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RE·VIEW

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Introduction

If there's a picture that tells a thousand stories, it's the one on page 19 of this issue of RE:VIEW. The graph shows the valuation of the South African retail sector against the valuation of the South African platinum sector, expressed on a price to book basis. It's clear that the retail sector is at present very highly valued by the consensus of the market, while the platinum sector doesn't enjoy a high valuation at all.

But these are just the numbers, what's more interesting are the narratives behind the numbers.

Those of you with long memories will recall that in 2002/03 South Africa was seen as a no-growth environment and every company wanted a listing on the London Stock Exchange and a head office in the City. As a result, locally based retailers were regarded as hopeless investments and weren't very highly valued by the market. The chart shows how poorly they were regarded. Of course, no one could foresee that the developed world would stagnate and wither under huge debt loads.

In 2007, the platinum sector was regarded as high growth: European demand for diesel cars was sure to provide years of increasing demand for platinum group metals to be used in these cars' catalytic converters. In addition, the term 'commodity super cycle' was being widely bandied about. As a result, the mining sector in general and the platinum sector in particular were valued very highly. Again, no one could foresee the future stagnation of the developed world and the resultant reduction in demand for catalytic converters and associated platinum use.

Today, investors regard the ability of South Africa-based retailers to grow in their home market and the rest of Africa very highly, and are prepared to pay up for it. The fact that current high growth rates of the sector might or might not be explained by the rapid growth of unsecured lending seems not to play a role in the market's assessment of potential risks or future outcomes. The chart on page 19 shows just how little risk investors are building into their valuation models for retailers.

At the same time, miners are now seen as ex-growth, stifled by bureaucratic rigidity bordering on corruption. Runaway input costs which are also depressing profitability to the point where mines are being closed. The chart shows just how much the market hates the prospects for this group of companies.

As usual, at RE:CM we say we just don't know. We don't know whether there's a bubble in unsecured lending, we don't know whether retailers will successfully (that is, profitably) expand into Africa and we just don't know whether the government will remain anti-mining forever. We prefer not to bet on any specific outcomes. Rather, we let ourselves be led by valuations.

Very simply, when you buy cheap assets, good things tend to happen to you. In 2002/03 when retailers were cheap, you didn't need to know what the future held. You just needed the fortitude to buy them while the Rand was collapsing and Rand hedges were flying. Eventually good things happened to the owners of cheap retail stocks.

At the same time, by way of example, Investec listed in London in 2002. This was the 'right' thing to do, according to the narrative of the day. Unsurprisingly, they were awarded a high valuation at the time. Fast forward 10 years and today Investec's share price is lower than it was in 2002. Nothing good happened to investors who bought at high valuations.

The current positioning of our portfolios doesn't correlate very well with the 'narrative of the day'. If this makes you feel uncomfortable, please study the chart on page 19 again. Our South African mandates contain very little exposure to the retail/finance sector and almost zero to the African story. They do contain increasing exposure to the mining sector, which is very cheap, together with as much offshore exposure as is possible within the different mandate constraints. Our global mandates contain very little by way of emerging market exposure, a significant tilt towards mining – but less so than our South African mandates, given the wider opportunity set – and an increasing exposure towards Europe. Our funds generally have very little exposure to 'income generating'' assets, which is another narrative that is gaining

currency, and which we're assiduously avoiding for valuation reasons.

We firmly believe that the benefits of this stance will reveal themselves in our ability to preserve capital in the event of market turbulence and an ability to grow your capital in real terms regardless of future market conditions.

The articles in this quarter's RE:VIEW speak very much to the way our funds are currently positioned. In the first article 'Bargains – But Only at the Right Price', Wilhelm Hertzog talks about the global and South African food retail sector, points out where we're finding bargains and where we're avoiding stocks in this sector.

In the second article, Daniel Malan delves more deeply into one of the assets we think is being underpriced by the market in 'A Gloomy Consensus'. Needless to say, we've established a significant position in this investment in all our funds. Daniel does a good job of explaining why.

In 'Challenging the Norm: The Case for Fully Flexible Mandates' Linda Eedes discusses why we believe fund managers should take full responsibility for managing their clients' assets. This includes taking on the responsibility for the mix between risky investments and cash. She makes the very important point that investors who have complete freedom to invest in cheap assets and avoid expensive ones generally reduce their clients' risk profile substantially.

In 'The Fear Bubble' I discuss the current market environment, the types of assets investors are underpricing and overpricing and why. Importantly, I discuss how we're positioning our funds in response to these pricing anomalies.

In the last article, 'Straight Shooters – the Influence of Experience and its Impact on Risk Exposure' Daniel Malan talks about how the experience level of the average fund manager – which is surprisingly short – tends to influence their risk appetite.

Again, I hope you enjoy this issue of the review and as always, we welcome any feedback, criticism and insights you might have.

Good Investing!
Piet Viljoen

Bargains – But Only at the Right Price

'I never make a trip to the United States without visiting a supermarket. To me they are more fascinating than any fashion salon.'

Wallis Simpson, American Socialite and Duchess of Windsor

'Experience tells me that someone's got to be getting squeezed, and whether that's the farmer, the supplier or the retailer, someone along the chain has got to be squeezed if you're going to sell milk at a dollar and bread at a dollar. You don't have to be an Einstein to work that out.'

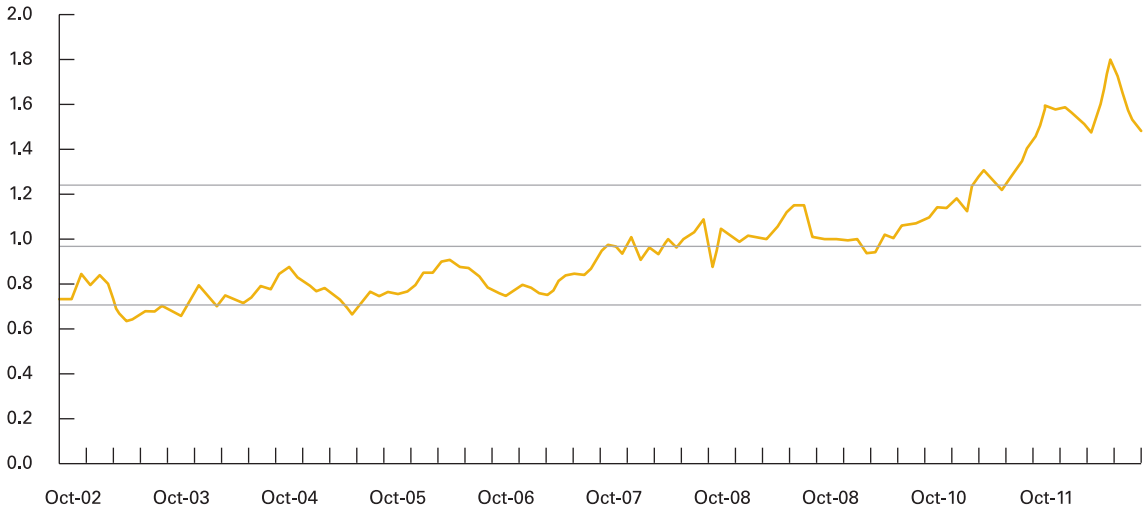
Silvestro Morabito, Chief Operating Officer of Metcash Food and Grocery, quoted in the Sydney Morning Herald on 7 July 2012

Large food retailers generate good returns on capital

We have written before about the favourable economics of large food retailers ('Multiple Schmultiple' in RE:VIEW Volume 6, October 2008 and 'On Top Of The Food Chain' in RE:VIEW Volume 10, October 2009). They benefit from economies of scale in distribution and in bargaining with suppliers. This helps them to generate attractive and durable returns on capital while offering very good value to their customers. Hence, like Ms Simpson, we also find supermarkets more fascinating than fashion salons – but for different reasons, we suspect.

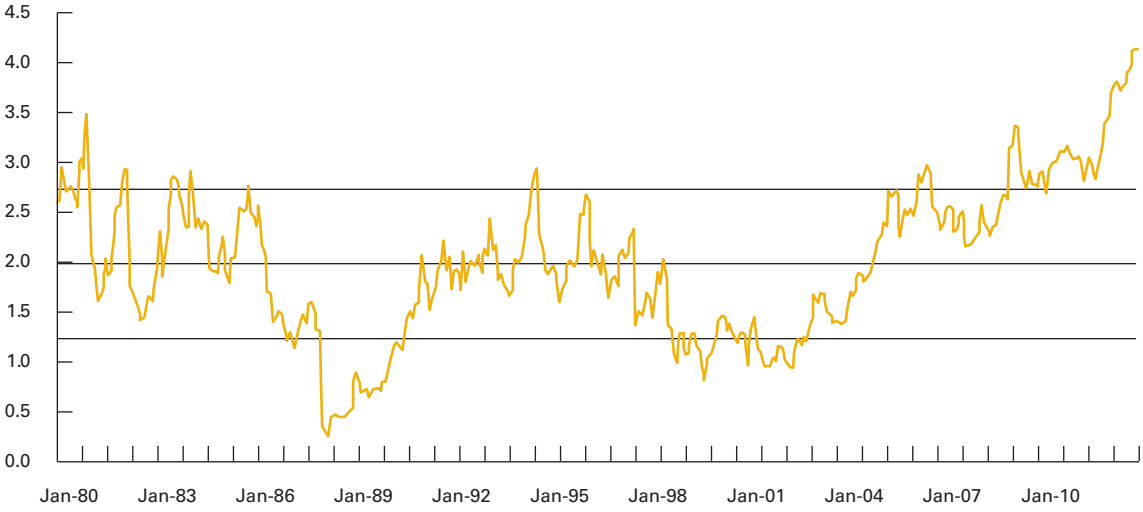
Food retail features prominently as an investment in the RE:CM Global Fund. Carrefour, the leading French retailer, is the largest single holding in the Fund. The Fund has also owned shares of Familymart, the Japanese convenience store business, and US giant Walmart for a number of years. By comparison, RE:CM clients no longer own any South African food retailers. We hold the local food retailers and their management teams in high regard, but current share prices are discounting such rosy long-term futures that there is very little margin for error. Conversely, the share prices of the developed market retailers reflect a great deal of pessimism about their long-term future.

Chart 1: Price-to-Earnings Relative of the Datastream South African Food Retail and Wholesale Index Compared to the Datastream Global Equivalent



Source: Thomson Reuters Datastream

Chart 2: Price-to-Book Relative of the Datastream South African Food Retail and Wholesale Index Compared to the Datastream Global equivalent



Source: Thomson Reuters Datastream

South African food retailers are trading at a premium

Chart 1 below shows the price-to-earnings ratio (P/E) of Datastream's South African food retail index compared to its global equivalent. We only show a ten-year history because the data before that is somewhat noisy.

South African food retailers have gone from trading at a substantial discount to their global peers to trading at a steep premium. The picture is as dramatic when looking at price-to-book ratios (P/B). Chart 2 above shows this, in this case going back to 1980.

As Chart 2 shows, South African food retailers have tended to trade at twice the P/B of global food retailers on average. This may seem odd at first, but is probably justified given that most South African food retailers own far less property than their global peers do. This effectively means the favourable economics of the business is concentrated onto a smaller capital base in South Africa than elsewhere. As a result, the capital invested in the South African business is worth more in the hands of an investor than a comparable amount of capital invested in a global business.

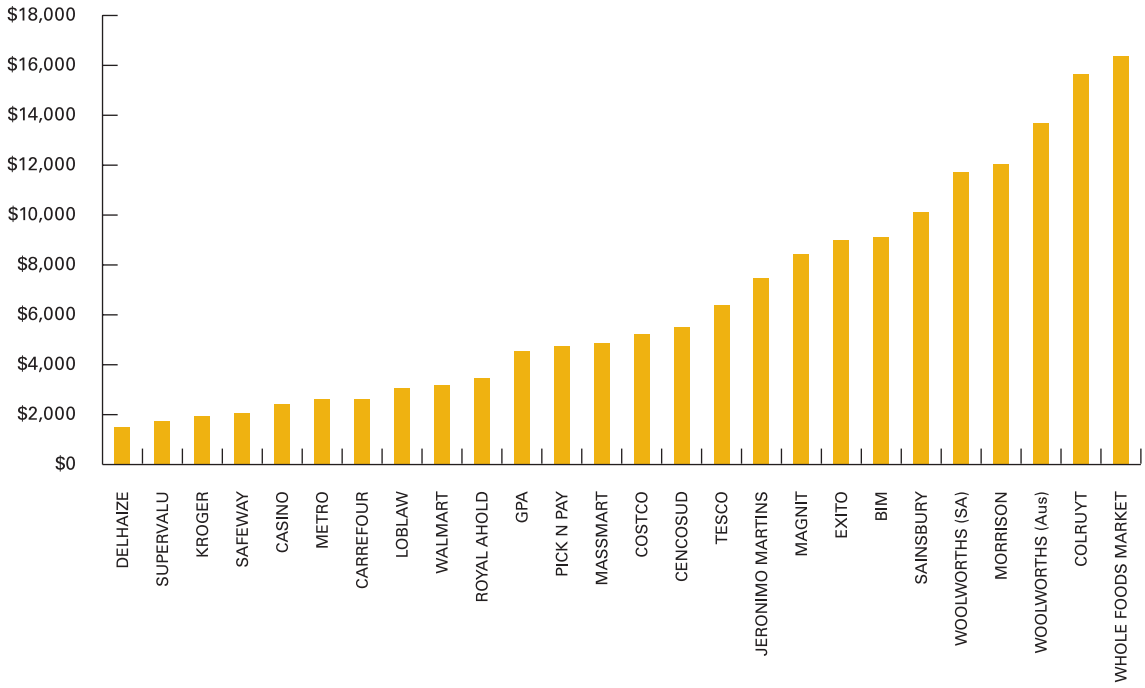
Enterprise value per square meter shows a similar trend

The basic economic unit of a retail business is a square meter of trading space. We find it interesting to compare the price investors are willing to pay for a unit of trading space in different markets. For this comparison, we calculate enterprise value per square meter (EV/sqm) for a number of global food retailers (shown in Chart 3 below). Enterprise value (EV) represents the market value of all capital – equity and debt – invested in a business.

To remove the distortion created by the fact that some of these businesses own their properties while others rent them, we capitalise all leases and add the resulting liability to EV. Where a company has significant franchise operations (as in the case of Pick 'n Pay), we capitalise the franchise fee income at a reasonable multiple and deduct the resulting asset from EV. The Japanese convenience store businesses (like Familymart) are pure franchising businesses to such an extent that EV/sqm isn't a meaningful number for them, and hence they have been excluded from this comparison.

We acknowledge that EV/sqm is an imperfect measure of relative pricing. For instance, it doesn't take into account the difference in value of a retail store in a prime location compared to a property in a secondary location. The sales mix between food and non-food also differs between companies, which impacts the comparability of the EV/sqm metric. Nonetheless, we do consider it instructive in pointing out wide divergences in the pricing of retailers.

Chart 3: Enterprise Value per Square Meter of Retail Space in US Dollars



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

Chart 3 shows that the South African food retailers are priced more or less in the upper half of the group. We have excluded Spar and Shoprite from this analysis because of the mainly wholesale nature of Spar's business model and because Shoprite doesn't publish trading space numbers. But given that Shoprite enjoys an EV to sales multiple only surpassed by Woolworths among the South African food retailers, we consider it likely that Shoprite will also feature among the more highly priced businesses on the measure of EV/sqm.

UK food retailers buck the trend

The more expensive end of the range in Chart 3 features mainly emerging market and/or hard discount operators. But interestingly, the UK retailers (Tesco, Sainsbury, and Morrison) also feature in the upper end of the range. The UK food retailers have tended to enjoy superior profitability to their peers in other developed markets and this is reflected in how the market rates them on the measure of EV/sqm. This superior profitability seems to have been enabled by a more rational competitive environment among the major players in the UK industry than in many other markets. Town planning restrictions have also made it hard for new competitors to enter the market. The vast majority of food retail market share in the UK is accounted for by a small number of listed companies. This appears to have played a role in making the competitive environment in the food retail industry in the UK more benign. Certainly more so than in continental Europe, where unlisted groups have often shown themselves willing to sacrifice short-term profitability to build longer term market share and scale.

There are, of course, reasons why food retailers in other developed markets feature so strongly at the bottom end of the EV/sqm scale - the economies in which they do most of their business are under pressure. In some cases (Carrefour being an example), the formats to which they are most exposed (specifically hypermarkets) have fallen out of favour, with consumers showing an increasing preference for convenience formats. But many of these companies have substantial exposure to faster growing markets. Carrefour, for example earns more than 25% of its revenue from Latin America and Asia. Their fundamental competitive advantage of scale, however, is intact in their home markets. Even factoring very modest or no growth into valuations, the share prices of the developed market food retailers that RE:CM clients own offer very attractive value.

Online retail has little impact

Online retail has had a marked impact on non-food retail in developed markets, and will in time probably come to impact emerging markets in a similar way. Food retail has been somewhat protected from that competition, but isn't immune. However, many of the large 'bricks and mortar' food retailers are also the leading online food retailers in their countries – Tesco is a prime example. In food retail, transportation and delivery costs as a percentage of the product price tends to be higher than for non-food items. This makes it more difficult for new entrants without established distribution networks to deliver products cost effectively. The timing of delivery of food is more critical than for non-food - a food order arriving a day late can cause major upheaval in a household. At the same time, people's daily lives are unpredictable, so home delivery of food isn't always optimal. If the delivery takes place when the customer isn't at home, the goods can't be left in the post box! This has resulted in 'clicks and bricks' operations (where customers order online and pick up the order at a store themselves, as opposed to having it delivered) becoming quite popular in developed markets. In this type of environment, there's still a big benefit to having a store base close to customers – a single distribution centre in an out of town location won't do. So we don't expect the food retail business model to be subject to the same disruption from online retailers as we have seen in many non-food categories.

Besides the attraction of the businesses themselves, many of the developed market food retailers own a great deal of property. This serves as a useful measure of downside protection. Carrefour, for instance, owns property that is valued at more than the current share price, after deducting the group's debt from the value of the properties.

So, in conclusion, we aren't valuing the developed market food retailers as if the future will look like the past. We agree that growth is likely to be slower and margins will likely be lower. But both in absolute terms, and especially compared to emerging market peers, we are increasingly finding a compelling combination of high quality businesses selling at low prices.

Wilhelm Hertzog

A Gloomy Consensus

'You pay a very high price in the market for a cheery consensus'
Warren Buffett

'Buy when there's blood in the streets'
Baron Rothschild

The tragic events at Lonmin's Marikana mine in mid-August led many investors to sell platinum shares down and brought the industry into the public eye for all the wrong reasons. While we're saddened by the loss of life, as independent-minded investment professionals we must take Baron Rothschild's advice and ask whether this offers us a potential investment opportunity. There's no guarantee, but recent events seem to indicate significant stresses in the industry that could push miners to streamline their business models and enhance profitability.

Several general features of the platinum industry stand out for us:

- **A classic margin squeeze:** Low cyclical demand - especially in Europe - is coinciding with escalating costs such as electricity, legislation and labour.
- **Excess supply:** High prices and the go-go valuations of 2007 led to many low margin projects opening up and a raft of new platinum players. Most of these are now in significant trouble due to a combination of underfunded expansion projects, poor balance sheets, low or negative profitability, weak shareholders and marginal geological assets. The withdrawal of this excess supply is overdue.
- **Expansion at the cost of profitability:** The business plan of Anglo Platinum (Amplats) in particular for the past 10 years has been to maximise expansion at the cost of profitability. Given Amplats' large relative size, this has significantly impacted the economics of the whole industry. We expect their approach to change under the guidance of new management incentives, steered by revised return on capital expectations at their holding company, Anglo American.

Buy when the consensus outlook is the worst

We have developed a framework, a mental model (a term coined by a man we greatly respect, Charlie Munger), that aims to identify pockets of excessive adjustment of prices to perceived and real risk. Through our study and experience of this model, we have learned to consistently apply a potentially successful strategy for investing in capital-intensive cyclical industries facing a downturn. Very simply, it is to wait for really bad news and a consensus around a very bleak outlook to be shared by most market participants. Then, buy the companies you expect to be the survivors.

We wrote two earlier pieces, 'Hitting the Right Note' in the RE:CM Market Commentary Series (15 October 2005) and 'The IT Sector' in the RE:CM Quarterly Investment Insights (Quarter 3, 2006). In these we discussed our investment experiences in the South African financial services and IT sectors. These came to the same conclusion: wait for the worst and then buy the stocks that are down the least.

Pick the strong to survive

The South African platinum sector divides into three tiers:

- **Tier 1** comprises quality stocks, with good operating assets (the largest and highest-margin reserves) and healthy balance sheets. These two factors are crucial in selecting survivors.
- **Tier 2** consists of platinum businesses with operating (currently producing) assets but these are high cost (marginal) and their balance sheets are poor.
- **Tier 3** companies are pre-production, meaning that they are still in developmental stage and have very poor balance sheets.

Table 1: Three Tiers in the Platinum Sector

	Asset Quality	+	Balance Sheet	=	Survival?
Amplats	✓		✓		✓
Implats	✓		✓		✓
RB Plats	✓		✓		✓
Lonmin	✓		?		✓
2nd Tier	?		✗		?
3rd Tier	✗		✗		?

Source: RE:CM analyst

Suffice to say, we believe committing client capital to equity in the second or third tier might not be a good idea. These companies may well survive this downturn and bounce back when the industry turns, generating huge returns, but the odds aren't attractive. We're not prepared to gamble our clients' capital by taking a swing for the fence on such an uncertain situation.

Quality offers some protection in a weak market. Table 2 shows that over the past year the share prices of the second and third tier companies are down 43% and 56%, respectively. In comparison, the four companies that make up Tier 1 are only down 17%.

Table 2: Annual Price Changes in the South African Platinum Sector to 19 September 2012

	Percent Change
Tier 1	
Amplats	-19,0
Implats	-12,3
RB Plats	-16,1
Lonmin	-38,8
	-17,5
Tier 2	**-43,1**
Tier 3	**-55,8**

Source: Thomson Reuters Datastream

The long-term returns from platinum stocks are good

A very interesting piece of data that most people currently ignore is that platinum companies are quite capable of earning good long-term returns on capital. Table 3 compares the long-term returns and the cost of capital of Amplats with those of five of South Africa's current 'must-own' companies: BAT, Richemont, Truworths, SAB and MTN. Amplats' excess return of 15% is right up there with the best of them. This includes the past 10 years when it generated poor returns relative to its history!

Table 3: Why Amplats is a Quality Business

	Long Term Average Return on Capital	Cost of Capital	Spread
Amplats	30%	15%	15%
British American Tobacco	24%	10%	14%
Richemont	15%	10%	5%
Truworths	33%	15%	18%
SA Breweries	17%	10%	7%
MTN	22%	15%	7%

Source: Company Reports, RE:CM analyst

RE:CM's own only Tier 1 platinum companies

RE:CM's funds only own Tier 1 platinum companies - Amplats, Implats, RB Plats and Lonmin. Together these companies represent over 70% of the world's lowest cost platinum supply and more than 90% of global reserves.

We started buying into the platinum sector 12 months ago and have steadily increased our exposure as share prices continue to fall. This is consistent with both our value philosophy and our investment process that allocates capital on a countercyclical basis into increasingly undervalued and unpopular assets.

In our valuation work we've anticipated that Lonmin may need to undergo an emergency rights issue and we've prepared our funds to take advantage of

this buying opportunity if it happens. Just like the Western Areas emergency rights issue of February 2004, we never know how or when such an event may happen, just that it's likely whenever a capital intensive project or business is tightly funded.

We also take some comfort that three of the four Tier 1 businesses have strong shareholders of reference backing them (Anglo American, Xstrata and Royal Bafokeng Holdings). This is important from a funding perspective should the industry's woes continue for longer than we anticipate.

Our success at RE:CM has come from doing our own work and our own thinking instead of copying others. We align our interests with those of our investors by being meaningfully invested alongside them and incurring the same fees. Our approach hasn't changed since we started nearly 10 years ago - we remain as committed as ever to independent thought and the hard work necessary to protect and grow the savings of our clients.

Daniel Malan

Challenging the Norm: The Case for Fully Flexible Mandates

'In the English speaking world, we all use keyboards known as QWERTY. However, this well-known keyboard is not optimal. When you prepare to type, your hands rest on the second row of letters known as the home row. Now, you might be forgiven for thinking that the most frequently used letters would appear in this row in order to minimize travel of the fingers. However, this isn't the case. In fact, only 32% of strokes are on the second row, while 52% of strokes are on the upper row. Other such quirks include two of the least used letters in the English language, J and K, positioned on the home row. And this is only the start of a long list of inefficiencies with this keyboard. So, why do we still use the QWERTY keyboard? The answer lies in historical inertia. QWERTY was originally designed in 1874. It was built to solve a specific technological problem with early typewriters: when keys were struck in rapid succession, the hammers that hit the ink ribbon would often jam together. The QWERTY layout was designed specifically to slow typists down. Letters that frequently occurred close together in words were spaced irregularly on the keyboard, causing the typist to pause, thus reducing the likelihood of jamming hammers. So, due largely to technological limits, the first commercially produced typewriters were manufactured with the QWERTY keyboard. Users became adept with QWERTY, and this comfort level acted as a barrier to change. This barrier created enormous inertia such that the majority of us use QWERTY today, despite the fact that more efficient keyboard layouts are available.'

James Montier

'It's a bitterly cold day. You have lost all feeling in your nose. Your ears are hurting. You hunch your shoulders together to bury your head under the raised lapels of your greatcoat. You turn a corner and you see a frozen pond. Can you risk taking a short cut across? Or would it be safer to walk to the bridge half a mile down the road? You notice a man on the other side of the pond. He gingerly steps on to it. It holds the weight of one foot. He carefully places the other foot on the ice. A young woman behind follows his lead. As you watch, some children arrive with skates, and more adults follow them. Soon, the whole village is having a party on the ice. Each person has given the next person the confidence to join the party. The more people clambering on to the ice, the safer it feels. It's logical, isn't it? Or is it? Something makes you stop. You turn around. You walk away. Behind you, you hear the crack and the first scream.'

Marc Faber

Just because something has been done in a particular way for a very long time, it does not mean there isn't another way that makes as much, or possibly even more sense. This paper discusses why RE:CM does not subscribe to some of the long-held beliefs in the industry.

We're especially sceptical of beliefs that suggest investments should be managed according to a stringent set of rules that dictate investment in particular asset classes. One example of this is fixed allocations to asset classes based on 'strategic asset allocation'. Another is the industry norm of setting a prescribed minimum limit for equity exposure in general equity funds.

We feel that full flexibility between asset classes combined with an absolute value philosophy makes the most sense for investors seeking the twin goals of protection against permanent capital loss and superior long-term real returns over time.

Strategic asset allocation doesn't reduce risk

In RE:VIEW Volume 16, April 2011 'Asset Allocation: Myths and Realities' we argued against Modern Portfolio Theory and strategic asset allocation policies. These approaches prescribe fixed exposure to asset classes according to an investor's risk profile and age. They recommend higher allocations to equities (more risky) at the beginning of the investor's working life and a shift into assets such as bonds (less risky) as a person nears retirement.

Our main problem with strategic asset allocation is that it measures risk in terms of volatility (short-term price movements). Asset classes with higher volatility (such as equities) are treated as having more risk and those with lower volatility (bonds) as having less risk.

Chart 1: All Share Index Versus South African Volatility Index (SAVI)

Source: Bloomberg

To examine this assumption, Chart 1 compares the South African Volatility Index (SAVI) to the FTSE/JSE All Share Index. If you followed the widely held assumption that volatility equals risk, you might well conclude that risk was low before the financial crisis in early 2008. Of course, the opposite was true. Even though market volatility was very low, the risk in the market turned out to be very high. Particularly the type of risk we prefer to avoid at RE:CM – the risk of permanent capital loss.

In fact, low volatility in the market was merely a function of market participants behaving in a similar way. This doesn't mean they were behaving in a sensible or correct way.

A study (Vanguard, 2011) which looked at the formulation of market bubbles noted this 'herding' as a necessary condition for a bubble – a surge in enthusiasm for a given asset among a substantial majority of market participants. Bubbles arise when there is a collective shift to riskier behaviour in the system as whole.

This happens as investors grow over-confident about their investment decisions. They think too much about recent positive results and fail to consider long-term information. These investors suffer from two conditions:

1. **Group-think** – investors begin to feel invulnerable, rationalise their behaviour and ignore contradictory information.
2. **Risk tolerance** – the group tends to make riskier decisions than the individuals would make on their own.

As a result, the entire financial system shifts to an even higher risk level – to a level that many market participants would individually agree is too risky.

Conversely, often when volatility is high – such as when the market plunged in 2008 – opportunities are created. As Keynes (1936) wrote, '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.'

Surely when determining the risk in an investment investors should be less concerned with the volatility of prices and more worried about the risk of permanent capital loss? This risk is at its highest when markets are overvalued and there is a very real danger of buying assets at prices well above what they're worth. That was the case in the crisis, as it is today. The South African Volatility Index is currently at all-time lows. We believe this doesn't represent low risk, but rather trouble ahead.

Minimum equity limits for equity funds don't make sense

We don't believe that minimum equity limits make sense if your objectives are protection against capital loss and generating superior real returns over time.

Asset prices in the late stage of a bull market are driven not by fundamentals, but by emotions such as greed and euphoria. Prices are typically driven well above fair value for many stocks. In such a market, a prescribed minimum equity limit may force managers to hold equities that are overvalued. This is because it's unlikely that there will be enough absolute value opportunities to meet their prescribed equity minimum.

We argue that managers should be able to defer to cash where there are no absolute value investment opportunities. This is a powerful benefit of the absolute value philosophy – it has a built-in framework for protecting against downside risk. As asset prices rise above fair value, a disciplined value investor will sell these assets, raising cash levels in the portfolio and providing a buffer against market declines.

We believe it's crucial that managers have the ability to step away from the market when risk is high and wait until it decreases before returning. Building a cash position not only protects capital when markets fall, it also means managers have cash to put to work when prices – and thus risks – are lower. By contrast, those investors that remain fully invested throughout the market cycle may not have any cash left to invest when prices fall to bargain levels.

Valuations really do matter

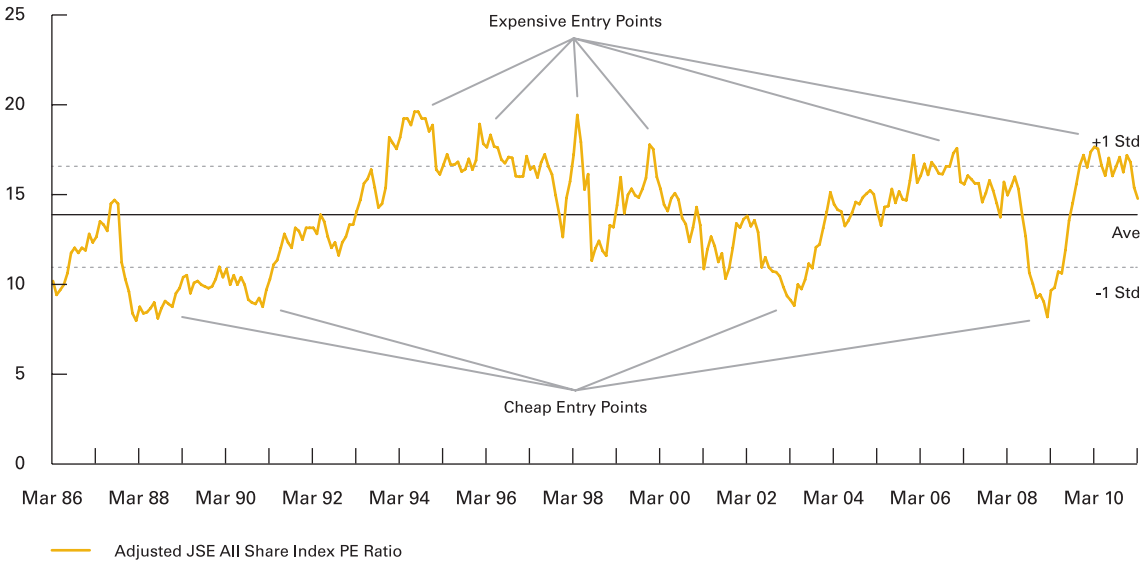
Our biggest concern with any investing method that prescribes asset allocation is valuation indifference. By this, we mean investing in asset classes based on predetermined rules that ignore current market levels. This exposes investors to the risk of permanent capital loss if markets happen to be expensive at the time of allocation.

Chart 2 shows the powerful mean-reversion tendency in the price-to-earnings ratio (P/E) of the FTSE/JSE All Share Index over the long term. It makes a big difference to your returns if you choose to invest when assets are cheap rather than when they are expensive.

Using the P/E as a basic measure of value, we compare the real (above inflation) returns you would have achieved over the subsequent five years if you had invested in the periods where the P/E was more than one standard deviation below the long-term average. In other words, this is when markets were 'cheap' on this basis.

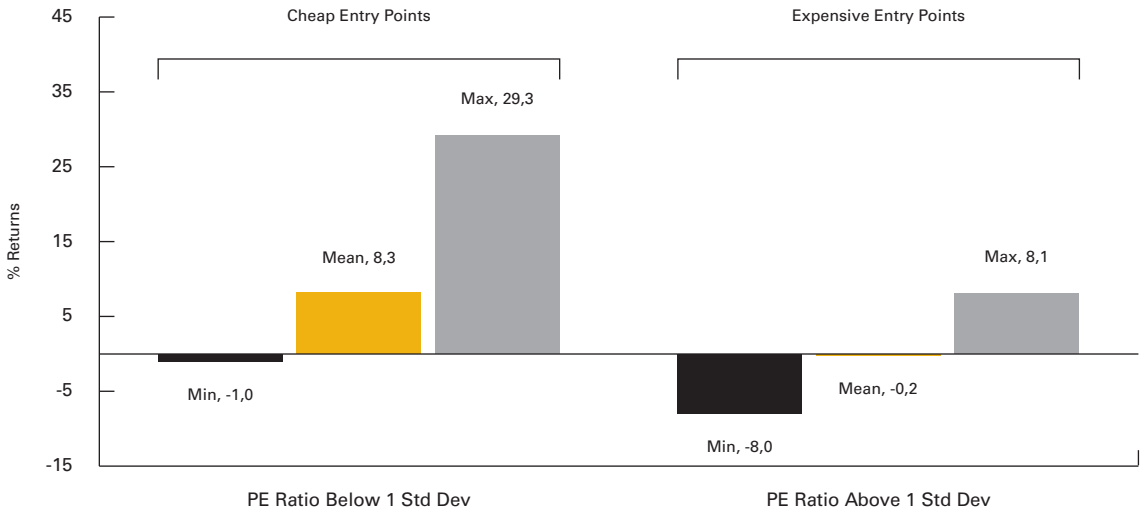
Then we did the same five-year forward return calculations for periods where the P/E was more than one standard deviation above the long-term average – when markets were 'expensive' on this basis. The results are shown in Chart 3.

Chart 2: The Impact of Valuation Indifference



Source: I-Net

Chart 3: Comparison of 5 Year Forward Real Returns (Annualised): 1986-2006



Source: I-Net, RE:CM analyst

The worst 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. If you charge into the market when valuations are expensive, you blindly expose your investment to the biggest risk of all – permanent capital loss. The biggest determinant of your prospective returns is the price you pay. If that price is well above what the investment is actually worth, it becomes largely irrelevant how good your asset manager is from that point onwards. They may beat the index and even their peers, but they're unlikely to deliver what most investors ultimately seek – good long-term real returns.

Valuations work across asset classes

Valuations are important for all asset classes, including bonds. Even an asset class that's lower in price volatility, and therefore perceived to be lower in risk, such as bonds, may be very risky in terms of permanent capital loss due to 'expensive valuations'. In a world that sees bonds as a lower risk asset class, philosophies such as strategic asset allocation suggest that bonds are an important building block of a balanced portfolio. Currently, the RE:CM balanced funds hold virtually no bonds at all.

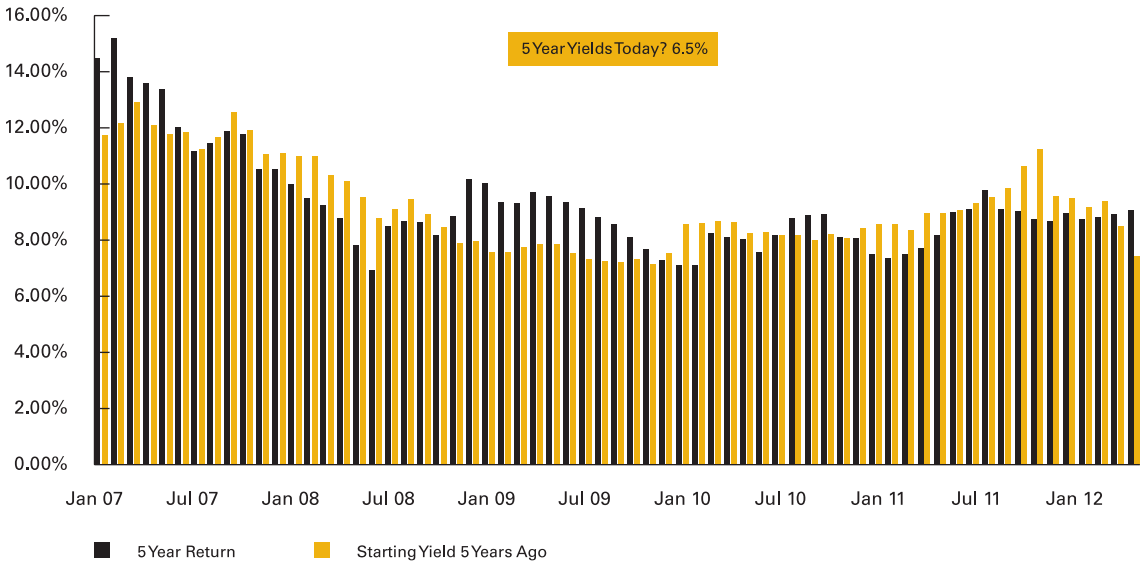
To defend our current small position in bonds, we compare the returns of actively managed South African bond funds over five years with a simple investment in a five-year government bond that's held to maturity. The results are shown in Chart 4.

Over 65 rolling five-year periods, the yield constituted 101% of the active return. So on average the passive yield was higher than the active returns the bond managers produced. This is something of an indictment against active management of this asset class. More importantly for us, it reflects a very crucial point – for bonds, the yield at the starting point is essentially the return you will ultimately get for your investment. This prompts the question – 'What are bond yields today?'

As Chart 5 indicates, bonds are currently at all-time lows. Five-year bonds are yielding around 6.5%. Two points are worth making here:

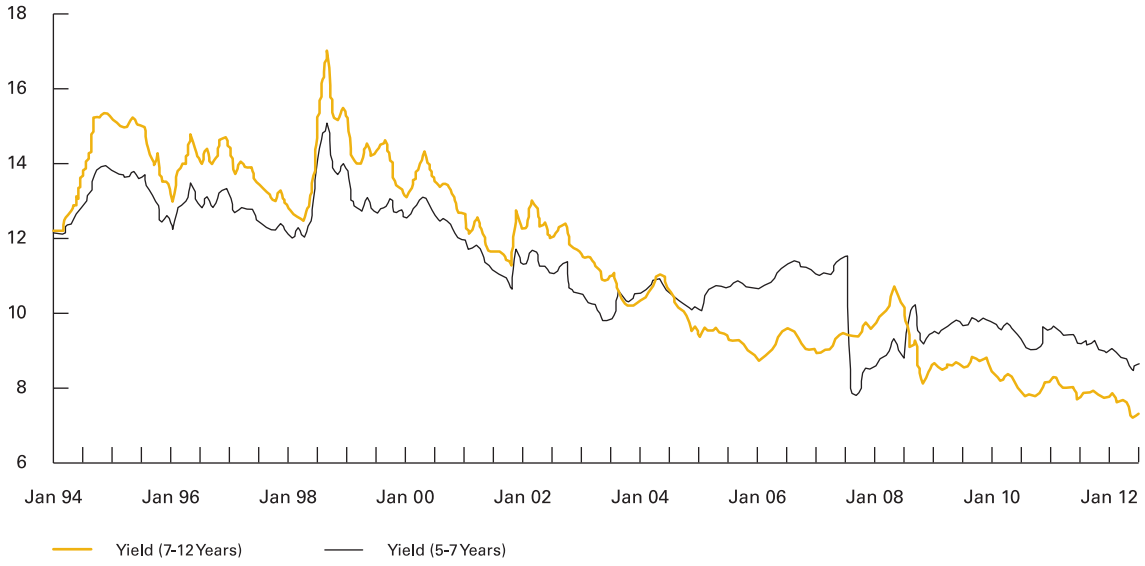
1. At these low yields, the probability for bonds retracing (implying significant capital declines) is far higher than the probability of a further decrease in yields.
2. If you assume inflation remains around 6% and a yield of 6.5% is the return you can expect (as the previous exercise implies), you're guaranteed to deliver very low returns above inflation. Contrast this with the performance

Chart 4: Average 5 Year Bond Fund Return vs 5 Year Yield at Start



Source: I-Net, RE:CM analyst

Chart 5: SA Bond Yields are Currently at All-Time Lows



Source: I-Net, RE:CM analyst

objective of our fully flexible balanced fund of consumer price inflation (CPI) + 8%.

3. If there is an unexpected bout of inflation, your nominal 6.5% return will very quickly look even poorer in real terms.

Thus, if protection against permanent capital losses and generating real returns are your priorities, it makes little sense to have any exposure to bonds at current yields.

Career Risk versus Investor Risk

Unfortunately, investment risk isn't the only risk that concerns investment managers. The central truth of the investment business is that investment behaviour is often driven by career risk. Jeremy Grantham (2012) writes of this phenomenon, saying that the prime directive for any professional investor is first and last to keep their job. To do

this, he explains, a professional investor must never, ever be wrong on their own.

To prevent this calamity, most professional investors pay ruthless attention to what other investors are doing. The majority 'go with the flow' which creates herding and momentum, driving prices far above or far below fair value. This is by far the largest source of inefficiencies in market pricing.

The majority of professional investors are 'benchmark cognisant' – they take positions relative to the index they're being measured against. When selecting investments for their clients, the index is the starting point. Whether they're positive or negative about a stock is then reflected in an overweight or underweight position compared to the weighting in the index. Usually there is a 'risk budget' around the index or a maximum underweight or overweight versus any particular stock. This may be a suitable method of ensuring that they're never too far from the crowd or market to be fired, but it doesn't accurately or honestly represent the absolute risk of the underlying investor.

Most professional investors will hold a position in the biggest stocks in the index, to a greater or lesser extent depending on their views, throughout the market cycle. An article titled 'Stocks the Fund Managers Go For' in The Citizen newspaper (7 June 2012) appears to support this. The article listed the 10 most popular local shares among South African unit trusts in terms of the number of funds that hold them.

Share	No. of Funds
Sasol	237
Anglo American	236
MTN	228
BHP Billiton	216
Standard Bank	181
Old Mutual	169
BAT	156
Naspers	155
Anglogold Ashanti	145
Bidvest Group	141

The article's premise was 'If a majority of local fund managers think that certain shares are worth holding, there's probably good reason for it.'

Unfortunately, the good reason may not be the reason investors are looking for – that it will turn out to be a good investment. There is a good chance these shares are widely held because they're among the biggest stocks in the index. All 10 shares listed are members of the FTSE/JSE Top 40. Eight of the stocks are among the 10 biggest companies on the local bourse by market capitalisation.

Take, for example, one of these stocks – Anglo American. Anglo American fluctuates between 10% and 15% of the All Share Index depending on its share price. Most professional managers hold a position in Anglo American, to a greater or lesser extent depending on their views, throughout the market cycle. To have no exposure to the stock would be too great a career risk if they are 'wrong'. If the professional manager matches the index exposure because they have no particular view on the stock, they would see themselves as neutral in terms of active risk. However, if the stock constitutes 15.5% of the index, as it did before the market collapse in 2008, and the manager matches this, we would contend that the underlying client isn't neutral at all in terms of risk. They hold 15.5% of their portfolio in Anglo American. The manager has 0% career risk, the client has 15.5% absolute investment risk.

At the time of the 2008 collapse, Anglo American was trading at all-time highs on a price-to-book value ratio of over four times. RE:CM held no Anglo American in any funds given the risk of permanent capital loss at these high valuations. During the market fallout, Anglo American fell from R556 to R138 per share – a decline of 75%. Despite a 'neutral' position from the professional's perspective, the investor would have lost more than 11% of her portfolio in absolute terms.

The top 10 stocks in the FTSE/JSE All Share index made up 65% of the FTSE/JSE All Share Index in May 2008. If a manager had matched the index exposure to each of these shares, taking zero 'active risk', their clients would have lost 34% of their portfolio in absolute terms.

Flexibility is crucial to minimise risk and maximise returns

This is why flexibility and the ability to deviate from the benchmark are crucial if the objective is to minimise investors' exposure to potential capital loss and to maximise their potential for real returns over time. This applies not only at the asset class level, but at the individual stock level as well. RE:CM portfolios and funds had zero exposure to Anglo American for several years. We

only recently introduced the stock given that we now see an absolute value opportunity.

In contrast to most of our peers, our clients have very little exposure to bonds and property. We hold high levels of cash in our portfolios – we won't compromise our absolute value principles by buying expensive stocks to 'stay in the market'. Buying what everyone else is buying may reduce career risk for the fund manager, but it also reduces prospective returns for their clients. More importantly, it may expose clients to excessive risk as herding drives prices far beyond what assets are fundamentally worth.

At RE:CM, we believe our clients have appointed us to manage their investment risk profile, not our career risk profile. If you do exactly the same thing as everyone else your outcome will, at best, be average. We believe we're paid to deliver superior real returns over the long term.

Linda Eedes

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The Fear Bubble

'The world has a shortage of financial assets. Asset supply is having a hard time keeping up with the global demand for store of value and collateral by households, corporations, governments...The equilibrium response of asset prices and valuations to these shortages has played a central role in ... the recurrent emergence of speculative bubbles ...the historically low real interest rates ...all fall into place once one adopts this asset shortage perspective.'

Ricardo J. Caballero in 'On the Macroeconomics of Asset Shortages.'

'The shrinking set of assets perceived as safe ... can have negative implications for global financial stability. It will increase the price of safety and...could lead to more short-term volatility jumps, herding behaviour, and runs on sovereign debt.'

I.M.F. Global Financial Stability Report April 2012.

'The paper has three primary results:

- First, a permanent decrease in the supply of safe assets can lead to a substantial over-shooting of the asset price from its fundamental value.
- Second, an increase in collateral requirements can lead to a substantial overshooting of asset prices.
- Third, when asset prices include liquidity premia there can be recurrent bubbles and crashes that arise as endogenous responses to economic shocks.'

William A. Branch, 'Imperfect Knowledge, Liquidity and Bubbles', University of California, Irvine July 6, 2012

No reward without risk

In his famous 'General Theory', Keynes (1936) wrote, 'If we speak frankly, we have to admit that our basis of knowledge for estimating the yield 10 years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence.'

'If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation.'

Keynes was scornful about 'investors' who wanted returns without shouldering any risk and uncertainty, and called for the 'euthanasia of the rentier' through policies calculated to slash the returns on riskless assets or even make them negative.

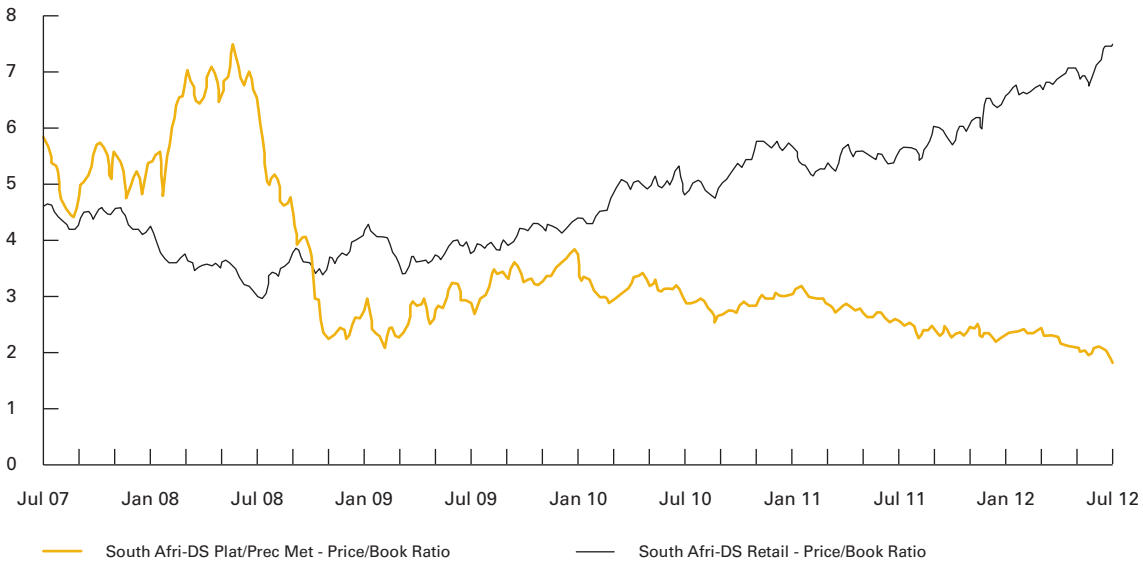
Today, fears about the global financial environment are prompting a run on safe assets, leading to irrational voluntary destruction of principal via self-imposed negative rates. The bubble in fear is an obvious reaction to earlier bubbles in more risky assets. In the current bubble, investors appear to be significantly overpaying for protection through buying bonds at historically low yields. This attempt to reduce short-term negative risks – such as another banking crisis, a return to recession or deflation – comes at the risk of substantial losses in the longer term.

Equally, investors are bidding up the prices of a certain class of equity to levels where long-term capital destruction is almost guaranteed. This includes 'defensive' business models like brewers and 'growth' business models like South African retailers and certain US technology companies.

Chart 1 shows how highly the market values 'growth' assets, and how poorly it values 'risky' assets. Retail shares ('growth') are trading above seven times price-to-book (P/B) while Platinum shares ('risky') are trading below two times P/B. Of course, it wasn't too long ago that 'risky' assets were actually valued quite highly. In 2007/08 we apparently still believed in the existence of Father Christmas and the commodity super cycle.

So investors are paying very high prices for 'safe' assets – however loosely defined – and can't sell 'cyclical' assets quickly enough. But before we

Chart 1: South African Retail Index Price-to-Book Ratio (P/B) vs South African Platinum / Precious Metals index P/B



Source: Thomson Reuters Datastream

join the herd, it would be useful to ask just what, exactly, 'safe' mean in investment terms.

Defining price, value and safety

To understand the true meaning of 'safe', one first has to differentiate between price and value. These are terms that are often used interchangeably, but shouldn't be. Price is what one pays for an asset. Value can be defined as the present value of all the future cash flows the owner will receive, specifically after all reinvestment needs of the asset/business have been funded. These two numbers sometimes coincide. More often they differ – sometimes by a wide margin. Now seems to be one of those times.

Now that we can differentiate between price and value, we can define safety in investment terms. Safety consists of two components:

- a fairly stable income stream from the underlying asset; and
- a price that is significantly less than the value of that income stream.

Government bonds satisfy the first component – they pay regular coupons, and their value is clearly fairly stable as a result. Even sharp increases or decreases in interest rates don't change the nominal value of a bond by huge amounts.

There's no doubt that companies that produce, for example, beer or toothpaste, also have reasonably stable earnings and cash flow streams. Most such companies are high quality businesses with significant barriers to entry in the form of distribution scale. They also have keen repeat customers. Because of this, they are in a position to pay regular and growing dividends. The equity of such companies is widely regarded as 'safe'.

Some currencies have similar attributes today – the Swiss franc, the Norwegian Krone, the Australian dollar, and even, to a lesser extent, the South African rand. This is because they're backed by governments that don't have too much debt. As a result, these currencies have been quite strong, to the extent that places like Norway are running negative interest rates to discourage flows.

So, recognising the benefits of owning these assets, investors buy as much as they can. This behaviour is further strengthened by the social proof of these having been the best performing assets during the financial crisis of 2008/09. Investors are determined not to make the same mistake they made in 2008 of owning assets that would benefit from the supposed "commodity super cycle".

Buying 'safe' assets at a high price makes them risky

The problem is that, increasingly, the second condition of investment safety is being violated – the prices of these assets aren't less than their value. This is important, for it's when things go wrong that the nature of true safety becomes important. If the consensus view on the investment environment turns out to be right, buying high priced, apparently safe assets might turn out to be a satisfactory strategy. It's unlikely to create huge wealth, but also unlikely to lose too much.

But what happens if reality turns out to be very different from the consensus view? For instance, buying ultra low-yielding long-dated government bonds guarantees losses in real terms in the event of even moderate inflation or interest rate rises any time before maturity. This is fundamentally irrational behaviour.

Assuming that we have no certainty about what the future looks like, we can ascribe probabilities to different outcomes. Let's say there's a 20% chance of hyperinflation, a 20% chance of moderate inflation and 60% chance of deflation. Let's also assume that – if you buy them at today's yields of 2% – under hyperinflation, bonds lose 15% of their value per annum in real terms. Under moderate inflation they lose 5% p.a. in real terms, and under deflation you make 5% p.a. in real terms. Your expected return will look something like this:

$(0.2 \times -0.15) + (0.2 \times -0.05) + (0.6 \times 0.05) = -1\%$ p.a. in real terms

Not a great outcome for a safe asset. And your worst case - hyperinflation - means you go backwards. A lot. If one understands compounding, losing money is a very bad outcome.

The current extreme preference for safe and liquid assets is thus no more rational than previous ventures into the 'investment du jour':

- emerging markets in 1994;
- financial stocks in 1998;
- technology stocks in 2000;
- 'rand hedges' in 2002;
- 'investment grade' collateralised debt obligations (CDOs) based on the US mortgage market in 2006;
- China and the commodity super cycle in 2008; and
- more recently, the second emerging markets craze in 20 years.

It might feel good, or the right way to invest, but the outcome – as we've seen time and time again – isn't a good one. With cash-strapped governments implementing very low interest rates, buying anything that yields even a little bit more than zero seems to make sense. But financial repression is no accident. It's the deliberate objective of a policy designed to curb demand for liquid assets and force greater willingness to commit to less liquid forms of investment. Financial repression limits current yield and availability of suitable safe assets. Keynes' advice of 80 years ago is being followed diligently.

'Safe' assets are still attractive to some

Of course, unintended consequences flow from most, if not all, government actions and this is no exception. The more the authorities try to make safe assets unattractive, the more demand there is for them. Baby boomers are too scared to buy anything that looks 'risky' as they're getting increasingly panicked about their advancing age and lack of savings. They feel cheated by the system in a number of ways. Firstly, they were recurrently sold 'hot' investment products by asset-gathering investment firms. This has eroded their retirement nest egg. Secondly, financial repression by their bankrupt governments means their (too small) nest egg struggles to earn a decent annuity income. And finally, they still have to maintain their kids, because there are no jobs out there.

It's the importance of non-rational motivations that explains why Keynes placed so much emphasis on 'animal spirits' or the state of investors' and entrepreneurs' expectations. By sapping that willingness to shoulder a degree of incalculable uncertainty, the bubble in fear destroys the vital process by which economies form capital, grow and generate employment.

The recipe for a true mania is all here – forced (price insensitive) buying and limited supply. We're already seeing the effects. Prices of 'safe' assets are sky high – ironically rendering them unsafe, according to our way of looking at the world. The price of 'unsafe' assets is at generational lows relative to their value. Unfortunately, few of these assets can be defined as high quality assets. But if we can find some that qualify as quality assets, we can back up the truck and load up on them – something we've been doing in the market for the equity of platinum producing companies.

With or without government intervention, the bubble in fear will eventually unwind. Eventually, enough households and businesses will recognise they're overpaying for liquidity and safety. In the meantime, the best way to think about current financial conditions is as a bubble in fear and demand for liquidity that has continued to inflate even as real economic and financial risks have begun to recede. It must eventually collapse when the usual bubble-generating processes are no longer capable of inflating it further.

The bottom line is that investors don't want to repeat their past mistakes, and in so doing, they're potentially making new ones.

Piet Viljoen

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Straight Shooters - The Influence of Experience and its Impact on Risk Exposures

'I succeeded by saying what everyone else is thinking'
Joan Rivers

'To a man with a hammer, everything looks like a nail'
Charlie Munger

We currently face an interesting set of circumstances:

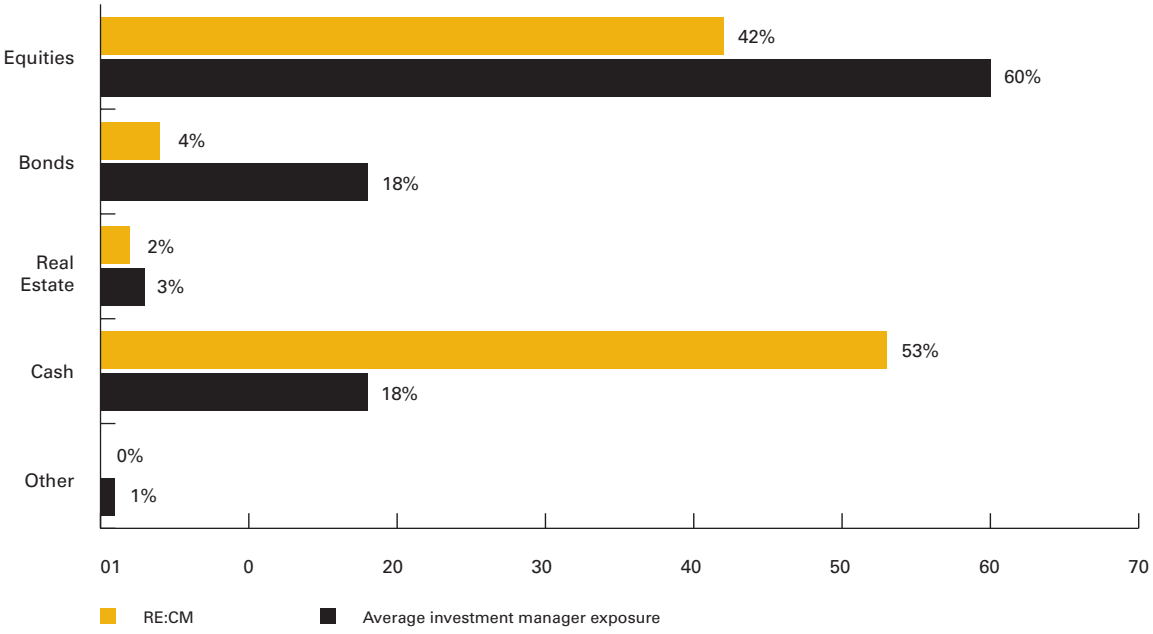
- The MSCI World Equity Index has more than doubled from its lows in the first quarter of 2009.
- The FTSE/JSE All Share Index (ALSI) has also more than doubled in the same period. Other than a six-month drop in 2008, the ALSI has been on a consistent winning streak since April 2003, beating the global equity market as can be seen in Chart 1.
- The ALSI is trading on high price-to-earnings (P/E) multiples on high levels of earnings mainly due to elevated profit margins.
- The ALSI is trading at a statistically significant premium to its own long-term P/E average and at a premium to developed market P/Es.
- Our investment team of 20 analysts does bottom-up valuation work on over 200 listed South African assets. This research strongly supports our top-down conclusion that the market is overvalued as a whole, albeit with rare pockets of value concentrated in a few sectors of the economy.
- From a macroeconomic perspective, interest rates, bond and property yields are all at record lows. The work of our credit and property research teams substantiates this observation from a fundamental bottom-up valuation perspective.

Everything seems to point to an overvalued South African market and a rational investor would be expected to reduce their exposure. Yet Chart 2

Chart 1: South African Equity Market (in US$) vs MSCI World Equity Market (in US$)

Source: Thomson Reuters Datastream

Chart 2: Average Asset Allocation of South African Investment Managers Compared to RE:CM



Source: Alexander Forbes Research and Product Development

shows that, according to Alexander Forbes (June 2012), most South African balanced investment managers are positioned with substantial fund exposures to equity, bonds and property.

This doesn't stack up. South African assets are clearly expensive, popular and continue to reach new highs. We have positioned RE:CM's funds accordingly yet most other investment managers have significant 'risk-on' exposures in their balanced funds.

As usual, we have our own ideas about why this might be.

Relevant market experience may be shorter than it seems

Symmetry Multimanager shared with us the results of a recent detailed internal study of experience across more than 200 South African investment professionals. The study included about half of the industry by number and a larger percentage by the value of funds managed. It didn't include every investment professional in the market, but the numbers agree with our own anecdotal evidence gathered from networking, attending company presentations and talking to company executives. The results of the study can be seen in Table 1.

Table 1 – Average years of industry experience

Junior staff	5.1 years
Mid-level staff	12.3 years
Senior staff	18 years
Average of all staff	**11.9 years**

When we pondered the implications of these figures, a few further considerations came to mind:

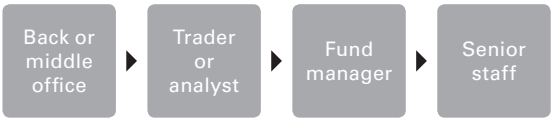
1. 'Experience' may not be 'relevant experience'

The statistic 'years of experience' includes total years of experience regardless of job function or industry, not necessarily investment experience. Take, for example, someone who spent five years building bridges, five years in performance calculation and fund pricing, five years doing investment research and five years managing money. This person could mark their years of experience as 20, their years of investment industry experience as 15 and their years of relevant research and money management experience as 10.

Since the study only covered total years of experience it is likely that the years of relevant research and investment management experience are less than the averages provided by the study.

2. Years spent managing money are less than the total

With rare exceptions, most money management firms only ever appoint an investment manager to manage money following many years of research experience. The typical career trajectory in the industry is:



So even if an investment manager has an impressive number of years of relevant experience, it is likely that their time spent actually managing money is far less.

3. How much research do investment managers do?

Many investment managers leave analysis to the analysts, so their years of research experience often end with their time formally spent as an analyst.

4. 'Managing money' vs 'managing'

Senior staffers tend to be tasked with managing the business and its people as opposed to managing money or (heaven forbid) actually doing research. As anyone who has ever tried it will immediately tell you, managing people and a business is a very time-intensive endeavour.

It is our view, taking these additional points into account, that a senior industry staffer with 18 years of experience probably has, at a rough guess, around nine years that can be classified as formative investment years.

Formative investment years shape an investor's outlook

We think of an investor's formative investment years as those formally spent as an analyst and investment manager. These years should ideally be unsupervised, allowing the investor to get to understand Mr Market, his psychology and his moods. Events during these formative investment years have a significant influence on both the psyche (confidence levels) and future approach to risk management of an investment professional.

Our assumptions above seem to indicate that, for many South African investment professionals, their formative investment years have been pleasantly spent analysing the current JSE bull market that started almost a decade ago in April 2003.

Admittedly this period includes a six-month mini bear market from May to October 2008. While that market decline was certainly deep (45% is definitely something to write home about), in terms of a proper grinding bear market it turned out to be nothing more than a damp squib. It was just too short to really be painful!

For most of the current crop of investment professionals, the real lessons Mr Market has handed out since late 2008 are:

- It pays to keep the risk-on button engaged at all times, so keep your clients exposed to even massively overvalued merchandise (as in 2007 and early 2008).
- You should buy into market declines regardless of valuations.
- The government will bail you out if things turn sour, using whatever monetary and fiscal means at their disposal.

Given their almost exclusively bull-market experience, local investment managers might be forgiven for imagining that markets only move in one direction - up!

Bear market experience outside South Africa offers better perspective

All three of RE:CM's classified 'senior' investment staff spend most of our time doing research and managing money. Combined, the three of us spent our formative investment years (which haven't stopped) dealing with the pain of the South African bear markets of 1987, 1991, 1998, 2003 and 2008.

Unlike most South African investment management companies, we invest globally and directly endured the US and global market correction of early 2000. As a team, we experienced the dramatic scale of the events that unfolded in the global financial crisis of 2008/09 while our South African peers were largely spared. We continue to feel the impact on research and investment management of the ongoing bear market carnage in Japan and Western Europe. We

know how quickly and sharply investment cycles and markets can turn.

Our risk aversion is evident in our choice of assets

In contrast to our South African peers, our balanced funds currently have the lowest levels of South African equity exposure we've ever had, with negligible exposure to government bonds and property. Our cash is held only with reputable counterparties and, in general, these funds are extremely conservatively positioned.

We hold the maximum offshore exposure our mandates allow. Our research helps us uncover decent opportunities to invest in high quality, undervalued businesses around the world. We continue to find enticing ideas in equity and property in the depressed markets of Western Europe and Japan.

While our views may be unpopular, our past experience and fundamental research tell us that the positioning of our funds is in step with our investment philosophy and process. We've seen markets like this before, as well as their inevitable aftermath. Our positioning is entirely logical and appropriate for the current set of market conditions, risks and opportunities Mr Market has dealt.

Daniel Malan

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