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LONG TERM COMMENTARY

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Is there value in South African equities?

The local equity market (FTSE/JSE ALSI) has performed poorly (-15%) year to date and is down 34% off its peak in May 2002. The extreme weakness of the Rand towards the end of 2001 boosted the short-term earnings of many S.A companies. The subsequent recovery in the Rand and weak offshore markets has resulted in investors lowering both their earnings' expectations and the values willing to be paid for those earnings respectively. The poor performance has been felt across virtually the entire market.

The value disparity that existed in the market 18 months ago, where we believed large segments of the market were over and undervalued, has narrowed considerably. Value has broadened across the majority of the market. Good indicators of the breadth of this value are:

1. It is becoming increasingly difficult for us to identify shares that we believe are substantially overvalued.
2. Our bottom up research is identifying an increasing number of opportunities in large market capitalisation counters that our clients previously had little or no exposure to.
3. An increasing amount of companies are being bought out and/or de-listed by business people across all sectors of the market.

The above indicators are typical of an overall market that is attractively valued.

The starting point or price paid is the most important variable a rational investor would use when estimating future equity returns. "It matters to the measurement when the measurement begins."* The expected return from equities depends on the initial dividend yield, growth in earnings and changes in valuation. Generally speaking the lower the dividend yield and/or higher the PE on the original date of purchasing a market on a normal level of earnings - the lower the expected future return. A brief comparison between the local All Share Index and the US S&P 500 Index highlights the good relative value offered by local equities.

* Bill Miller: Legg Mason Value Trust Annual Report

Looking at the table:

	ALSI	**S&P 500**
Initial dividend yield (%)	4.1	1.8
The current level of earnings	Average	High
<u>Valuation levels</u>		
Long-term average PE (x)	11	14
Current PE (x)	9	28

Furthermore, it is likely that SA is about to enter a period of declining interest rates. Domestic interest rates are high relative to the developed world and scope for a material decline in rates exists. This will be positive for local economic activity and allow companies to increase their current low levels of gearing (industrial shares in particular) which should be positive for underlying earnings. It should also become apparent that equities are more attractive relative to other investment choices. Ten-year bonds currently yield 8.3% after tax versus the 10.8% earnings yield offered by equities. The bond market has to a large extent already discounted the expected drop in interest rates. As detailed in previous commentaries we believe that equities offer good value relative to bonds.

We believe local shares are attractively valued and should deliver long-term superior returns from current levels. As Warren Buffet once said, **"We like to do business in a pessimistic environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."**

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