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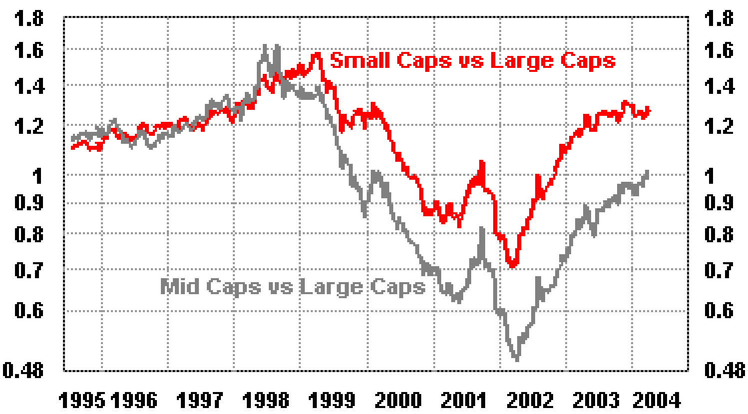
The disparity in value within the market

The disparity within the South African market continues to narrow. The extent of disparity peaked in 1997/98 when irrationality drove small capitalization financial services and IT shares to extremely overvalued levels and at the same time drove large capitalization resource and industrial shares to extremely undervalued levels. At that time there were a large number of very expensive shares and a large number of very attractive shares with very few fairly priced shares. As you are aware the period of irrationality ended in tears for many investors as share prices that were extremely overpriced corrected. Our clients have benefited significantly from this normalization in values. Following the correction, people have tended to become increasingly rational in their valuation of South African shares. As a result disparity in valuations within our share market has narrowed substantially. This is true not only in terms of the relative valuations between small, mid and large capitalization shares but also the disparity between the major sectors within the market (resources, financials and industrials).

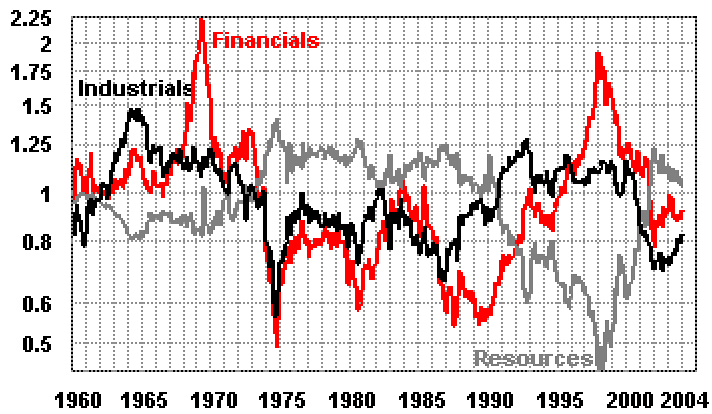
Large, mid and small capitalization companies

Graph 1 illustrates how the disparity between small, mid and large capitalization shares has narrowed over the last several years. From being extremely expensive in 1997/98, small and mid capitalization shares became extremely attractively priced two years ago. This was reflected in our portfolios that were very overweight mid capitalization companies (many of which were large businesses that happened to be very attractively priced e.g. Edgars, Foschini, Anglovaal Industries). Small and mid cap shares have however significantly outperformed over the last two years and there is not much difference in value between different sized companies currently. It is therefore no surprise that we have increasingly been finding value in larger capitalization companies that on a relative basis have become increasingly attractive.

Graph 1: Small Caps & Mid Caps vs Large Caps



Graph 2: Indices Relative Performance



Financials, industrials and resource companies

Graph 2 illustrates the three major sectors of the market (resources, financials and industrials) relative to the overall market. The extent of the disparity between sectors in 1997/98 was the most extreme it has ever been, with financial and IT shares being ridiculously expensive and resource shares being the most attractive they have ever been. Over the last six years this disparity has narrowed significantly. While South African industrial shares remain marginally attractive relative to resources, the differential in valuations between sectors is now small and the increased exposure to selected banking shares is indicative of the value we are now finding in that sector.

The reduced disparity in valuations within the market is not unique to South Africa being mirrored in many foreign markets. What is more unique is the relatively broad-based value that now exists in our market. We continue to believe that despite the large rise in the South African market over the last year in both local currency and dollar terms; there remains the prospect of good long-term returns from South African shares relative to bonds and cash. Obviously, the lower disparity in valuations means that one's ability to obtain the level of outperformance achieved over the last few years is reduced.

However, until the extent of disparity in value increases, there remain opportunities for stock-pickers like Allan Gray to add value. One such area currently is that we are finding that one can acquire high quality businesses that are currently being rated similarly to average or poor businesses.

Commentary by Stephen Mildenhall, Chief Investment Officer, Allan Gray Limited