

The fourth quarter of 2001 will be remembered by South Africans as the quarter in which our currency finally succumbed to the pressures of the currency speculators. The collapse of the Rand has been dramatic, making it one of the weakest currencies in the world in 2001. The Rand (at time of writing R13.40 / US\$) has depreciated year to date by 44% against the US\$, by 41% against the Euro and by 39% against the Australian dollar. In real terms, the Rand has now easily surpassed the lows that the currency registered during the Rubicon era of the early 80's. This has come at a time when our country rating has been raised to investment grade by both Moodys and Standard & Poors, and when our bonds have expressed unprecedented confidence in the South African government's economic policies.

This sharp depreciation in the Rand has led to Allan Gray's portfolios under-performing during the fourth quarter. As we have pointed out in previous issues of *GrayIssue*, our portfolios had very little exposure to the large offshore listed shares in the All Share index. Not only has the weak Rand dramatically increased the Rand prices for these companies, it has also reduced their cost base as significant portions of their production costs are denominated in Rands. This in turn has led to an improvement in their earnings' expectations and prices in hard currency.

Our current views can be summarised as follows:

- While we place very little emphasis in our investment process on economic forecasts of interest rates and exchange rates (because the probability of successful forecasting is very low), we do recognise and take cognisance of their absolute levels. The way a market prices currencies and money is not materially different from the way a market prices companies (shares). As with shares, markets can and will from time to time completely misprice currencies. With our value orientated investment process we try to exploit mispriced markets and mispricing within markets. However it can happen that this mispricing goes to extremes as we saw with domestic TMT stocks in 1998 and the NASDAQ in 2000. During these extremes Allan Gray normally does not perform very well. By any valuation measure, the Rand is now extremely cheap.
- Sentiment towards the Rand is at an all time low, and most South Africans have given up on their currency. Capitulation is a classic sign of a bear market bottom. From its current level, we believe the Rand has got substantially more upside than downside.
- We continue to view most of the offshore listed shares in the All Share index as expensive, even in hard currency terms. This is largely driven by the fact that most major global stock markets continue to trade at extremely high valuations. The forward PE on the offshore listed component of the All Share Index, which represents 39% of this index, is 17 while the rest of the market trades on a forward multiple of approximately 8.
- The more attractive valuations are therefore to be found amongst domestic industrial and consumer companies. With the recent sell off in domestic banks, these shares now also trade at more attractive values. Our portfolios continue to favour these types of counters.

Our rigorous investment process benefits hugely from mispricing within markets. However, when markets become irrational with resultant mispricing, it tends to impact negatively on our performance, especially if it goes to extremes. On the other hand we tend to benefit hugely when valuations return to normal levels, which invariably happens over the longer term.

*Commentary by Arjen Lugtenburg, Director*