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LONG TERM COMMENTARY

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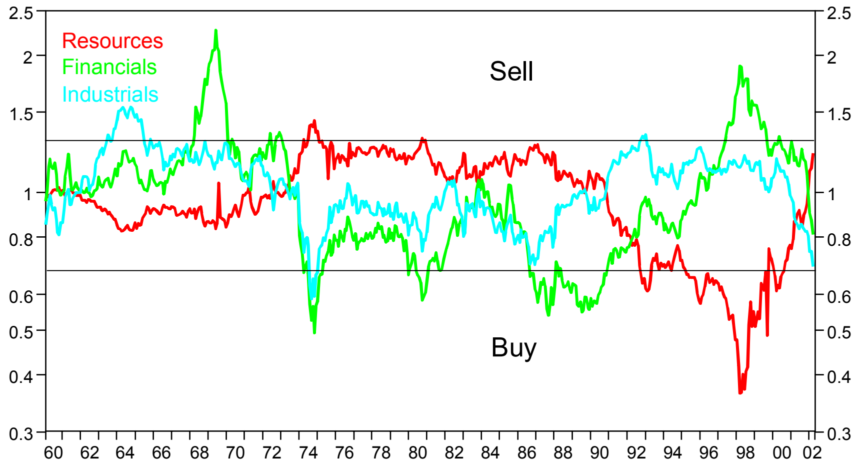
INDEX HISTORY IS OPPORTUNITY FOR INVESTORS

A 40-year view of the major components of the All Share Index, the financial, resources and industrial indices, relative to the All Share Index, indicates that while all three have gone up and down over time, none has dominated (see graph; source Igraph). At certain points each has offered tremendous investment opportunity. In the past it has given us a clear signal as to when to start becoming interested in certain sectors.



Allan Gray's underlying philosophy means that we buy into good companies in sectors that are unpopular. We use the current example of the Industrial Index: SA Industrial shares are the cheapest they've been since the early 70's. In fact if one takes out Richemont and SAB, which make up nearly 40% of this index, and whose prices are now made on European stock exchanges, then you could say that relatively speaking, domestic industrial shares are the cheapest they've ever been.

We can compare the earnings and PE ratios of Tiger Brands and Anglos to illustrate the point. In 1992 the PE ratio for Tigers was 20 while Anglos had a PE of eight; today it is the other way around. Despite the fact that since 1981 the Rand has gone from one to 12 against the US$, Tigers has still matched the earnings growth of Anglos over this period. The reason for this dramatic change in rating cannot be ascribed to differences in earnings growth, but rather it is based on market sentiment towards these two companies at any one time.

In the early 90's shares like Tigers, Nampak and AVI were the 'must-have' investments; today it is shares like Anglos and Billiton. At Allan Gray we have never followed the herd or the so-called popular sectors. Rather our performance over the past 28 years can be attributed to investing in shares that are attractively priced, even though they might have been extremely unpopular at that point.

For example, when resource stocks were out of favour during the 90's, we invested heavily in them. In fact, comments were often made during that period that Allan Gray only bought resource stocks. Resource stocks, we believe, are now overvalued and we have therefore sold most of our resource holdings and are now buying industrials as well as financial stocks. As a result, Allan Gray is now overweight in shares such as Tigers, Nampak, AVI and retailers such as Foschini, Mr Price and Woolies, to mention a few.

Of the three indices, the financial index has been the most volatile over time. The reason, in our opinion, is because it is a highly geared index thanks to the banks that normally hold only 10% of their capital in equity with the rest made up of depositors' money. Examples of banks that have been through crises such as Bankorp, Nedcor, Regal, Cape Investment Bank, Sechold and now Unifer and Saambou also illustrate why the financial index is the more volatile index. This risk was not reflected in the ratings of financial stocks for some time but now that recent events have corrected this, for the first time in years we can see value in financial stocks.

Another reason Allan Gray believes that it is time for the industrial index to perform is the weakness of the Rand.

Through the multiplier effect, the windfall that exporters, resource companies and the agricultural sector are experiencing from the weak Rand will, in time, work their way into the rest of the economy. We refer to the R15bn windfall taxpayers received in the recent budget as an example of the multiplier at work. As resource companies earn more profits due to the weak Rand, they pay more tax that in turn enables the tax authorities to reduce the tax burden of the man in the street.

With this in mind and the fact that the industrial sector is the cheapest it's been for a long time, prospects look very bright for local industrial stocks.

Commentary by Arjen Lugtenburg, Director