GRAYISSUE

Looking back at 2011 and preparing for the years ahead

Adapted from the Chief Investment Officer's comments, which will appear in our 2011 Annual Report.

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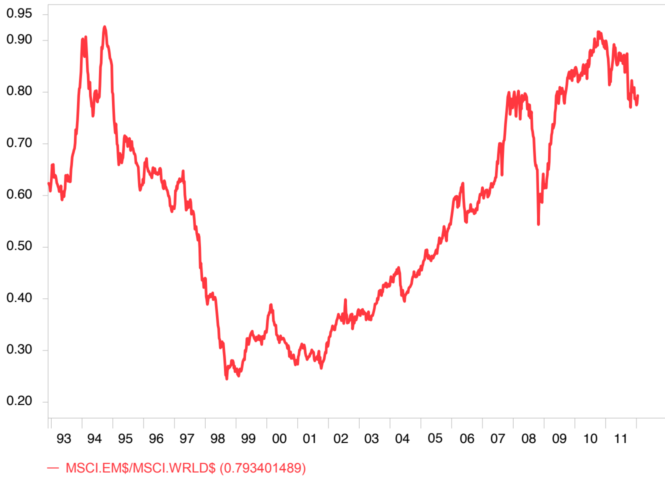
South Africa has thus far been spared the crushing austerity measures affecting Europe. Three important factors have been in our favour so far: a decade of strongly rising commodity prices, capital inflows from foreigners and a less indebted starting point. But one should be careful not to extrapolate these favourable factors indefinitely into the future. Underlying these positive influences are many things to worry about, such as our high levels of unemployment and little discernible progress in employment growth; inefficiency in our ageing deep-level mines; and the relatively high proportion of our public budget spent on wages and social grants, which are not adding to future productive capacity. Our own age of austerity may still lie in wait. In my opinion, South Africans need to save more to properly prepare themselves for this possibility.

Global equity markets

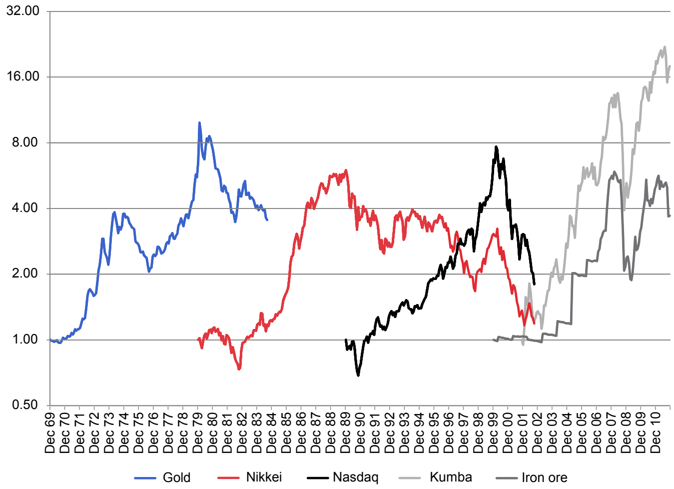
An important feature of 2011 was the underperformance of the emerging markets – the MSCI Emerging Market Index returned a negative 18.2% in dollars, and the FTSE/JSE All Share Index (ALSI) returned a negative 16% in dollars. The MSCI World Index returned a negative 5% in dollars for the year (see **Graph 1**). This was only the third calendar year this millennium in which emerging markets underperformed developed markets (the other two years were 2000 and 2008).

Graph 1 | MSCI Emerging Market Index/MSCI World Index (US$)



Source: I-Net Bridge

Graph 2 | Iron ore in a bubble?



Source: Datastream, I-Net Bridge (recreation of a BCA graph)
All figures are in real US dollars rebased to 1.

Almost a quarter of the Allan Gray Balanced and Stable Funds are now invested overseas. This lends more scope to these Funds than they previously enjoyed to diversify their country, currency and sector exposures. Orbis is able to access investment opportunities in sectors of the global economy which are under-represented on the JSE.

For example, the biggest sector exposure in the Orbis Global Equity Fund is to the technology sector (33% of the Fund). In contrast, technology sector stocks account for 1.2% of the value of the South African shares in the Allan Gray Equity Fund, and for only 0.3% of the ALSI. Orbis is able to invest in global technology companies such as Cisco, Qualcomm, Google, SAP and Samsung, which are simply not available to us on the local market.

The vast bulk of the exposure in the Orbis Global Equity Fund is to shares listed in the developed markets of North America, Europe and Japan. Many of these companies stand to benefit from potential further growth in demand for their products and services from the emerging markets, but with arguably less downside risk in the event of macroeconomic disturbances. Our research process puts little weight on where a share is listed, and which index it falls into, and places great emphasis on the attractiveness of the share price relative to that individual company's fundamentals.

Investors not constrained by retirement fund regulations, which limit exposure to certain asset classes, are able to further increase their exposure to global markets and currencies by investing in any of our three rand-denominated foreign unit trusts, without the need for foreign investment approval.

South African equity markets

Arguably the toughest issue for our local investment team right now is around the questionable sustainability of commodity prices and mining company profit margins, which are mostly substantially higher than their long-term averages. For example, the 21st century boom in iron ore prices has been of a similar magnitude to the Nasdaq tech bubble in the 1990s, the Japanese stock market bubble in the 1980s and the gold bubble in the 1970s (see **Graph 2**).

We believe that many commodity prices are significantly above their normal levels, which makes some mining company shares not nearly as attractive as suggested by a naive glance at their currently low P/E multiples. At present, we remain underweight the diversified mining companies – this may detract from our relative performance if commodity prices and mining company profit margins stay in the stratosphere for a few more years. However, we have found the most rewarding investment strategy to be one based on an assessment of a company's true long-term value, rather than its immediate prospects.

Commentary by Ian Liddle, Chief Investment Officer, Allan Gray