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Managing the Allan Gray Bond Fund for total return

We manage the Allan Gray Bond Fund for total returns rather than relative to the All Bond Index (ALBI). This means we aim to achieve a high total return for investors while minimising the risk of loss (whether a credit loss or a loss through adverse interest rate movements), instead of trying to minimise the difference between the Fund's return and that of the Index.

We try to accomplish our goal of total returns through buying bonds when we believe they offer good value, and moving the Fund into cash and money market assets when we think the outlook for cash is superior. Even when we have a positive outlook on bonds it is unlikely that the duration of the fund will materially exceed that of the ALBI. The reason is that the risk return trade-off of the very long-dated government bonds does not often appeal to us.

What is 'duration'?
Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. The higher the duration, the higher the interest rate risk. For example, the price of a bond with a duration of six will increase by approximately 6% if the interest yield on that bond declines by 1%. The duration of the All Bond Index is 6.2.

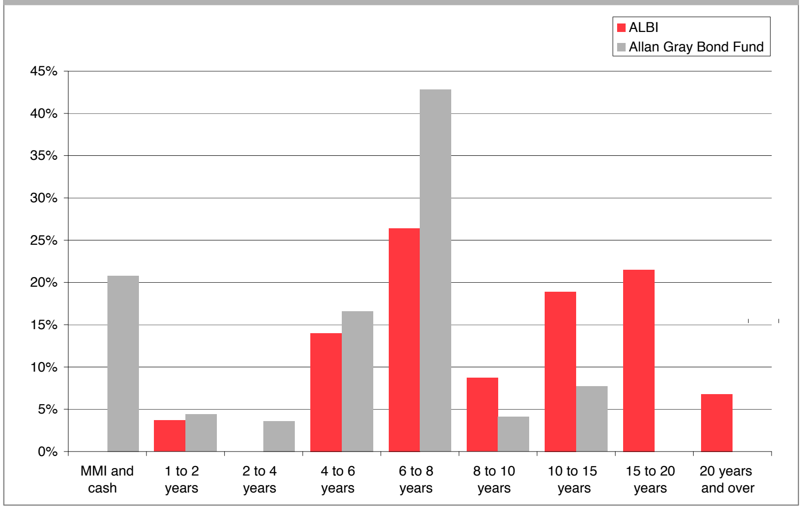
Little trading takes place in the Bond Fund as we believe it is very difficult to predict short-term movements in interest rates. We prefer to formulate a medium- to long-term inflation rate outlook, and optimise the positioning of the Fund around that.

Managing relative to the All Bond Index

Due to the fact that the duration of the ALBI has little to do with the duration that could provide an optimal risk/reward trade-off for investors, it would be illogical for us to base the Bond Fund's duration around that of the ALBI. The duration of the ALBI is influenced by where issuers believe it is optimal and cheapest for them to borrow money over the long term.

Investors do have an influence on the type and maturity of bonds an issuer sells to the market, but investors may be looking to buy bonds for different reasons. Some investors are looking to hedge long-term interest and inflation rate risks and will be drawn to the long-dated bonds. But these long-dated bonds may not make sense for an investor looking to generate real returns at low risk. Nonetheless all the bonds go into the ALBI.

Allan Gray Bond Fund and ALBI maturity profile



Our portfolio positioning

Currently the Bond Fund has a duration of 3.8 because we think the best value can be found in bonds with durations of three to five. Bonds in this area of the yield curve mature between 2013 and 2017. The government bonds that mature in this period yield about 8.30% while the corporate bonds yield 10.8% – which we think is a good return compared to cash, considering the risk.

We are unwilling to invest in long-dated corporate or government bonds for a few reasons. The long-term outlook for inflation in South Africa is uncertain as there is a risk that the structural imbalance of the current account deficit will lead to a weaker rand and higher inflation. The consistently high increases in administered prices, for example electricity and property rates, and wage increases in the low double digits, will be felt in the inflation rate unless productivity gains can offset these factors. The borrowing requirement of government and parastatals could approach R250 billion per year over the next few years. This is a lot of money compared to the savings pool in South Africa, and could lead to higher bond yields as investors demand higher returns to entice them to take up all the issuance.

Commentary by Andrew Lapping, portfolio manager, Allan Gray Limited

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