GRAYISSUE

LONG TERM COMMENTARY

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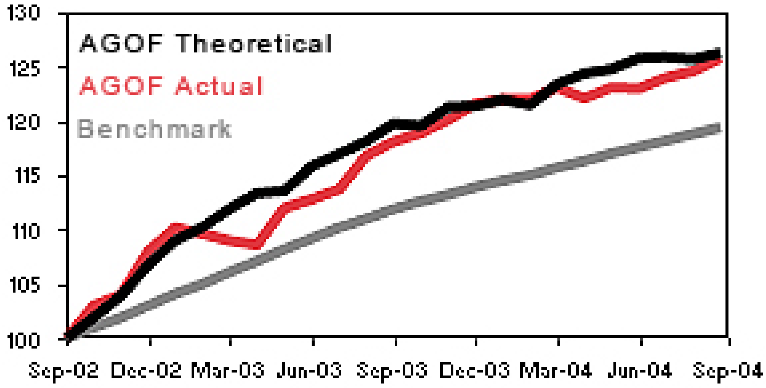
The Allan Gray Optimal Fund

The Optimal Fund was launched just over two years ago as a long-term absolute return fund for investors who wish to avoid the volatility generally associated with stock and bond markets, but still wanting exposure to specialist stockpicking skills and to enjoy a positive rate of return irrespective of the directional movement of stockmarkets. By its nature it is a low risk fund. The Optimal Fund invests in a portfolio of shares and then substantially hedges out stockmarket risk by selling stock index futures. As a result the returns of the Fund consist of two components:

- The return on cash implicit in the pricing of stock index futures
  Plus or minus
- The out/underperformance of the Fund's share portfolio versus that of the index (alpha)

To the extent that the manager can outperform the index there will be a positive alpha, which is added to the return on cash. As alpha is uncorrelated to whether or not the stockmarket generates positive or negative returns, the Fund can deliver positive returns in up or down markets with a low level of risk. The construction of the share portfolio is done in such a way that the Fund should theoretically capture a reasonable portion of the alpha of our Equity Fund versus the market over time. The below graph illustrates that the actual return of the Optimal Fund has tended to track the theoretical return since inception.



As indicated in the table below, the Fund has outperformed its benchmark since inception (12.1% p.a. vs. 9.3% p.a.) having significantly outperformed it in the first year and returned a performance marginally below the benchmark return in the second year. As detailed in previous GrayIssues the current relatively low level of disparity of value within the South African market has provided fewer opportunities for outperformance (alpha) in the short-term.

	Return			Risk	
	1st Year	2nd Year	Cumulative since inception (p.a.)	Volatility	Max. drawdown
Allan Gray Optimal Fund	18.1	6.5	12.1	4.2	1.4
Benchmark (Cash) (Pre-tax)	11.9	6.7	9.3	0.7	0.0
FTSE/JSE All Share Index	-2.2	35.9	15.3	18.3	20.0

The low risk nature of the Fund is illustrated by the comparison of the Optimal Fund versus the returns of the FTSE/JSE All Share Index over the same period. While the FTSE/JSE ALSI has delivered a higher return over the two-year period (15.3% p.a. vs. 12.1% p.a.) it was with substantially higher risk as measured by volatility of returns (18.3% versus 4.2%) and higher maximum drawdown (20% versus 1.4%). During periods of strong share markets, as we have seen in the last year, people tend to pay less attention to the volatility of equities. It is interesting that many people prefer absolute return funds (or cash) when stockmarkets have been weak and prefer share investments after periods of significant outperformance. To perceive shares to be more risky after they have fallen and less risky after they have risen is clearly illogical. Yet after the 36% return of the FTSE/JSE ALSI in the year to 30 September 2004, the appetite for cash and absolute return funds is less than it was a year ago when the return of the FTSE/JSE ALSI for the preceding year was -2.2% versus the 11.9% return of cash (or the 18.1% return of the Optimal Fund).

While we continue to believe that South African equities offer the prospect of superior long-term returns from current levels and are more attractive than South African bonds, cash and property, they are certainly not as attractive as they were a year ago. Depending on an investor's risk profile there remains a place for a lower risk investment, such as the Optimal Fund, in one's investment portfolio.

Commentary by Stephen Mildenhall, Chief Investment Officer, Allan Gray Limited and Portfolio Manager of the Equity, Stable, Optimal funds and Global Fund of Funds, Allan Gray Unit Trust Management Limited