margin of Safety of an Investment

Once we are satisfied that we understand the investment case the portfolio manager will still assess the merits of including the investment in a client portfolio based on quality and a margin of safety. While we have established certain heuristics to help with this assessment, it is largely subjective and an experienced portfolio manager must do this. We also try to avoid the pitfalls of the illusion of knowledge here by selecting only experienced portfolio managers to manage client assets. Length of experience and a proven track record are pre-requisites to manage client assets. Research conducted in the fields of sport, science, music and the arts has shown the strong correlation between prolonged efforts of deliberate practice designed to optimize improvement and superior performance.

In general, an experienced portfolio manager will seek a greater margin of safety and allocate less capital to a new idea if the investment case is weaker (based on more unknowns, lower conviction, or lower quality) than if it was stronger (fewer unknowns, higher conviction or a higher quality company). By mitigating risk in this way, we are still able to protect client capital. And by working in this way, we are able to get the odds on our side and increase the probability of a favourable outcome.

Analysts and portfolio managers are human and suffer the same weaknesses that all humans do – the illusion of knowledge is no exception. Understanding this weakness and designing processes aimed at highlighting or eliminating this illusion allow us to put our client portfolios in a better position - with a higher likelihood of a favourable outcome than would otherwise be the case. By continuously evolving and refining our processes and focussing on the effortful activities of our analysts to optimise their performance, we can reduce this illusion and calibrate our knowledge to yield better outcomes for our clients.

Lonn Potgieter

ASSET ALLOCATION: MYTHS AND REALITIES

Five monkeys were put into a cage. A banana was hung inside the cage and a set of stairs placed under it. Before long, one of the monkeys started to climb the stairs towards the banana. As soon as he touched the stairs, all of the monkeys were sprayed with cold water. After a while, another monkey attempted with the same result.

Soon none of the monkeys tried to climb the stairs.

The cold water was put away. One of the monkeys was removed from the cage and replaced with a new one. The new monkey saw the banana and wanted to climb the stairs. To his surprise and horror, all of the other monkeys attacked and restrained him. After another attempt and attack, he realised that if he tried to climb the stairs, he would be assaulted.

One of the original four monkeys was then removed and replaced with a new one. The newcomer went to the stairs and was restrained by the group. The previous newcomer took part in the punishment with enthusiasm. Likewise a third original monkey was replaced with a new one, then a fourth, then the fifth.

Every time the newest monkey took to the stairs, the group punished him.

All of the monkeys, which were restraining each other, had no idea why they were not permitted to climb the stairs or why they were participating in the restraint of the newest monkey. After replacing all the original monkeys, none of the remaining monkeys had ever been sprayed with cold water.

Nevertheless, no monkey approached the stairs to try for the banana. Why not? Because that's what they'd been taught and as far as they knew that's the way it had always been done.

Mentioned in Stephenson, G. R. (1967). Cultural acquisition of a specific learned response among rhesus monkeys.

In 1986, a landmark paper by Brinson, Hood and Beebower found that asset allocation accounted for 93.6% of the variation in average fund returns over time. This paper has since spawned reams of marketing literature emphasising the importance of asset allocation.

In a later update, (by the same authors), asset allocation was said to explain 91.5% of the variation in quarterly returns for US pension funds. Several studies conducted thereafter have attributed varying degrees of overall performance to asset allocation, but all authors agree that the decision to be invested in or out of the market at the right or wrong time is a key driver of overall portfolio performance.

However, such agreement does not explain how to do it. What are the appropriate asset classes? Should asset class weights be fixed or dynamic? How should asset allocation be determined?

Challenging Widely Accepted Logic

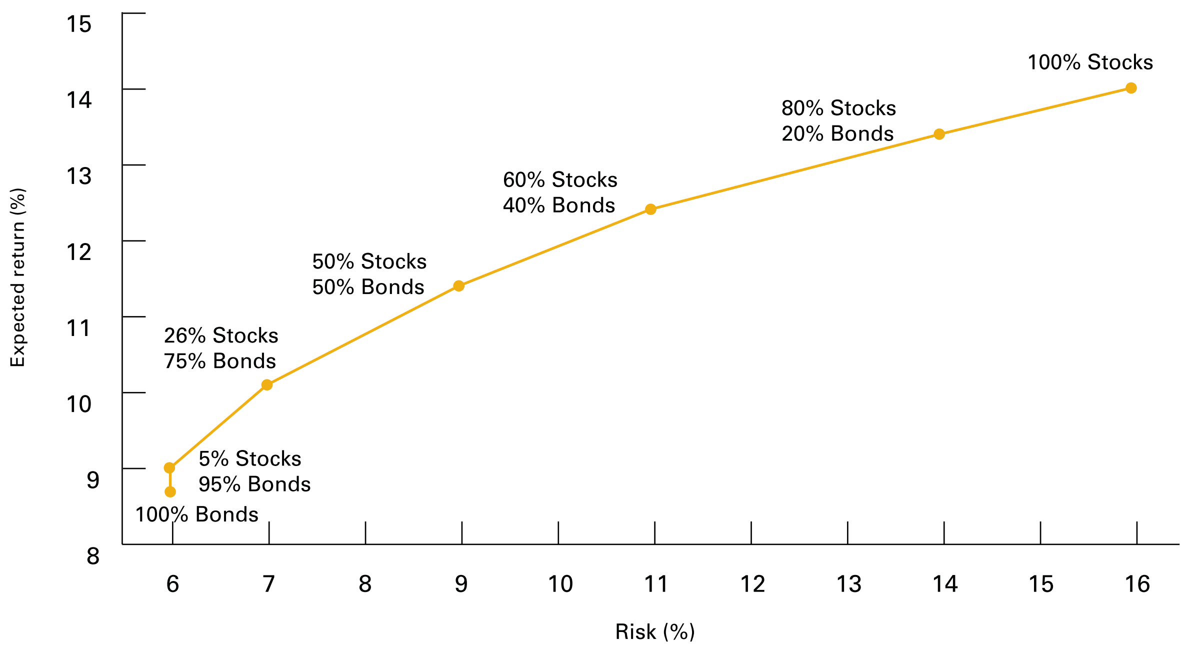
This article challenges the widely accepted logic of Modern Portfolio Theory where mean variance analysis is used to determine optimal combinations of bonds/equity/cash/global. It argues that dynamic asset allocation makes more sense than strategic (fixed weight) asset allocation policies, including so-called "life-cycle" policies, but points out the risks of using a top-down investment process requiring forecasts as inputs.

Instead, it argues that a more reliable method of asset allocation is as a by-product of a bottom-up, valuation-driven process which focuses on buying cheap securities on a case-by-case basis, and defaults to cash in the absence of sufficient opportunities. It also provides evidence that using this approach, RE:CM has managed to allocate capital effectively amongst the asset classes over time, providing an additional source of return to bottom-up stock selection.

Modern Portfolio Theory (also commonly referred to as mean-variance analysis)

In 1952, Harry Markowitz published an article, which formed the basis of what is now known as Modern Portfolio Theory (MPT). Markowitz argued that by combining assets that are not perfectly correlated, an investor could reduce their investment risk without reducing expected returns. He maintained that it is possible to derive a portfolio of risky assets that returns the smallest amount of risk for a given return. Repeating this process numerous times for different levels of expected returns, standard deviations, and correlation coefficients produces the mean-variance or Markowitz efficient frontier. (See Chart 1)

Chart 1: Stocks and Bonds Efficient Frontier (1976 - 2007)



Source: Fidelity

Investors wanting a low risk portfolio could select one from the bottom left portion of the efficient frontier. Those wishing to seek higher returns by taking on more risk could choose a portfolio from the upper right portion. Bonds characteristically have lower returns and lower standard deviations than shares. Therefore, a bond-heavy portfolio would be located on the lower left portion and a stock-heavy portfolio on the upper right portion of the frontier. This lead to the development of "life-cycle" funds with asset allocation being determined by an investor's age. Higher allocations to equities were recommended at the beginning of the work life, with a shift into assets such as bonds as a person neared retirement.

The Problems with Strategic Asset Allocation

However, we believe there are significant problems with strategic asset allocation through mean-variance analysis:

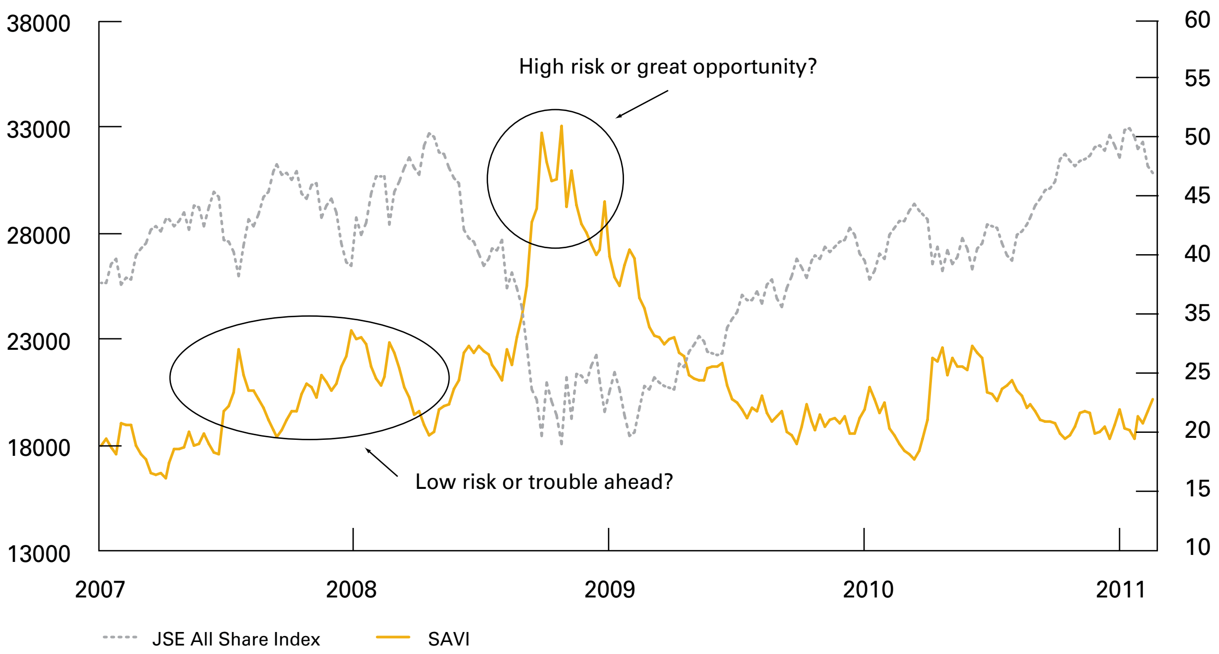
1. It Measures Risk in Terms of Volatility

Because of MPT, the concept of volatility, or standard deviation, as a measure of risk has become firmly entrenched in the financial services industry. We contend that volatility is a poor measure of risk for the following reasons:

- Volatility just looks at movement - all of which are permanent as they are historical. Whether or not they are important to the investor depends on the inventor's time horizon.
- When it comes to risk, volatility treats upward and downward movements equally. We know that investors are more concerned with losses than unexpected gains and in particular the risk of permanent capital loss.

- Figure 2 shows the South African Volatility Index (SAVI) versus the FTSE/JSE All Share Index. If you follow the widely-held assumption that volatility equals risk, you might well have concluded that risk was low pre-financial crisis in early 2008. Rather, the opposite is true: when volatility is low, risk is in actual fact high.
- On the other hand, when volatility is high, opportunities are created. In Keynes' words "It is largely the fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them."

FTSE/JSE All Share Index vs Volatility Index (SAVI)



Source: INet

2. Diversification Benefits Aren't There For You When You Need Them Most

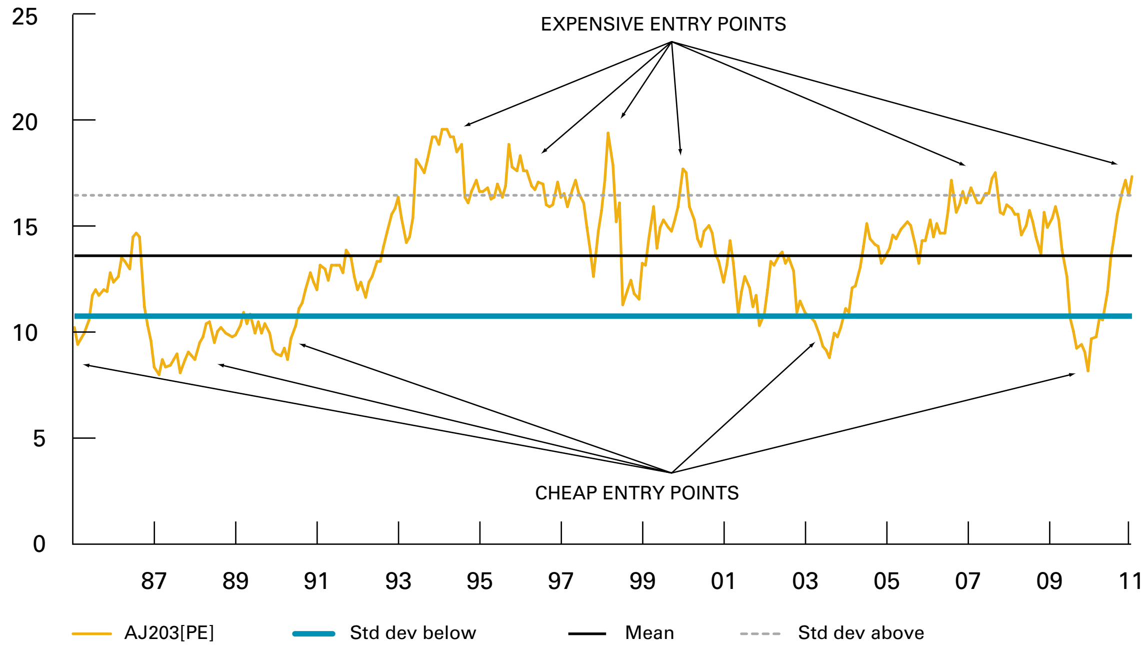
Efficient frontier analysis relies on diversification as a way of reducing overall risk. By combining asset classes that are not perfectly correlated, an investor is said to be able to reduce their investment risk without reducing expected returns. However, the effects of diversification are not symmetrical. For instance, US investors have historically sought to diversify their portfolios by including non-US equities. When both markets experience returns one standard deviation above their average, the correlation is -17%. However, when they both experience returns one standard deviation below the average, the correlation is 76%.

This asymmetry in correlation renders the average correlation meaningless and is also exactly the opposite of what an investor seeks. When our portfolio's main growth engine performs well, we are happy for other assets to perform well along with it. However, when it performs poorly, we need the other assets to provide the benefits of diversification. Unfortunately, diversification tends to work precisely the other way around.

3. It Doesn't Take Valuations into Account

The most significant problem with MPT is that it assumes you would be happy with the same amount of exposure to a market irrespective of prevailing valuations.

FTSE/JSE All Share Index PE Ratio: 1986 - 2011

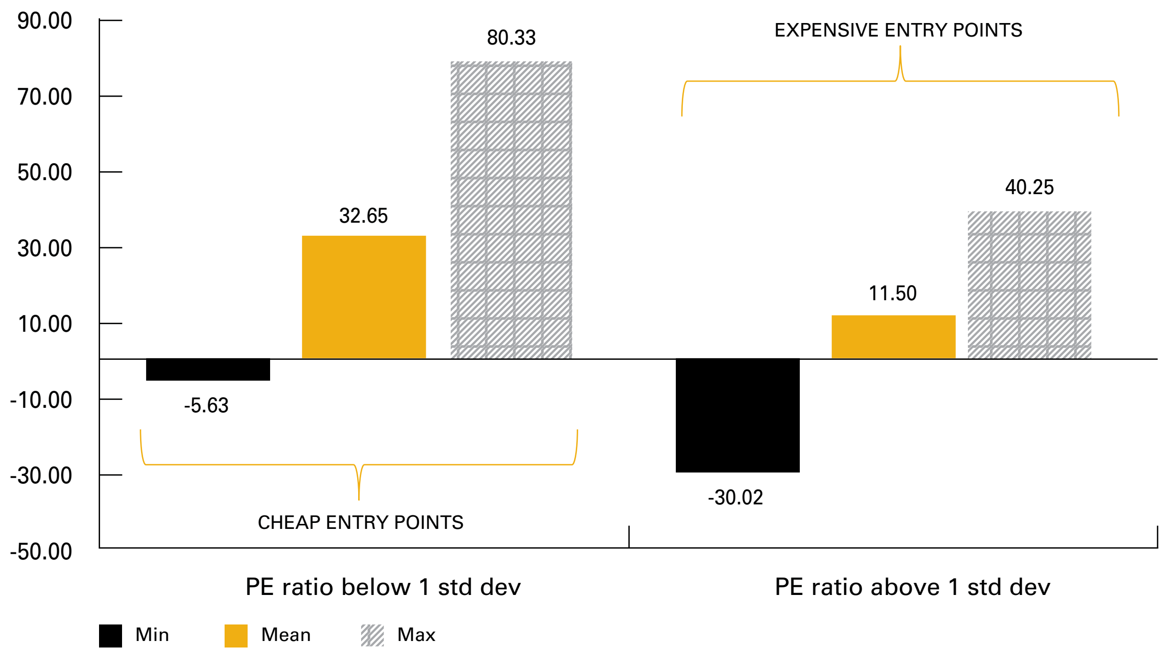


Source: Inet

Looking at the graph above, we can see a powerful mean-reversion tendency in the price/earnings (P/E) ratio of the JSE All Share Index over the long term. Using this as a basic measure of value, we compare the returns one year forward for all periods where the P/E ratio was more than one standard deviation below the long-term average i.e. when markets were "cheap" on this basis.

Then, we did the same one year forward return calculations for periods where the P/E ratio was more than one standard deviation above the long-term average i.e. when markets were "expensive" on this basis. The results were as follows:

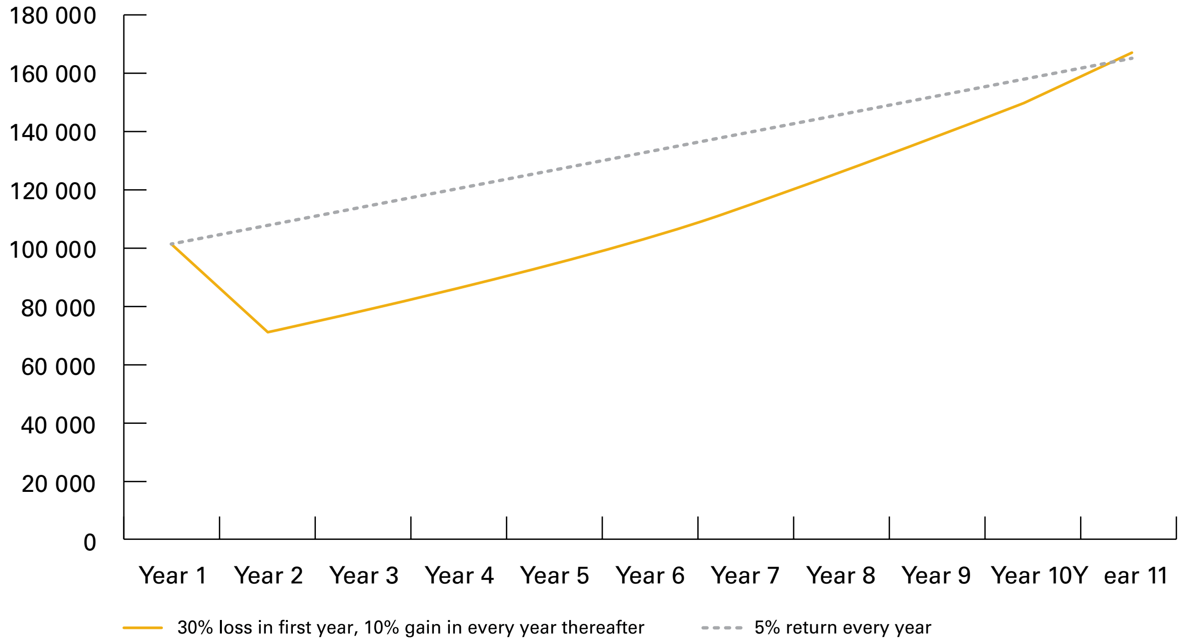
Comparison of 1 Year Forward Returns for FTSE/JSE All Share Index: 1986 - 2010



Source: INet, RE:CM Analyst

For entry points during "cheap" periods, the average return one year following was 32.7%. However, the average return one year after "expensive" entry points was only 11.5%. The lowest single period return was -30%. For the unlucky investor who allocated capital to the equity market at that time, the implications of an early loss on future returns are significant:

The Cost of Loss



Source: The Intelligent Investor (Benjamin Graham)

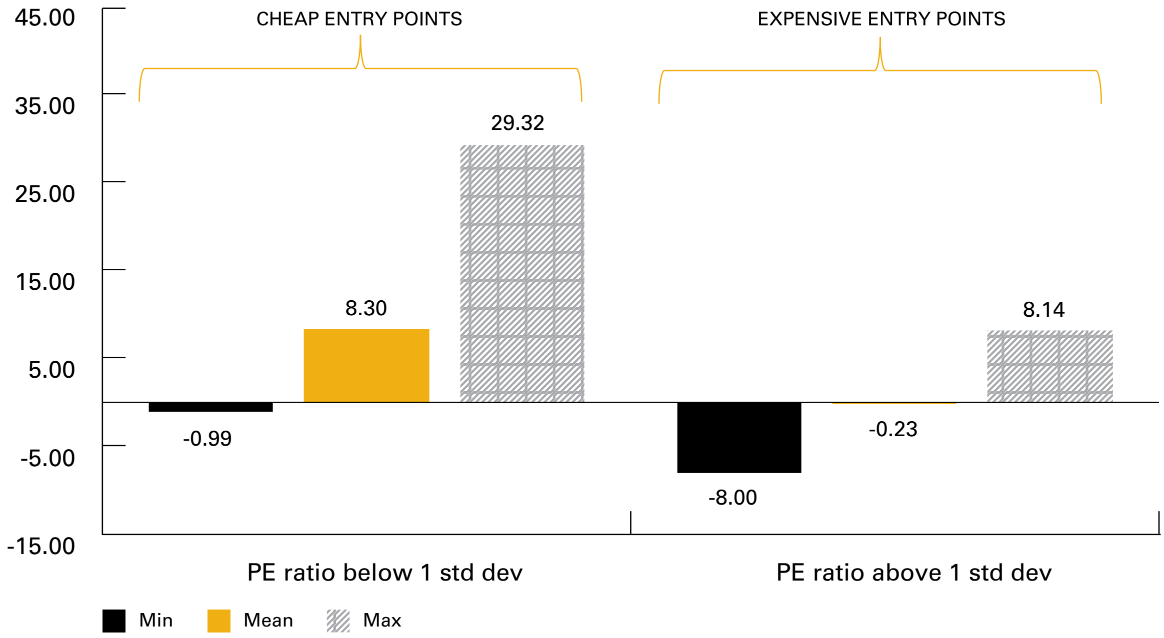
Consider the above. With a 30% loss in the first year, even if the portfolio returned 10% every year thereafter, double that of another portfolio returning 5% annually, it would still take 10 years to recoup the initial losses and catch up - simply because they paid too much, and thus lost too much, at the outset of their time horizon.

Strategic asset allocation supporters might argue that one year is too short a period to RE·VIEW – that given a full market cycle, your starting point becomes less instrumental in determining returns over the longer-term.

Let's Look at This Over 5 Years in Real Terms

Repeating the same exercise, but this time for *real* returns 5 years forward, yields sobering results:

Comparison of 5 Year Forward Real Returns for FTSE/JSE All Share Index: 1986 - 2006



Source: INet, RE:CM Analyst

The minimum return five years after an "expensive" entry point was -8% per annum in real terms – a considerable erosion of capital. The average return was zero – no capital growth in real terms. However, only the worst-case scenario for the "cheap" entry points was close to zero with real returns generated for every other period measured. Valuations really do matter. Ignore them at your peril.

4. It Relies on Historical Inputs

Historical performance is the most common approach used to obtain estimates of the inputs required for mean-variance optimisation. However, historical returns are unreliable as future indicators of returns and are often contrary indicators. Historical returns are at their highest at market tops. Analysis of asset class returns shows that after extraordinarily good or bad performance, a reversal of fortunes is more likely to occur than not. The danger is that based on historical returns, you end up buying high and selling low rather than the opposite.

Those who advocate fixed-weight allocations invariably rely on using historical data as inputs. For those who evaluate investment opportunities prospectively, based upon fundamentals, the idea of fixed-weight asset allocation strategies simply makes no economic sense.

What About Tactical/Dynamic Asset Allocation?

An alternative to strategic (fixed) asset allocation is dynamic or tactical asset allocation, which moves among various asset classes to take advantage of short and intermediate term market inefficiencies as a source of return.

Many investors use a top-down investment process to determine which asset class to allocate capital to. They may well follow a process such as:

1. Forecast the economy;
2. Forecast the path of interest rates;
3. Forecast the sectors which will do well within that environment and finally;
4. Forecast the stocks that will do well within that sector.

Let's assume you are correct 70% of the time (which in itself would make you a statistical anomaly). If you require all forecasts to be correct in order for your investment thesis to work, you have only a 24% chance of getting it right. Given all the other forecast inputs an analyst's model requires, this number is in reality probably even smaller!

James Montier (2010) in "The Little Book of Behavioural Investing" notes the following on forecasting:

1. Consensus economists have completely failed to predict any of the last four recessions – even when we were in them.
2. Analysts forecasting companies' earnings two years prior to the actual event are wrong by a staggering 94%. Even at a 12-month time horizon, they are wrong by around 45%.
3. In 2008, analysts in the US forecasted a 24% price increase, yet stocks actually fell by nearly 40%. In fact, between 2000 and 2008, the analysts hadn't even managed to get the direction of change in prices right in four out of nine years.

Even if we Could Forecast Macroeconomic Variables, How Useful Would it be?

According to the Credit Suisse Yearbook (2010), macroeconomic variables are not very useful in determining where to invest. Their research indicates that stock market moves are a much better indicator of future GDP growth than the other way around: "*The supposed link between economic growth and stock-market performance is statistically weak and often perverse. Unless an investor is blessed with clairvoyance, there is no evidence that GDP growth is useful as a predictor of superior stock-market returns*".

Why Do Investors Keep Asking For Forecasts When the Evidence is so Overwhelmingly Against it?

Montier suggests that we're taught that we need forecasts in order to be able to invest. We like to have an anchor – a starting point such as consensus that gives us a basis to form our own judgments about whether a security is under or overvalued. Investing means dealing with the future, and the future is something we don't know too much about.

Howard Marks, founder of US investment manager Oaktree Capital, puts it succinctly: "*In my opinion, the key to dealing with the future lies in knowing where you are, even if you can't know precisely where you're going. Knowing where you are in a cycle and what that implies for the future is different from predicting the timing, the extent and the shape of the cyclical move.*"

The good news is that once you reject forecasting as a waste of time, it frees you up to focus on the things that a disciplined investor can measure with a reasonable degree of accuracy. We agree with Keynes when he said: "*I'd prefer to be approximately right rather than precisely wrong*."

So How Does RE:CM Determine Asset Allocation in the Absence of a Top-Down Investment Process?

We use a bottom-up investment philosophy based on thorough, fundamental research, which assesses each investment idea on a case-by-case basis. We aim to buy undervalued assets, sell overvalued assets, and to wait until the market corrects these perceived misvaluations. Note this is very different from market timing where investors try to call the top or bottom of the market. Our decision as to whether to be invested in or out of the market, in or out of bonds, or in or out of any asset class is an outcome or by-product of our bottom-up process. If we don't find sufficient ideas in equities, property or bonds which meet our criteria, we default to cash – or what we prefer to call "deferred alpha".

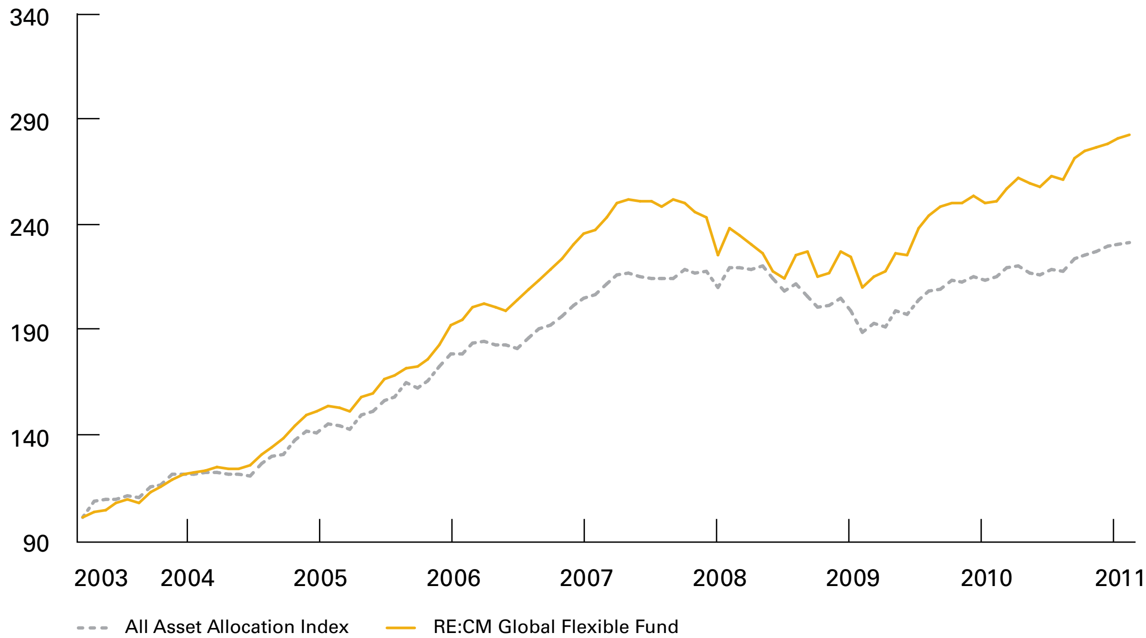
We Start with the Best Generator of Real Returns – The Equity Market

Our starting point when looking for investment ideas is the equity market. We know this is the best generator of real returns over the long-term. Our biggest consideration when limiting the risk of capital loss is to ensure that we do not pay more for an asset than what it is worth. We look for a significant margin of safety between the price we pay and our estimate of intrinsic value. When it comes to returns, we are concerned with real capital growth in absolute terms rather than nominal relative returns versus a market index. We look to pay for sustainable earnings levels rather than peak earnings, and look for them to be protected by either the value of the underlying net assets or what we believe are sustainable companies with competitive advantages such as barriers to entry and pricing power.

Our balanced portfolios are invested in cash or money market securities, with which alternative investment ideas such as bonds compete. For this segment, the yield needs to compensate us adequately for the increased risks we accept - namely liquidity risk, counterparty risk and default risk. Bonds need to offer a real yield with adequate inflation protection over time. When we believe bond yields do not offer this compensation, as we currently do, we prefer to defer to cash.

How has RE:CM's Asset Allocation Fared as an Outcome of this Bottom-Up Process?

Evidence that our bottom-up valuation-based approach to asset allocation works is the fact that the RE:CM Global Flexible Fund, our flexible balanced fund, has outperformed the All Asset Allocation Unit Trusts Universe by 3% annually since its inception in 2003, delivered real returns of 10% over inflation (CPI) on an anualised basis after fees.



Source: INet

Crucially, our bottom-up process resulted in us having a low allocation to equities leading up to the financial crisis in 2008, when assets were expensive. However, when the market declined, the discipline of our process forced us to commit capital to take advantage of cheap valuations, resulting in an equity allocation of 75% - the maximum for Regulation 28-compliant funds. While many market participants preferred to "wait and see", we actively participated in what may quite possibly turn out to be the best buying opportunity of our investment career lifetimes.

Asset allocation – an Important Component Of Overall Returns Over Time

Investment managers need to be able to show that whether their process is top-down, bottom-up driven or a combination thereof, it has resulted in effective asset allocation over the full cycle – protecting capital by avoiding overvalued assets, and growing capital by taking advantage of significantly undervalued assets. The extent to which valuations are cheap or expensive at the start of an investment horizon has a significant impact on returns thereafter. Consequently, the idea of valuation-indifferent fixed-weight asset allocation strategies simply makes no economic sense. Investors who have a time horizon of at least five years should focus on generating the best long-term real returns while limiting the risk of permanent capital loss. A balanced fund such as the RE:CM Global Flexible Fund, which seeks out investment opportunities across the full range of asset classes, does a good job delivering exactly that.

Linda Eedes

REGULATORY CHANGES IN SOUTH AFRICA

I rarely ever quote; the reason is, I always think.

Thomas Paine; The Writings of Thomas Paine Vol. I (1904)

I hate quotations. Tell me what you know.

Ralph Waldo Emerson; May 1849; Journals Vol. II (1975)

It is a good thing for an uneducated man to read books of quotations.

Winston Churchill; My Early Life (1930)

The three quotes above can be found at the top of the very first page of an excellent 1,000 page book called 'History in Quotations' by M.J. Cohen and John Major, published in 2004. We agree with these sentiments. If you are a regular RE:VIEW reader, you are probably wondering why we often use quotes in these thought pieces.

1. Do We Really Think?

2. Do We Really Tell You What We Know?

Following honest introspection, we say "Yes" to both these questions. The bare bones of our individual research convictions inspire the content for these thought pieces. We use quotes, analogies, irony and humour to make them more interesting for readers and help make key points. Please note that telling you what we think we know is not always correct. Some of our thought pieces have not stood the test of time, similar to the way that every individual stock we select in a fund will not be a winner. Fortunately there have not been too many such examples – be that thought pieces or stocks! We believe testament to the men and women who spent much time and effort developing original thought from the convictions generated by their personal research.

The South African government implemented significant changes to the retirement fund industry Regulation 28, effective July 1st, 2011. As we manage pooled retirement savings for a number of our clients within this legislation, we would like to share with you our views on a few key changes in the legislation. The unit trusts that we manage that are subject to this legislation are the Nedgroup Investments Managed Fund and the Symmetry Inflation Plus Fund. We purposefully changed all our other unit trust mandates in 2008 to fall outside of the ambit of this legislation in order to allow us the maximum amount of investment flexibility.

Key Change 1: Direct Commodities

Previously one could invest 10% of a fund in Kruger Rands (i.e. gold). The market for Kruger Rands for large investors can be inefficient due to illiquidity and consequently this option was never really a viable investment alternative. While the commodity maximum exposure stays at 10%, one can now use any exchange traded commodity (such as copper, silver, lead, wheat, orange juice or pork bellies). Very interestingly gold is still the exception at a 10% maximum; any other single commodity will be limited at 5%. The barbarous relic strikes again! We have not been shy to take a look or a position in direct commodities over the years, but regulatory mandate limitations have always hindered full scale implementation for clients. This is no longer the case and if our analysts can build a solid investment thesis that meets our hurdles (low risk of permanent capital loss, acceptable margin of safety) our portfolio managers will allocate fund capital. Currently, besides a small position in gold in our global fund we don't own any other direct commodities and nor do we intend to given the current odds on offer.

Key Change 2: Hedge Funds and Private Equity Funds

Previously one could invest a maximum of 2.5% of a fund in so-called 'Other Assets'. The industry classified both hedge funds and private equity funds inside this band and managed accordingly. This has now increased to 15% in total, with a limit of 10% in either. Considering the relative scale of the savings pool this is a very substantial change that will disrupt the fund management industry for some time to come. A lot of savings capital could potentially shift from the hands of traditional long only fund managers to these alternatives. The fund management industry notoriously enjoys zero barriers to entry - anyone with a laptop and a shingle could potentially lay a claim on managing these assets. It will be up to trustees and consultants to figure out the wheat from the chaff, and fast, because if they don't the market will do it for them, with potentially damaging consequences for their retiring and retired savers.

As an aside, in one of the greatest and most ironic twists we've witnessed in the financial services sector, one of our domestic holdings, Brait, completely changed its operating business model and effectively turned its back on this vastly increased asset base opportunity in its well established private equity businesses. One can only wonder why, but our best guess is the associated stress of raising assets from potentially fickle clients has ultimately won the day, as it almost always does once the manager has made enough money to build up their personal asset base.

We will not be investing in hedge funds as we do not have the expertise or wish to spend the time to try and figure out such opaque investment structures. It belongs firmly in the 'too difficult' basket for us. We would invest in private equity funds of managers with demonstrable skill over full market cycles and a solid philosophy and process we can understand. We will also continue to build on our own expertise in this area.

Key Change 3: Unlisted Shares

Previously one could invest a maximum of 5% in unlisted shares. This limit will increase to 10% and opens up opportunities to allocate more meaningful fund capital exposures. This has its issues no doubt, including pricing and associated costs as there is no readily available share price. From the perspective of the fund manager/analyst, investing in unlisted businesses brings to bear a whole range of considerations, including Board and/or management involvement of the underlying investments, which is a skillset that is rare, time-consuming and potentially very stressful.

Via our established research and investment activities in unlisted businesses over the past 8 years, culminating in the capital raising and listing of RE:CM & Calibre in 2010, we have painstakingly built up our expertise in this area and anticipate to take advantage of this allowance – but only when it makes sense to do so.

Key Change 4: Mid Cap and Small Cap Equity

Companies with market caps of between R2bn and R20bn: A single fund can now own a maximum of 10% of the investee company (down from 15%).

Companies with market caps of less than R2bn: A single fund can now own a maximum of 5% of the investee company (down from 10%).

These two changes may appear harmless, but where there are large single funds with exposures that are in breach of the revised legislation it could mean that they become forced sellers of very illiquid securities – with the potential to dislocate market price from business value. The limitation implies that there will be less capital hunting for investment opportunities in the listed mid cap and small cap equity minority universe, which we would welcome. This will in time of course be countered by the increased pool of capital available to control buyers such as private equity funds. Here's to hoping they take a while to get going, but that's wishful thinking given the economics on offer! RE:CM and Calibre, our listed investment vehicle, is ideally positioned to take advantage of any such dislocations caused by regulatory factors.

A Final Regulatory Change – Increase In Offshore Limits

A seemingly small other legislative allowance is the increase in offshore limits for Regulation 28 funds from 20% to 25% upon approval, with an additional 5% in African markets outside South Africa. This is another step towards the further relaxation of exchange controls, implying further flexibility in terms of our investable universe. It is very interesting to us that Botswana enforces no foreign exchange control limitations on their institutional savings industry. In our view this is the way it should be; please give us a good reason why not to include the worlds' best businesses and other asset class opportunities in your investable universe?

In 2005, with an investment team consisting of 4 people, we embarked on a major expansion drive to invest in our research capacity, culminating in the current investment team of 18 professionals that we anticipate to settle at approximately 24 people over the next year or two. This was a deliberate step at the time to increase our circle of competence to include global asset classes, a rather large challenge given a zero standing start. We started managing our own award winning global fund in 2006 and delivered acceptable returns since inception through a particularly difficult timeframe. Our domestic clients have benefited from our increased knowledge and ability to invest in a wider range of high quality assets than would have been the case if we had continued to research only the South African market. Since 2002, with the launch of the incubation funds that culminated in the listing of RE:CM & Calibre in 2010, we added private equity and arbitrage expertise to our research armoury. There are other initiatives in two identified research disciplines where a combination of very good people, hard work and a solid process can make a meaningful difference to our clients. We will update you on these in due course.

In conclusion, we believe that many of these changes are playing into our existing strengths. We are sounding a word of caution for trustees and consultants about the use of increased flexibility, but we also take comfort from the knowledge that increased flexibility in the hands of proven capital allocators can and should make a meaningful difference to prospective long term returns. Our clients should expect nothing less from us.

Daniel Malan

OF DISGUISES, DELUSIONS AND LEARNING

"When I first saw them, I thought, 'I hope these guys are not on the run. This disguise is not going to work.'"

Keith Richards; on ZZ Top during their induction ceremony into the Rock and Roll Hall of Fame in 2004.

The secret of life is good judgment. How do you get good judgment? From experience. How do you get experience? From bad judgment.

Anon.

An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.

Ben Graham, Security Analysis, 1934.

…some speculation is necessary and unavoidable, for in many common-stock situations there are substantial possibilities of both profit and loss and the risks therein must be assumed by someone.
There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are speculating when you think you are investing…

Ben Graham, The Intelligent Investor, 1949, emphasis added by RE:CM.

We believe that in order to get better at anything you have to draw up a plan, stick to it, execute on that plan, realise good and bad outcomes and lastly you have to reflect on all the outcomes, challenge your original plan and improve it. Then repeat the cycle. This applies to most walks of life but is particularly useful in the complex investment world, where short term outcomes are generally random but long term outcomes are generally not.

There are certain disciplines like art where a juvenile prodigy can blow away a master craftsman. Whether it will stand the test of time is another matter. Creative business formation is another; Facebook may be worthy news flow in today's social network besotted world, but people living 50 or 100 years from now might never have heard of it, we just don't know. Ask the founders of MySpace. Environmentally clean nuclear power next door seems like a really good idea, until a tsunami hits Japan and there's a leak. 'Sorry' just doesn't quite cut it and 'not in my backyard' becomes the new standard for voters, who drive political incentives, behaviours and ultimately can impact regulatory decisions.

If we distil our business down to its essence; we love to 'figure stuff out'. We surround ourselves with different people who share the same passion for 'figuring stuff out'. One of the biggest compliments someone from RE:CM can pay anyone is to say the words 'That's interesting', because it means we've been challenged and it made us think.

Looking at outcomes is fun, but it is also painful. Human nature takes credit where none is due; and lays blame at another door. Thinking back to that brilliant intercept try in the dying minutes of your Grade 7 rugby match to win by a point is really fun and likely to be etched in your inner mirror forever. It's all about you, forget about the team effort.

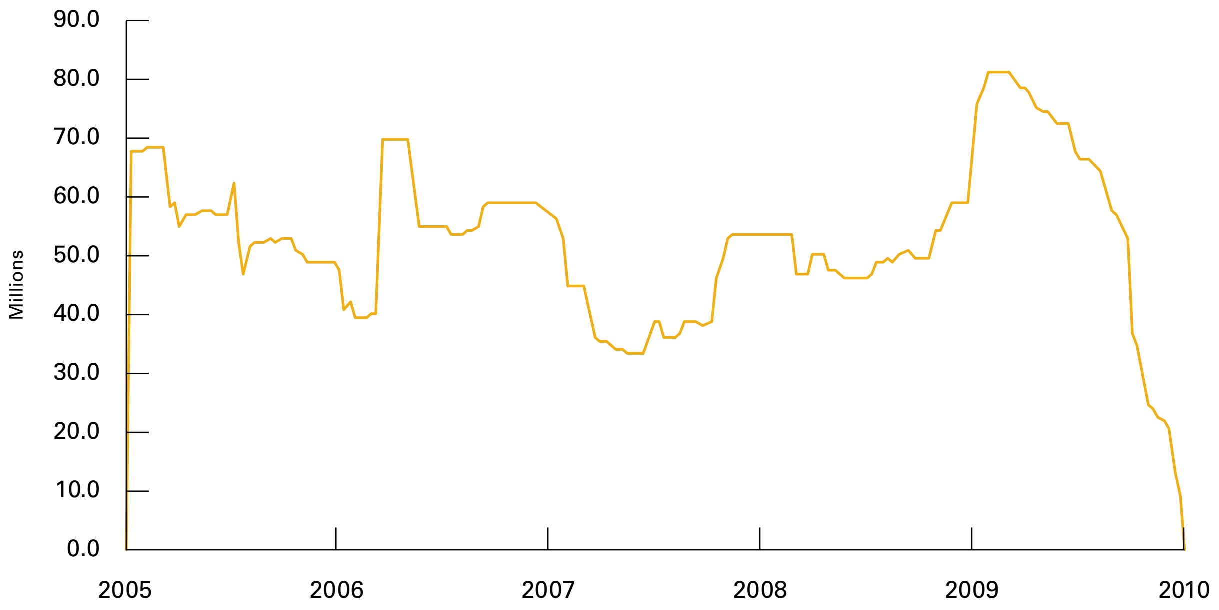
In our effort to challenge our own previously held convictions, we assess the outcomes of our investment decisions over their full ownership cycle. From the day we start buying to the day we completely finish selling. We call these studies 'tombstones' and we think it is a very apt description. In combination with our careful record-keeping of the analyst and portfolio managers' thinking at each decision point it provides us with enormous insight into all the nuanced aspects of investment decision making, from idea generation to analyst, trader and ultimately portfolio manager decisions.

The example we would like to discuss and share some of our learning with you is the JSE listed gold and uranium miner Simmer & Jack. The following three charts show:

1. The number of shares owned by our clients,
2. The share price, and
3. The actual profit and loss position on the stock over our full ownership cycle.

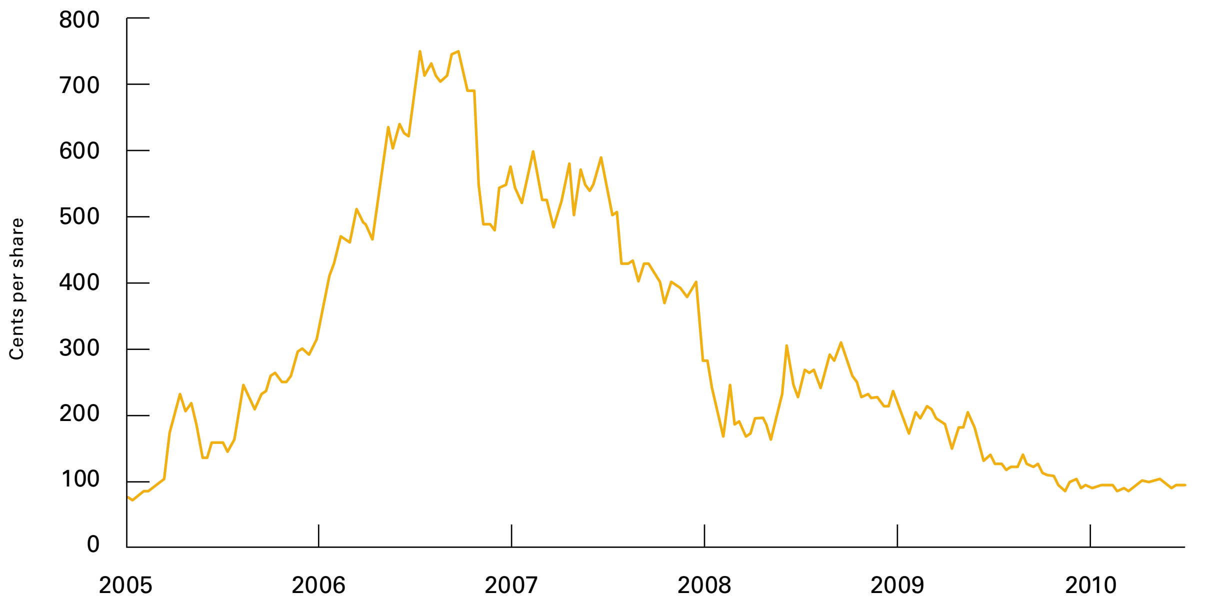
Hold on to your seats because this was a wild ride.

Chart 1: RE:CM Client's Holding in Simmer & Jack, in Millions of Shares



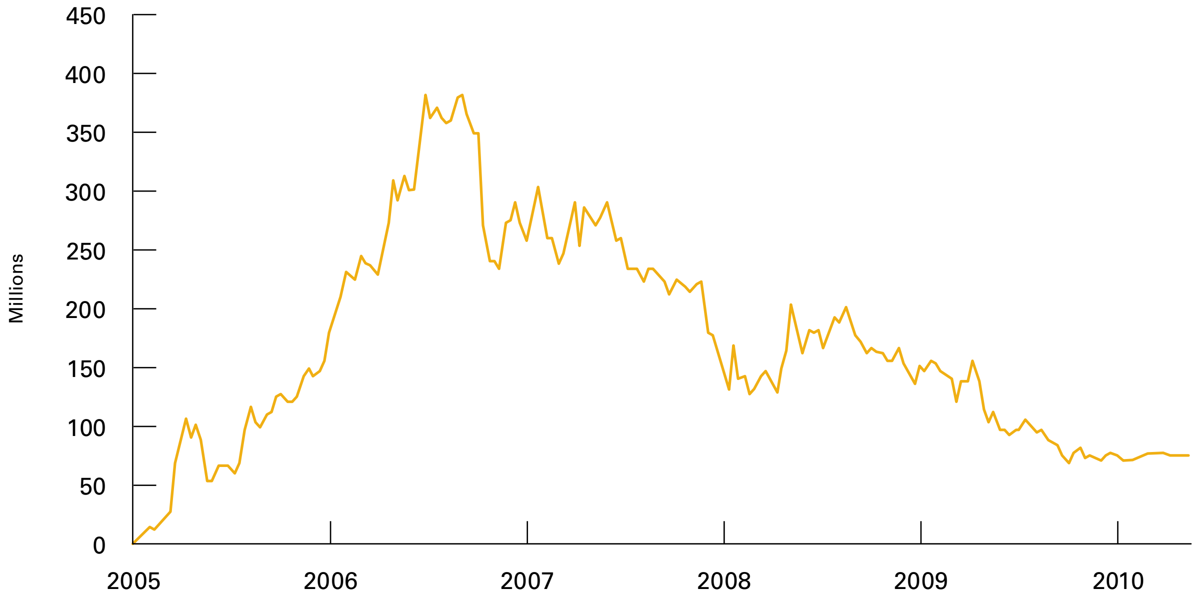
Source: Company reports, RE:CM analyst

Chart 2: Simmer & Jack Share Price History, in Cents per Share



Source: Thomson Datastream

Chart 3: Cumulative Cash Value Created (profit) from Simmer & Jack, in Millions of Rand



Source: Company reports, RE:CM analyst

Let's start with the good news (hint: when someone does that there's probably a lot of bad news to come!). After all is said and done our clients made a cash profit of R75mn out of this investment idea, resulting in an internal rate of return of 66% per annum that beat inflation plus 8% (a compound return of 14.3%) and the JSE Allshare index (a compound return of 16.6%) by a very wide margin.

From the three charts, all taken over the exact timeframe of our full ownership cycle, you can see that in the first 18 months it just could not have been scripted any better. From our first (and only) purchase at 65cps in late 2005 the share price rocketed up 7.7 times to R5, and our portfolio managers' actions were spot on in selling 50% of the initial number of shares held. We limited our clients capital commitment to only ½ percent of their capital – in recognition of the very significant risks at hand. At the time we knew we were investing in a very low quality business, countered by it offering very attractive odds. The amount of client capital placed at risk was considered appropriate.

Then, in late 2006, we suddenly turned around and bought 30mn shares at R5, right before the share price increased by a further 50% to R7.50 over the next 6 months. This is where our first and biggest mistake crept in - more on this later. Again the portfolio managers' actions were spot on in selling shares, which then continued tracking the share price all the way down to R4. After the price halved again to below R2 in late 2008 we turned buyers, again just before the price increased by 50% to R3 in early 2009, at which levels the portfolio managers again started selling.

That concludes the good news; it's all downhill from here.

At prices below R2 and all the way to R1.20 in early 2010 we continued increasing our holding, to ultimately reach our maximum number of shares of 80mn by July 2010. At that point the analyst and our portfolio managers (and the author of this thought piece is a member of both these parties) lost his/their last shred of faith in the management of this business, changed the investment recommendation to a sell and 9 months later in early 2011 we finished selling the rest of our shares, ultimately selling all 80mn shares for an average price of approximately 95cps.

Now that the table has been set, let's dig in. The two key questions are:

What Were our Mistakes?

1. The key mistake in this whole episode hits one straight out of Ben Graham's classic thought pieces, with the benefit of hindsight. The analyst mistakenly started mentally re-classifying Simmer & Jack as a lower risk proposition at a much lower margin of safety compared to our initial purchase levels, basically turning what was a sound investment decision at 65cps into a speculation at R5. Over a 2 year period since the initial purchase this viewpoint was very firmly cemented by favourable price confirmation and other news flow which served to increase our conviction levels, despite warning signs that were surfacing and either ignored or argued away at the time. Interestingly, on another angle altogether, the sound investment decision at 65cps was accompanied by ridicule, difficult questions from colleagues and clients and hence extreme levels of personal discomfort, while the speculation at R5 was accompanied by general acceptance of the perceived brilliance of the analyst, nods of agreement all round and hence extreme levels of comfort. No prizes for guessing which one we should prefer!
2. The analyst stuck to his mistaken conviction for too long, eventually culminating in the continued capital commitments of 2009 that served to destroy so much of the created value for clients. By the time he finally realised it the damage was largely done. To his credit he did eventually come around and given the way things are currently going in the uranium world following the very unfortunate on-going Japanese nuclear disaster, seemingly just in time!
3. The investment team did not truly interrogate the analyst enough once the warning signs started appearing to test his and their own conviction levels.

What Did We Do About It?

1. Part of our investment process is to monitor all our capital commitments against their original investment thesis. We use any tools at our disposal but it comes down to the analyst and the investment team taking a fresh and critical look at the original research and its related assumptions. We have also found that it helps to 'appoint' someone to create an argument against a position to help identify any gaps in our thinking.
2. Inside the RE:CM research engine room we are all equals - anyone can interrogate another analysts' convictions at will. However, over the years we've learned that younger analysts treat more experienced analysts' work with too much respect and everyone treats analysts that happen to be on a 'hot streak' with too much respect. We know all too well that a hot streak is exactly that – short-lived – and that the higher the peaks the bigger the inevitable fall. This last point is a major threat to a sensible investment decision making process. We apply the same critical perspective to any new or established piece of research irrespective of the experience or recent outcomes of the analyst.
3. The last point to be made in this thought piece is industry specific. Deep level marginal gold mining is definitely not for wimps and relies heavily on skilled execution by management. Placing markers in the sand by which an analyst can measure managements' promises of the few things directly under their complete control provides an early warning system that can greatly assist sensible decision making.

In conclusion, he may know absolutely nothing about investments, but we wish we had Keith Richards in our team to remind us from his very unique world perspective to consider whether what looks like acceptable odds may amount to nothing more than a speculation in disguise.

Daniel Malan

THE CHICKENS ARE COMING HOME TO ROOST

"It seems that the construction industry has accepted that increased levels of fixed investment are probably sustainable for some time into the future. This should increase forecasting confidence."

Murray & Roberts Annual Report 2007

"…and we expect that average revenues over the three years between 2009 and 2011 may quintuple to about R40 billion."

Murray & Roberts Annual Report 2008

"We know from experience that in a stable construction market, the 12 month forward order book divided by 65% should on average indicate minimum revenue for the period ahead."

Murray & Roberts Annual Report 2009

"The scale and duration of major projects often requires conservative revenue recognition that includes a portion of claims not yet resolved."

Murray & Roberts Annual Report 2010

"The scale and duration of major projects secured by the Group over the past few years presents a number of challenges, not least of which is how to account for revenues earned relative to cash received."

Murray & Roberts Annual Report 2010

"Contractors have always been easy targets for slowed, deferred or non-payment."

Murray & Roberts Annual Report 2010

"It is better to have a permanent income than to be fascinating."

Oscar Wilde

Murray & Roberts Recent Interim Report

Murray & Roberts, one of the darlings of the South African construction industry, reported its interim results to much brouhaha earlier in the quarter. Some of the salient points covered were:

- collusion within the construction industry,
- on-going problems regarding mega-projects (specifically the Gautrain and the power projects they undertook for Eskom); and
- exceptional charges relating to uncertified revenue.

The presentation produced a rather melancholic picture of Murray & Roberts who only three years ago were talking quite confidently about sustained growth.

Quality Revenue or the Quality of Your Top-line is Important

The purpose of a business is to make money but you have to generate revenues before you can achieve this. Revenue is referred to as the top-line in business compared with the bottom-line, which is profit. It is very important to remember that if a business drops low quality revenue into the top-line, this will translate into poor quality earnings in the bottom-line. Simply put, rubbish in, rubbish out!

There are many examples of this. The late 1990's saw an expansion in the laying of fibre optic cable by telecommunication companies in the United States. Suppliers of the hardware and the fibre optic cable sold portions of the network to businesses who built their business models on selling bandwidth. The premise for this expansion rested on the argument that this supply was required to meet the future exponential increase in demand for Internet bandwidth at the dawn of the 'new economy' during the dot-com bubble.

At the time, the network suppliers were allowing the buyer of the network to defer payment to a later period, sometimes stretching this period over a number of years. Accounting treatment of revenue allowed the supplier of the network to recognise 100% of the revenue immediately even though the receipt of the cash flows was deferred to later periods. Even more concerning was the lack of prudence by the management of these companies in recognising this revenue upfront given the fragility of the future cash receipts and the business models of their customers. Once the buyers of the network could not generate their own revenue to meet their obligations to the suppliers of the network, it reflected in the earnings of the network suppliers. This highlighted the poor quality of previously recorded revenue. A lot of receivables raised due to these sales had to be written off once the irrational allocation of capital, in the over-supply of optic fibre cable and networks supporting bandwidth, had come to an end.

No Use Crying Over Spilt Milk

The accounting treatment of revenue can become quite tricky depending on the complexity of the transaction that gives rise to the revenue. But construction companies have a unique method of recognising revenue. They make their money building a structure to the client's specifications. This can take long time to complete, which can extend beyond financial reporting periods. Revenue is usually recognised once the risks and rewards of ownership are transferred from the seller to the buyer. For example, when someone buys bread and milk, the moment at which money is paid and the buyer walks away with the purchases is the moment that the risks and rewards are transferred to the buyer. After that moment, if something happens to the bread and milk, it is the buyer's risk to bear. If the buyer drops the milk outside the shop entrance and the container breaks, spilling the milk, well ... there is a very well-known saying that covers the buyers' options in this event.

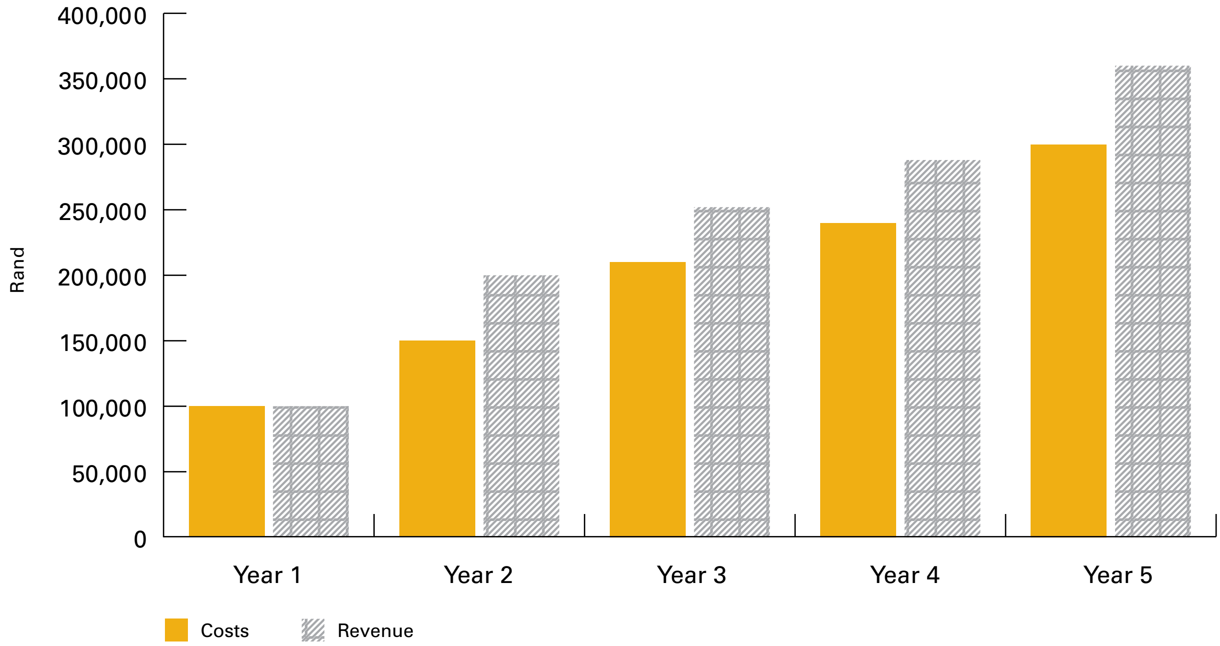
This transfer of risk and reward is more difficult to identify in the case of a service such as a construction project. Revenue is usually recognised over the duration of the project. Fortunately, accounting standards have provided guidelines on how to recognise revenue generated from construction contracts.

Building Your Dream Home

Let's say that one contracts with a construction company to build a house. It is a very intricate house and the contractor will take five years to build it. It will cost R1 million and the contractor agrees to a contract cost of R1.2 million which will result in profit of R200,000 for the contractor at a margin of 17%. We realise these numbers are not realistic but please bear with us for the sake of the argument. The contractor recognises revenue in his financial statements according to the percentage of completion method, which means that the contractor recognises a proportion of total revenue in any given financial reporting period depending on the proportion of costs incurred in that financial reporting period. Before the point in time that the contractor can determine the outcome of the project, accepted accounting treatment determines that revenue should only be recognised to the extent that costs have been incurred and that the costs will probably be recoverable. This means the contractor records no profit.

After working on the house for a year, the contractor is uncertain about the outcome. At this point they can not confirm that the project will cost a R1 million to complete however costs of R100,000 have been incurred in putting in the foundations. So, revenue of R100,000 is recorded for Year 1. The initial amount will probably be paid as there is no reason to think otherwise and therefore no profits are recorded in the first year.

In Year 2, things start to move quicker and a further R150 000 in costs are incurred. It is also possible at this point in the project to see that the total costs of the project will end up being R1 million. To date costs of R250 000 have been incurred which is 25% of the total cost. So, 25% of the total revenue to be earned can be recognised, less what was earned in the previous year so R200 000 is recognised as revenue and R50 000 as profit (R200 000 revenue less R150 000 costs incurred). The outcome for each of the 5 years is illustrated below with the profit recorded each year being the difference between the contractor's costs and the revenue incurred:



Source: Company reports, RE:CM analyst

Sharp End of the Stick for the Contractor

This is the ideal outcome - except life is not always ideal. You will notice that actual payment of this recorded revenue has not been mentioned. During the course of the five years, advance payments will be made for the contractor to fund his working capital but the balance of the outstanding payment is paid at the end of the construction contract. This is the sharp end of the stick for the contractor. Using our example, let's assume that the contractor needs to incur an additional R200,000 in order to complete the project. In Year 5, the contractor will incur R500,000 instead of the planned R300,000 and would expect to recoup these costs with a mark-up from the customer. But the customer delays payment because he disputes these extra costs or because he has fallen on hard times and now there are no funds to pay creditors. All of a sudden, the picture has changed. The contractor is no longer sure of recovering the costs and the expected losses have to be recognised immediately.

Let's compare the two scenarios in Year 5.

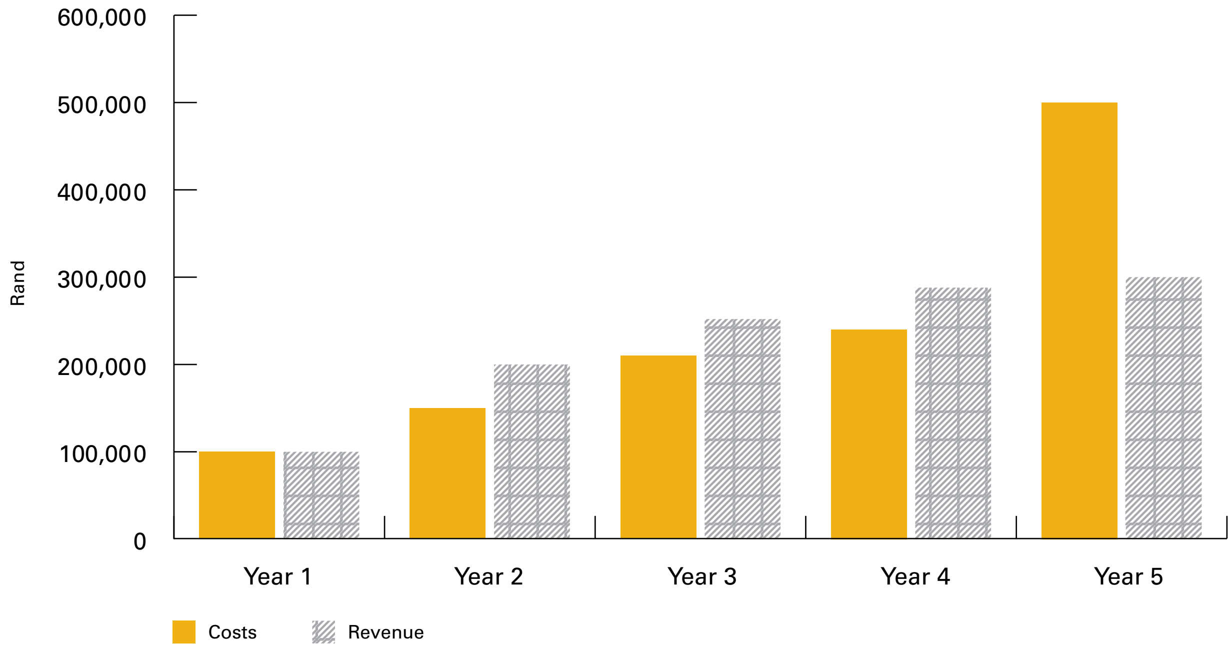
1. Everything Runs Smoothly – Ideal Conditions
The contractor incurs costs and is able to recover these costs and the mark-up from the customer so revenue of R300,000 is recorded as costs, R360,000 as revenue and a profit of R60,000 is shown.

2. The Contractor Incurs Additional Costs – Less Than Ideal Conditions
The contractor has had to incur an additional R200,000 to complete the project. The customer is either unwilling, not legally bound to or simply unable to pay the contractor for the additional work that has been done. Here the original R360,000 can be recorded as revenue but costs of R500,000 have to be incurred meaning that a loss of R200,000 has to be recognised immediately in Year 5! Hardly ideal for the contractor. See opposite page for a Table of Comparison:

Table of Comparison

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Ideal conditions						
Construction costs	100 000	150 000	210 000	240 000	300 000	1 000 000
Revenue	100 000	200 000	252 000	288 000	360 000	1 200 000
Profits	-	50 000	42 000	48 000	60 000	200 000
Profit Margin	0%	33%	20%	20%	20%	17%
Less than Ideal conditions						
Construction costs	100 000	150 000	210 000	240 000	500 000	1 200 000
Revenue	100 000	200 000	252 000	288 000	360 000	1 200 000
Profits	-	50 000	42 000	48 000	-140 000	-
Profit Margin	0%	33%	20%	20%	-28%	0%

Over the five year period the contractor has one year that has broken even, three good years at gross margins greater than 20% and a final year where a loss of R140,000 has been incurred. Looking at the financials for the five year period and looking at each year in isolation would give you the impression that the contractor has been able to grow revenue at a very stable rate from Year 1 through to Year 4. This looks very appealing to an outsider trying to assess this business. However, Year 5 is not a pretty picture showing a large loss. It is important to note that the contract as a whole did not make a profit after the losses incurred in Year 5 but that the contractor was able to show profits for 3 out of the 5 years that the project was being undertaken. When taken all together, the graph looks very different:



Source: Company reports, RE:CM analyst

Rather Sickly, Fairly Quickly – Financial Health and Market Conditions

This needs to be kept in mind when looking at the top line of a construction company. Things might be looking rosy over time but the sharp end of the stick is still coming. On multiple construction contracts with different time horizons, it is possible to offset some of the potential losses that can be incurred in the final year of a construction contract with the revenue and profits recognised in years 2 and 3 of another construction contract. However, there can come a time when trading conditions mean that not enough new contracts can be entered into to cover losses from previous contracts meaning that it is not possible to offset any potential losses on older contracts and the financial health of the company can look rather sickly fairly quickly. As an outsider, we need to ask ourselves how much risk the contractor is taking on in Year 1 in order to secure an attractive looking top-line in Years 2, 3 and 4.

Looking at Murray & Roberts

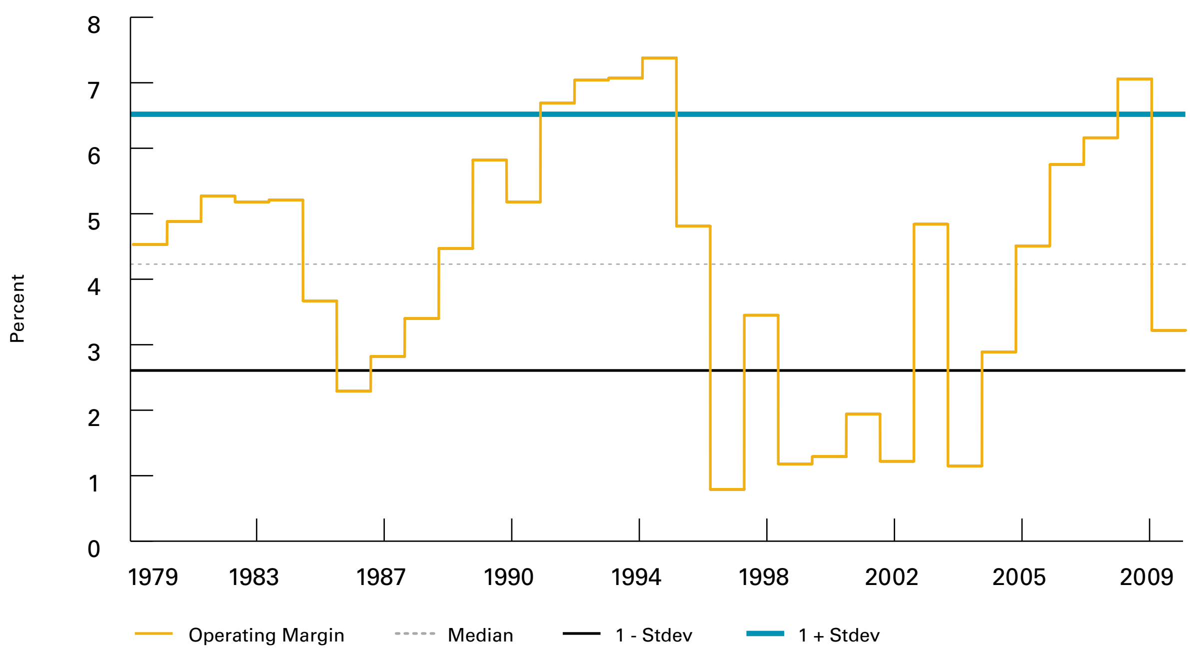
This is a simplistic way of describing what Murray & Roberts have gone through in the last few years. After some amazing growth in their top-line (R11.9 billion in 2006 to R33.8 billion in 2009; compounded growth rate of 29.8%) they are experiencing a contraction in demand as government agencies and parastatals are closing the taps on the supply of construction contracts. This, combined with changes in "scope and scale" on existing projects due to unforeseen complexities and customers deferring payment due to their own financial shortcomings, has resulted in a perfect storm for Murray & Roberts. The storm was quantified to the tune of a R795 million charge hitting the income statement in this six month period ending in December 2010.

Nothing 'Exceptional' About It

What is also interesting to note is that this charge has been called an exceptional item in the income statement. We are not passing comment on the correctness of the accounting treatment but we would argue that there is nothing exceptional about it as the risk of incurring such a charge is part of completing construction contracts. Calling it an exceptional item does tend to give the impression that it occurred due to events outside of managements' control and therefore they should not shoulder any blame for its existence. For further commentary on our view on the human psychology behind the propensity of individuals to look to place blame elsewhere, see our article entitled "Woza 2010!" in the 12th edition of RE·VIEW (April 2010) which also happened to focus on Murray & Roberts. (It is very important to point out now that this practice is not limited to Murray & Roberts; it is prevalent throughout the construction industry.)

These losses arise due to construction companies willing to write business in order to increase the size of their order book due to the prominence this number holds in the eyes of the investing community. The need to disclose a large order book results in some lemons being entered into which are very difficult to make into lemonade when the cycle turns. Murray & Roberts management is surely not ignorant of this fact, as they have been in the industry through many cycles. This is visible in the following graph of Murray & Roberts operating margins (this is an update from a similar graph depicted in "Woza 2010!"):

Murray & Roberts 30 Year Operating Margin



Source: Thomson Datastream

Murray & Roberts' operating margin is reflecting the charges incurred in writing riskier business in order to build the order book and then experiencing the work drying up. As much as the operating margin has fallen, history shows us that it can still fall further. Of the R795 million charged to the income statement, R410 million related to revenue that had already been recognised in previous periods while R385 million related to work that had been undertaken in the current half year. This was the same six months that resulted in a total of R15.8 billion of revenue being recognised. Admittedly, not all of this would be due to construction contracts, but rather the sale of products, but it would predominantly relate to revenue derived from construction contracts. As an Outside Passive Minority Investor (OPMI) with no special insight into the inner workings of Murray & Roberts, the question has to be – how much more in similar 'exceptional' charges could still be incurred?

What Makes One Contractor Better Than Another Contractor?

This accounting treatment allows management of construction companies to obscure their levels of risk management when it comes to entering into construction contracts and the terms and conditions agreed to. The construction industry is characterised by low barriers to entry and results in a very competitive operating environment. What makes one contractor better than another is simply their ability to manage the risks inherent in construction contracts, that have been demonstrated above; and their ability to manage these risks can be seen in how they account for revenue over a period of time.

Management can be conservative in the way they enter into contracts as well as how they recognise the related revenue. One way to do this is to be conservative in their estimate of when the outcome of the contract is certain and therefore the stage in the life of the contract that they recognise profits. Having said that, this ability that management can possibly have, in being better able to manage risk and account for revenue than the next guy, does not translate into a sustainable competitive advantage.

Investment Option Comparisons – How Much Would Your Rand be Worth?

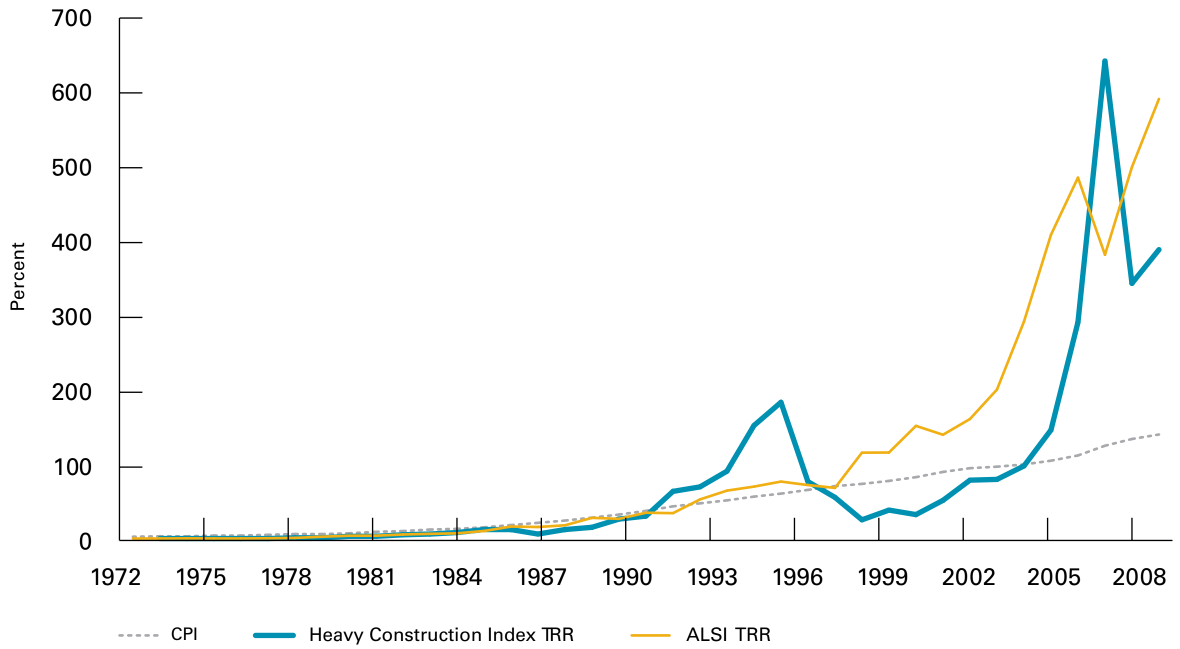
It is insightful to compare how much an investor would have made by 2010 if a Rand had been invested in an index of South African Heavy Construction companies back in 1972 compared to the return that would have been achieved by investing in the ALSI or simply letting inflation do its work.

Leaving inflation to do its work would have meant that the Rand would have turned into R140 in 2010 while a Rand invested in the index of construction companies would have returned R387. Not bad ... except when you realise that a Rand invested in the ALSI at the same time would have returned R588!

This Highlights Two Key Points.

1. The relative underperformance of the Heavy Construction industry compared with the market over time.
2. The power of compounding and not incurring permanent losses in capital.

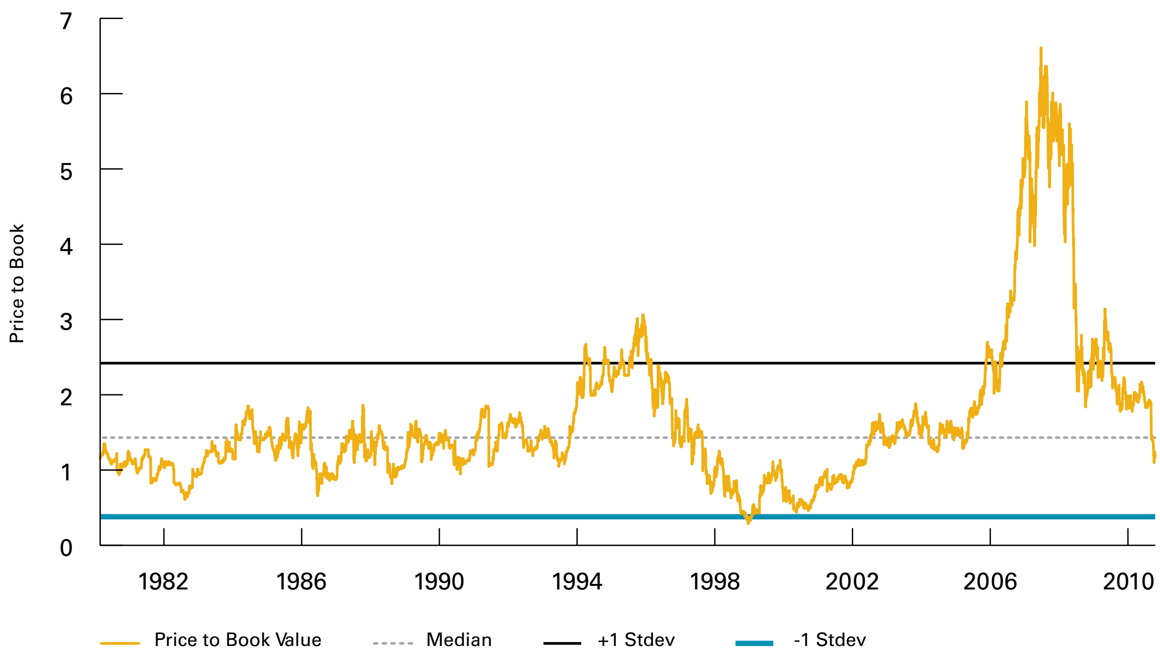
Comparative Returns Since 1972



Source: Thomson Datastream, I-Net Bridge

"How Much Can We Lose?"

Murray & Roberst 30 Year Price/Book Multiple



Source: Thomson Datastream

Murray & Roberts' price-to-book multiple has dropped significantly since the heady days of 2007 when the stock was being valued at six times book value. RE:CM did not allocate your capital to construction stocks during this period when the sector appeared very attractive to market commentators because the stocks on offer were not at a discount to their intrinsic value or at an acceptable margin of safety. On recent evidence, it appears that this decision was the correct one to make.

From this simplistic quantitative measure it appears that Murray & Roberts is starting to trade at roughly fair value, possibly even below. This is interesting but when we think about allocating your capital to potential investments, our first question is: "How much can we lose?". To protect your capital, we always invest with a margin of safety or in other words when a business is offered to us by Mr Market at a discount to its intrinsic value. When Mr Market comes a-knocking and offers us a portion of Murray & Roberts at the appropriate discount for a company with no sustainable competitive advantages and very volatile financial statements then we will allocate your capital accordingly. But not before then.

Richard Court

STRIKING OIL

"Scientists are seeing more and more evidence that we are specifically designed by Mother Nature to fool ourselves."

"Probability is not a mere computation of odds on the dice or more complicated variants; it is the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance."

Nassim Nicholas Taleb – Fooled by Randomness

"We have the people and the technology, the experience and the innovative spirit to reach new frontiers, to meet the challenges of the future, and to grow our business significantly beyond where it is today."

From Sasol Annual Report

"I am pleased that we have been able to resume dividend payments, and our intention is to grow the dividend level in line with the company's improving circumstances. We are now taking action to create and realize greater value."

Bob Dudley – BP Chief Executive Officer

Humans are emotional beings. How we feel influences the way we interpret the world at any given point in time and influences our behaviour. In the practice of investing emotion is known to be the chief enemy. Consequently, finding a way to counter emotions is critical.

With the oil price spiking above US$ 120 it is an opportune time to reflect on your exposure to energy stocks. In the light of recent portfolio actions concerning BP and Sasol we hope to demonstrate how our investment process protects your investment with us from our emotions and ensure that we stay on course.

Ultimately, investing boils down to weighting risk. The size of individual positions is fundamental. Daniel Malan, our investment director wrote about this in an article "Man is an animal" in the October 2010 edition of the REVIEW. We apply four criteria in determining the weight of a position namely:

1. Quality
2. Cheapness
3. Business cycle position
4. Popularity.

In conjunction with the above, we also consider the absolute downside risk of each position.

Let us investigate Sasol and BP in this regard.

1. Quality

The higher quality the business the faster and more sustainable it grows intrinsic value. A high quality business justifies a larger weight than a low quality business.

Are Sasol and BP high quality businesses?

It seems that energy companies are unique in the commodity world. As a rule, commodity suppliers are not able to distinguish their products from one another. With the exception of sectors where the bulk of supply is concentrated, which implies an ability to influence price, or where a company has a sustainable cost advantage, commodity type businesses are generally poor over full business cycles.

The oil sector falls into the category of exceptions. Ever since oil was first used as an energy source, ownership has been concentrated in the hands of a few. This enabled the oligopoly of producers to control production and influence the price of oil over the long term, leading to excess returns being earned for their investors over long periods.

Today, the Organisation of the Petroleum Exporting Countries (OPEC), a cartel that coordinates the supply of oil of its members, controls the bulk of low cost oil production. By aiming to maximise the present value of its future oil proceeds it acts as the swing producer, and in so doing sets the price of oil.

OPEC production is followed by non-state-owned super majors such as BP, Chevron, ConocoPhillips, ExxonMobil, Royal Dutch Shell and Total. They are next in line on the cost curve yet still produce oil substantially below the marginal cost of production and have thus also earned excess returns over long periods.

Due to low cost, concentrated suppliers acting in their self-interest to maximise the price, 'striking oil' has become synonymous with making money.

Sasol, in turn, is unique amongst energy companies. It did not literally strike oil. Its tale is one of a political drive for energy self-sufficiency that subsidised an otherwise uneconomical project to the point where, due to improvements in the technology and know-how and a rising world marginal cost of production it became economically viable. Figuratively speaking, Sasol had struck oil. In fact, it has outperformed all the oil majors over the last 20 years in US dollars, both in absolute terms and on a risk-adjusted basis.

Sasol and BP both qualify as high quality businesses and therefore justify a greater weight than similarly valued quality businesses.

Keep in mind that Sasol's technology that converts coal or gas into oil equivalents make it different from the oil majors in two important ways.

- Firstly, as opposed to piping out oil directly from a well at low cost, Sasol's process is extremely capital intensive and consequently its cost of production is higher compared to the oil majors. This means that Sasol is more sensitive to the movement in the oil price, both up and down.

- Secondly, with gas and coal in ample supply Sasol has significant 'oil reserves' on hand whereas the oil majors have spent increasing amounts to find new barrels of oil to replace diminishing reserves. The feasibility of Sasol's projects depends on the cost of production relative to the oil price. Currently their cost ranges between US$60-80. Suffice to say, at the current oil price Sasol has endless growth opportunities.

2. Cheapness

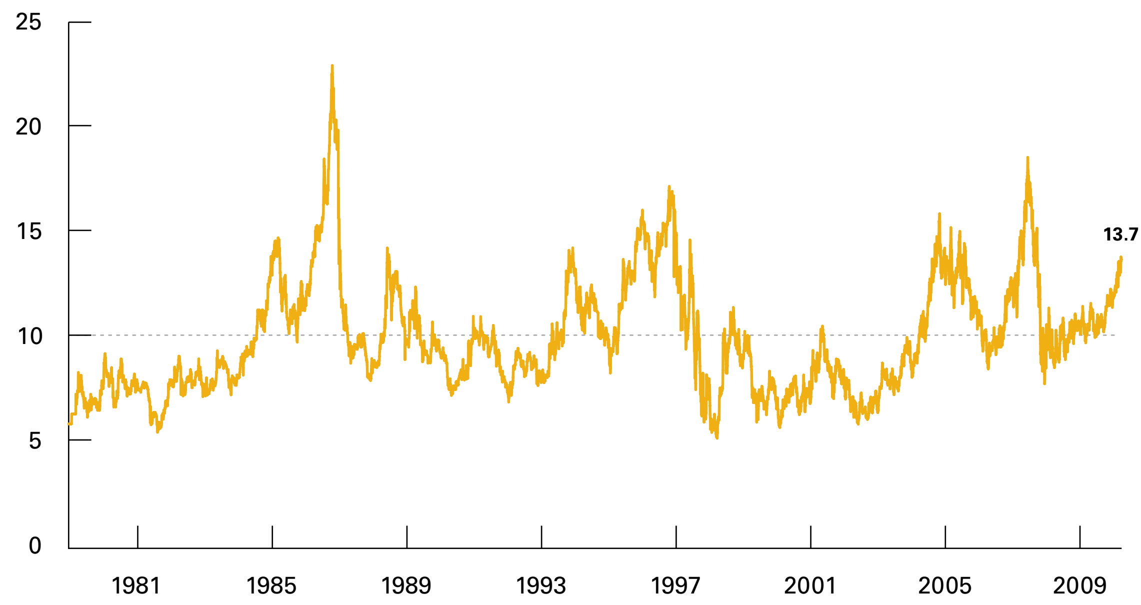
A lower price to value relationship equates to a higher margin of safety. A higher margin of safety implies less risk of permanent capital loss, and better future investment returns. Logic therefore dictates that the cheaper a company's shares are priced in the market relative to intrinsic value, the higher the weight it should carry in a portfolio. This is the approach we follow, in contrast to the point of departure of the market in general, where capital is allocated based on the weight of a share in the benchmark index.

In recent times Sasol has traded close to our estimate of intrinsic value while BP offers a considerably larger margin of safety. This is illustrated in Figure 1 and 2 which shows the Price: Earnings ratio for the two companies.[1] Note that to demonstrate the Price: Earnings Power relationship, BP's Price: Earnings ratio excludes the impact of the Deepwater Horizon oil spill on earnings.

Based on their respective discounts to intrinsic value, BP thus deserves a higher weight and Sasol a lower weight.

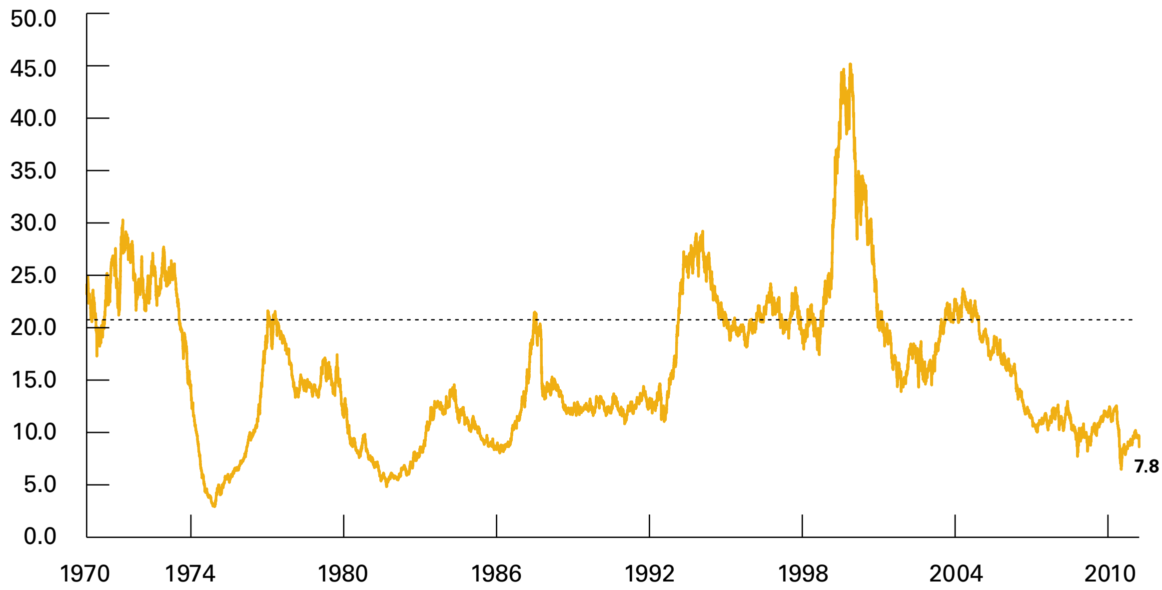
1. Earnings are calculated as 3-year average earnings using 1.5 years historic and 1.5 years forward earnings relative to the price point. This allows for stable earnings numbers and PEs, especially for BP, and account for the fact that PEs are forward looking. 1.5Yr forward earnings for the most recent PEs are substituted by the consensus earnings forecast over the next 1.5 years.

Figure 1: Sasol Price: 3-Year Rolling Earnings



Source: Thomson Datastream, RE:CM analysis

Figure 2: BP Price: 3-Year Rolling Earnings



Source: Bloomberg, RE:CM analysis

3. Cycle

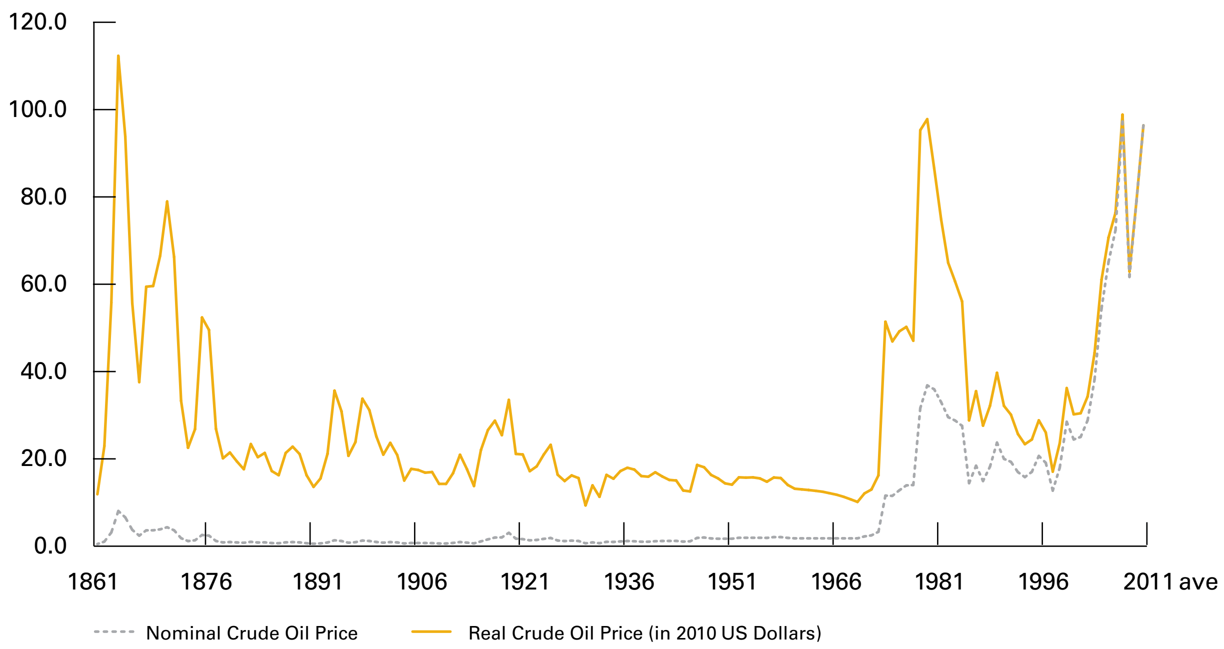
There are two errors that come standard to the practice of forecasting namely extrapolating recent history and projecting positive growth into the future from almost any point in the business cycle. This typically culminates in over optimism about the future at the top of a business cycle and over conservativeness about the future at the bottom. These sentiments are reflected in over-priced shares at the top and under-priced shares at the bottom which in turn frequently means poor future returns for investors from the top of the cycle and good future returns when the cycle is low.

We realise that we are no better at forecasting. To counter this we reduce the weight of a company when its business cycle turns up and increase its weight as its business cycle turns down.

Similarly, Sasol's market valuation follows a business cycle. It tracks the rand oil price. Figure 3 illustrates the annual average oil price in US dollar since 1861 both in nominal terms and adjusting for inflation. The current price of oil at US$ 120 per barrel is even higher than the last data point in the graph which represents the 2011 year-to-date average. Clearly, the oil price is high in both nominal and real terms.

However, it may be most useful to compare the oil price to the marginal cost of production. Over the past decades new finds of low cost oil reserves was limited and as time has passed the cost of producing an additional barrel of oil rose as higher cost reserves and production methods were developed to meet demand. The oil mix has changed and today the marginal cost of oil production is higher at US$60-80 per barrel. This in turn justifies a higher oil price than in the past. But, the recent spike in the oil price to levels way above the marginal cost of production, both in US dollar and Rand terms, point to a cycle that has turned high. As a result, a maximum weight position is not possible for either BP or Sasol, regardless of their quality or estimated level of cheapness.

Figure 3: Brent crude in US$ (annual average price)



Source: Energy Information Administration, RE:CM analysis

4. Popularity

Being contrarian or making unpopular decisions is difficult in all areas of life. It is no different with investing. It is much easier to hold shares that everyone else is holding. There is comfort in consensus.

In addition, the personal risk of going it alone is often too high. Jeremy Grantham discusses the concept of career risk and how people generally get in trouble for being wrong on their own, but not for being wrong as part of a group. For many fund managers, the risk reward trade-off of being positioned differently is often not worth it from this perspective.

We know that you have appointed us to manage your risk return profile, not our career risk profile, which is why we built in a mechanism to force us to do what does not always come naturally – buy what is out of favour and avoid the "flavours of the day".

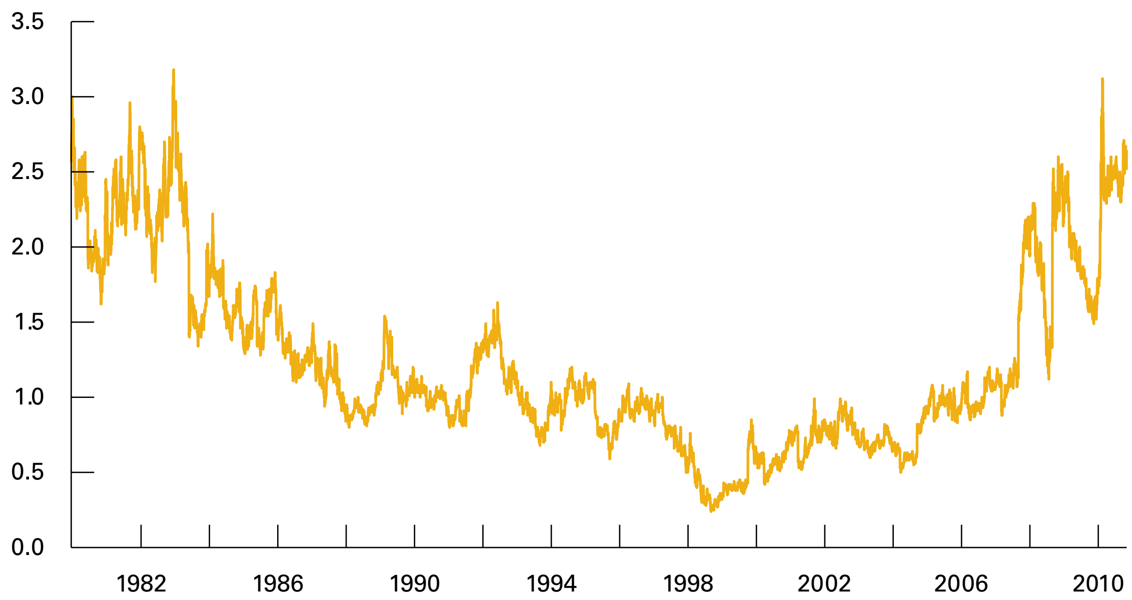
Market sentiment currently favours Sasol over BP. A higher oil price makes Sasol's technology more viable. As a result the market is comfortable to assign a higher rating with the expectation that it will make more money in the future as projects are approved and executed. Together with some well-received recent cost performance and management actions it is fair to say that the sentiment surrounding Sasol has turned positive.

Conversely, the replacement of reserves has become more difficult for the oil majors in recent times. Increasingly they have embarked on more complex projects in more risky geographic regions. For BP this resulted in the Deepwater Horizon oil spill disaster. To say that BP is unpopular right now is perhaps an understatement.

These sentiments are reflected in Figure 4 which plots Sasol's Price / Net Asset Value relative to BP's. Currently investors are willing to pay close to 3 times more for Sasol's Net Asset Value than for BP's.

Our process demands a higher weight in BP which is unpopular and a lower weight in Sasol which is popular.

Figure 4: Sasol and BP Price / Book Relative



Source: Thomson Datastream

Downside Risk

Recently during 2008, Sasol traded as high as R518. Buying at those sorts of levels invariably led to a permanent loss of capital. Clearly, a good quality company is not always the same as a good investment. Price is important.

If we consider the current valuation of the two companies in Figure 1 & 2, it appears that the risk of permanent capital loss is much higher for Sasol than for BP. Recall that Sasol is more sensitive to a change in the oil price. Reversion of the oil price from its current elevated level back to the marginal cost of production implies a lower intrinsic value for Sasol than is currently reflected in its share price.

In addition, even though the marginal cost of production appears sticky at its current level it has fluctuated in the past and it is likely to decrease again at some point in the future. The downside potential in the event of such an enduring decrease in the oil price is significantly higher for Sasol than for a lower cost producer like BP.

Conclusion

Ultimately the future matters but it is important to distinguish between what we reliably know today from less reliable predictions about the future. How many of Sasol's growth projects will be executed and how much value it will add is hard to tell.

More importantly, we are loath to pay up for the expectation of very good outcomes. We believe that Sasol's current share price suggests a very good outcome while BP's price suggests a very poor outcome.

Both BP and Sasol meet our definition of quality but while BP offers an attractive margin of safety, Sasol is trading close to our estimate of intrinsic value. For both companies the business cycle is at a high point but it appears that Sasol is currently popular and BP shunned.

Both due to price relative to value and the risk management tools inherent in our process, we have significantly downsized your position in Sasol while adding BP to portfolios where mandates allow.

It may currently feel good to own Sasol while it may feel a bit nauseating to own BP. But, comfort and risk is positively related. Sizing positions inversely with the business cycle and popularity forces us to do what does not come naturally. Ultimately we hope that this protects you from our human fallibility.

Johannes Visser

MANAGING MANAGEMENT ACTIONS

"Time is the enemy of the poor business and the friend of the great business."

Warren Buffett

"Our assets walk out the door each evening. We have to make sure that they come back the next morning."

Narayana Murthy, founder of Infosys Technologies Limited

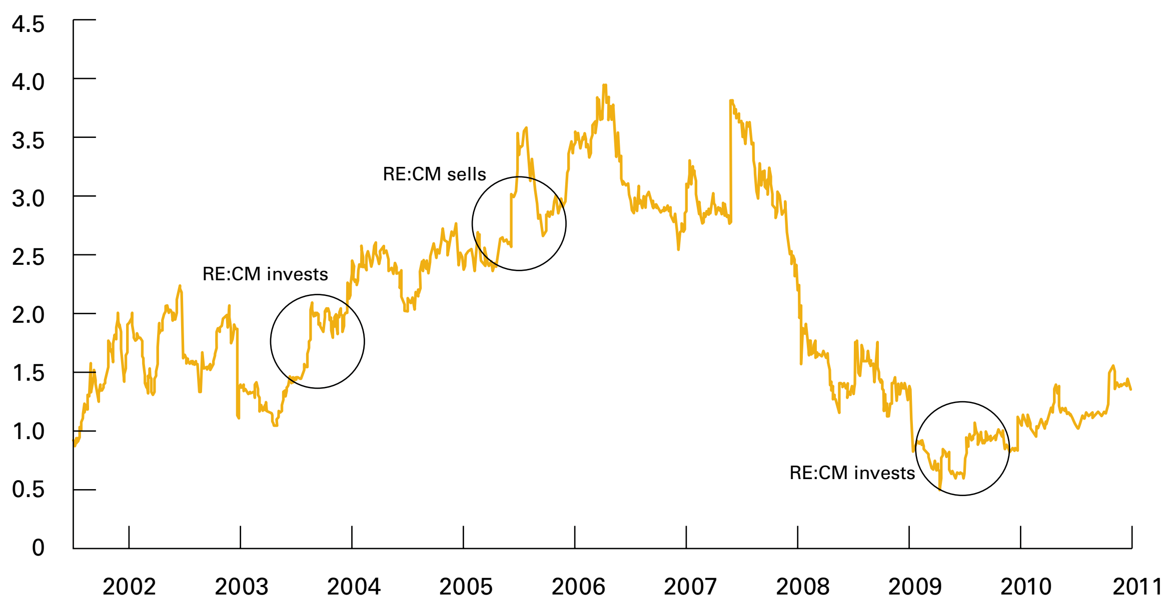
We recently completed a review of the ownership cycle of two investments where company management action played a significant role in concluding our investments in the businesses. As a way of giving you greater insight into how we think about buying and remaining owners of businesses, we would like to explain these two examples.

Mustek

Mustek is a small company that primarily assembles and distributes computer hardware. Its best-known brand is Mecer. This is a highly competitive, low margin industry, but the market loved the company for a few years after it listed in the late 1990's small cap/IT bubble. The company subsequently fell out of favour and the stock became very cheap in the early 2000's. At that point, RE:CM clients did own shares in the company (refer to Chart 1), but the stock then went back to being expensive along with the rest of the South African market in 2005 – 2007. The 2008/9 bear market treated Mustek with the same disdain as it did many small cap stocks, and this gave us the opportunity to buy into the company again for clients, starting in mid-2009.

At the time, the market was pricing Mustek at a steep discount to its net working capital per share. In short, if one added up all the current assets (stock, debtors and cash), ignoring any fixed assets like property and equipment, and subtracted all the company's liabilities, one came to a number substantially higher than the share price. Historically, this has been a good price to buy into businesses – though the market doesn't often present such prices, and typically only in the lowest quality businesses. Chart 1 shows how Mustek has been priced relative to its net working capital since mid-2001, and the circled areas show where we took action for clients.

Chart 1: Mustek Market Cap Relative to Net Working Capital

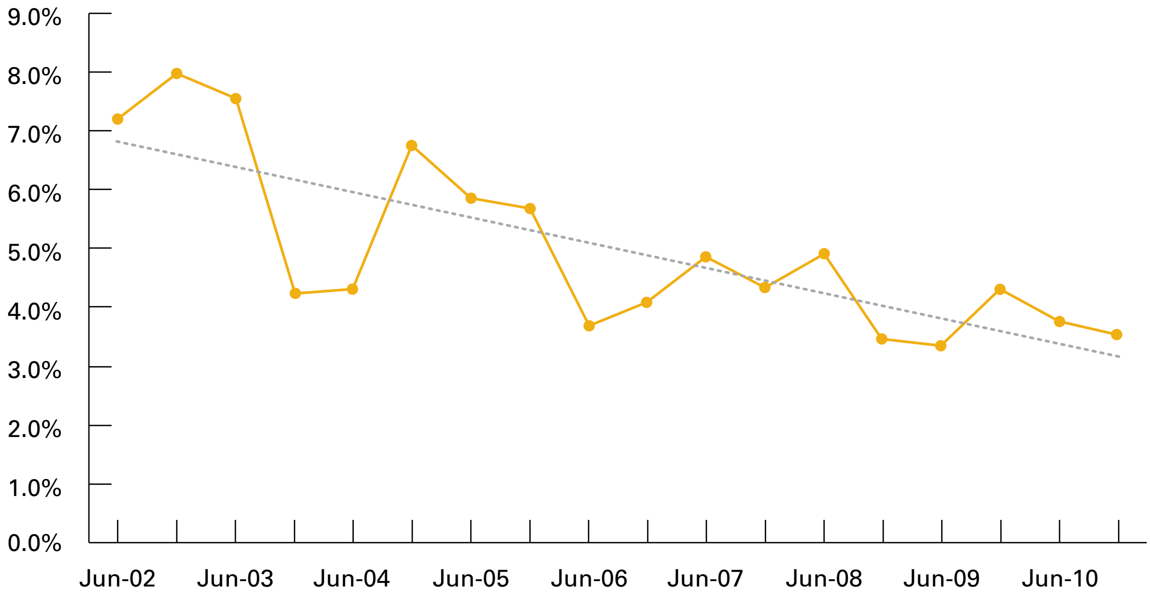


Source: Company reports, Thomson Datastream, RE:CM analyst

The share price recovered steadily from its mid-2009 lows, and then jumped in December 2010 when a consortium including management proposed a buy-out of the company at a price of R5.55 per share. We have indicated that we will accept this offer. R5.55 per share is a discount to net asset value (but a small premium above tangible net asset value), and in the context of Mustek's history as shown in Chart 1, does not look like a high price (representing about 1.5 times net working capital). In addition, history shows that one typically does not want to be on the opposite side of the table to management in a transaction involving their own company's shares. Why are we willing to accept this "low" offer? Two points were top of mind when we came to this decision:

1. Mustek's operating margin has shown a steady downward trend over time. Tough cyclical conditions affected the recent numbers; but even in the times when the local economy was booming, the steady downtrend showed no sign of reversing.

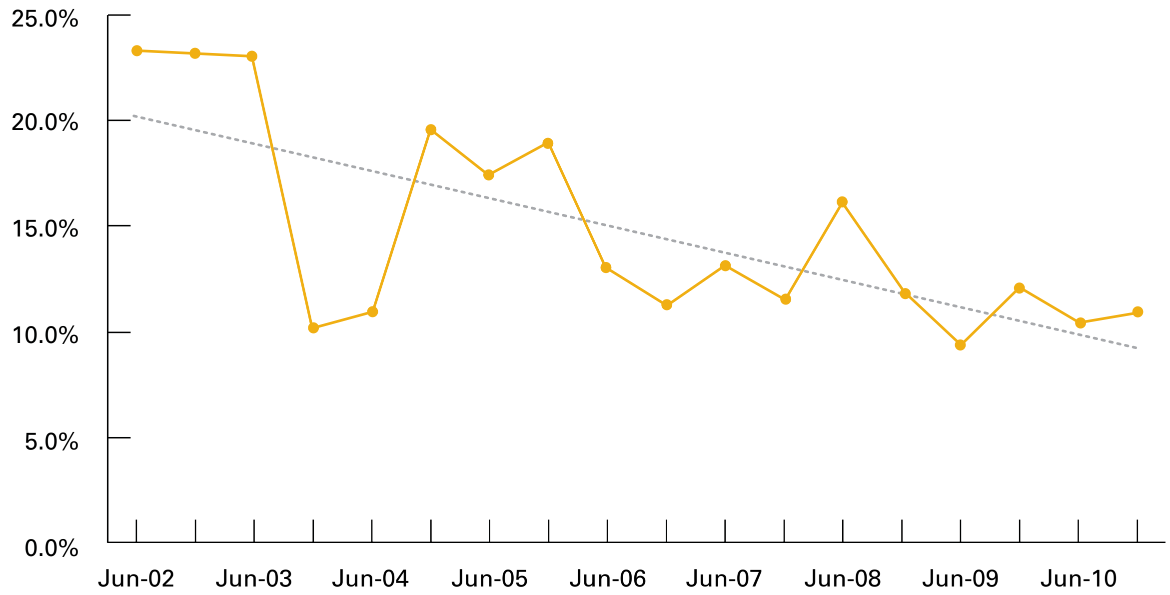
Chart 2: Mustek Rolling 12 Month EBIT Margin



Source: Company reports, RE:CM analyst

2. A declining operating margin is not necessarily a problem, as long as the company can increase asset turnover to enable them to keep earning high returns on capital. Mustek has been evolving from an assembler (a more capital intensive, but higher margin business) to being more of a distributor of other manufacturers' products over time (a less capital intensive, but lower margin business). In that context, a decline in operating margin is understandable. The expectation is that returns on equity will at least be stable, to reflect the benefit of requiring a lower level of capital investment. However, the return on equity the company has generated mirrors the operating margin trend despite employing a substantial amount of gearing at times – which should have boosted returns on equity.

Chart 3: Mustek Rolling 12 Month Return on Equity



Source: Company reports, RE:CM analyst

To us, these trends indicate a company struggling to maintain competitiveness against strong competition in its market. And given the low barrier to entry nature of the business, we would be surprised to see Mustek return to the 7% operating margin, 20% plus return on equity type of profitability that it generated in the early 2000's. A business earning returns on equity in the low teens is only worth its net asset value at a stretch – a stretch we are happy to let management, and not RE:CM clients, engage in.

Brait

Brait is a second example, but has been a far more significant investment for RE:CM clients for the past number of years, featuring amongst our top ten holdings at times. Here management actions have resulted in a material impairment of our earlier assessment of the value of the business.

Investment management businesses like Brait are asset light, but people intensive. This makes them potentially fantastically profitable from a return on capital point of view (an assembled workforce is not an asset that is capitalised on a company balance sheet), but it also makes them risky. If the people decide to leave, a lot of the value of the business goes with.

Brait has probably been the flagship third party private equity fund management business in South Africa for the last decade or more. Private equity has not been the easiest of businesses lately. The 2008/9 financial crisis spooked clients, and it seems to have become quite hard to raise funds from third parties – without which, there is of course no business. As far as we can tell, the arduous process of raising funds and holding client hands through a difficult cycle had become such a time intensive process that Brait's management have decided their efforts are better applied to managing permanent capital. While this is perfectly understandable, it also means that the private equity management business, which was very valuable as a going concern, no longer has any value at all. The remaining cash flows that will accrue to shareholders from managing the last of Brait's third party private equity funds until the end of its life is substantially less than the going concern value of such a business. The dramatic decline in the share price after the announcement of this change of course for Brait is a reflection of this fact.

We believe this sharp share price decline is entirely justified. The company kindly published what it thinks its adjusted net worth currently is (about R16.50 per share). The adjusted net worth is the value of existing investments on the company's balance sheet, plus an estimated value of the remaining third party asset management business. Our own work corroborates the view of the adjusted net asset value as an approximate fair value. But keep in mind that investment companies (such as Remgro) typically trade at a small discount to such an estimate of fair value (to account for costs such as head office costs). Adjusted net worth may therefore even be a generous estimate of fair value.

Given all of the above, you may well be thinking that we would be aggressively opposing the restructuring (which requires shareholder approval) on behalf of our clients (who collectively have been one of Brait's largest shareholders for some time). We have however indicated to management that we will support the restructuring. The reason is simple: in a business so dependent on its management and employees, and where that management team has so clearly set its mind on following a given path, it is in our opinion a futile exercise to attempt to force management to return to the path that they have already left behind psychologically by means of shareholder votes. One may win the battle, but the war was fought in the hearts and minds of management.

So what are we to do? We have taken the only logical course of action open to valuation-based investors facing an asset that is priced above intrinsic value in the market (as Brait has been, despite the price decline post the announcement of the restructuring). We have sold the bulk of our clients' Brait shares. This took place in an environment in which we would typically prefer to be buyers rather than sellers (i.e. during widespread selling of the stock). But we are satisfied that we have managed to sell our clients' shares at levels exceeding intrinsic value.

We continue to hold the investment capability of Brait's management team in high regard. One day, when Brait is priced at bargain levels in the market, we will be very happy for our clients to own Brait shares again. We hope that this day comes sooner rather than later.

Wilhelm Hertzog

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