

RE·VIEW

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RE·CM



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INTRODUCTION

Anyone who has not been on Mars over the past few months will know that markets have been extremely volatile. During this time, the world view that emerging markets will take over from developed markets as the main engines of economic growth has been tested, and found wanting. Just as Europe is sinking into a morass (mainly of its own – politicians' – making) China seems to be slowing down. This is not the story that our eternally bullish friends at asset-gathering fund management, investment banking and stockbroking firms had been selling to their clients!

The net result is that emerging markets (including South Africa) have performed very poorly over the past year. As our clients will know, at RE:CM we almost never sign up to the theme du jour. We have been negative on the investment prospects of emerging markets generally, and South Africa specifically, for some time now. One of the main reasons we did not buy into this fad for emerging markets (and, let it be said, African markets are exactly that), was that as South Africans, with most of our assets and liabilities already in South Africa, we failed to see the benefit of buying more of the same - especially if it is expensive, which it was! Can we now add emerging markets to the list of themes which have costs investors dearly? This list already includes property in 2008, resource stocks in 2006, technology in 2000 and small companies in 1998. But our clients, and regular readers of these quarterlies, probably already know this.

With this background, I am pleased to report that all our funds have performed well. I would specifically like to highlight the following:

1. The RE:CM Global Fund. This fund has declined by less than 1% for the year to date, compared to a 15,1% decline for the MSCI world index. The fund has now generated 7% p.a. outperformance of its benchmark since inception almost six years ago. It sold its last emerging markets exposure in October of last year (at the peak of the excitement about emerging markets) and since then most of its exposure to equity has been through US and Japanese companies. We continue to be very optimistic about the prospects for investment returns from Japan. So much so that one of our analysts, Johannes Visser, will be spending the next two months in Tokyo, learning more about that market.
2. The RE:CM Global Flexible Fund. You might recall we balloted our clients to change the mandate of our funds to be more flexible. In the case of the Global Flexible fund, over the past two years we have used that increased flexibility to significantly increase its offshore exposure to around 50% of the fund. This has helped the fund weather the recent rand sell off very well, to the extent that it has earned positive returns this year so far.
3. The RE:CM Money Market Fund. This fund is now exactly one year old; its returns have placed it in the top three money market funds. These returns have not been earned by taking on more risk. Rather, the fund has taken much less risk than any other money market fund. It has compensated for this through the lowest fees in the market. It is the low fee structure that results in our clients earning such competitive returns. This is the way we like it at RE:CM – as usual, a lot of our own money is in this fund as well.
4. The RE:CM Australia Equity Fund. This fund has weathered the downturn in the Australian market (and currency) very well. We have long been of the opinion that the Australian dollar was one of the most overvalued currencies in the world - along with the rand, of course. As such, we have concentrated on buying the equity of companies that earn a significant proportion of their income from foreign (i.e. non-Australian) sources. This has worked very well, and the fund has outperformed its benchmark by a wide margin. For rand based investors – where the currency effects cancel out – we think this fund is very interesting. The Australian market has a much better spread of good quality companies than the South African market. For US\$ based investors the fund has become much better valued, but is not yet compelling.

We are proud of the returns generated by all our funds; the above is just a selection. For more information on our funds – please visit our website (www.recm.co.za) where you can find factsheets on each of them.

In this quarterly RE:VIEW, we have five articles which we hope you find interesting. As opposed to the widespread doom and gloom out there, the general mood in the articles is upbeat; very simply, as markets decline, we generally tend to find a lot more value. However, we think there is definitely still a bubble or two out there. It would be surprising if this

were not so given the fact that the price of capital worldwide is almost zero due to the authorities' desperate attempts to prop up a failed system. Mispriced capital always leads to bubbles and huge risks for investors. Unsurprisingly, we try to avoid these as far as possible. In the first article, two of our analysts, Razeen Dinath and Richard Court discuss the concept of quality businesses vs. cyclical businesses, and specifically analyze the iron ore industry. At the risk of preempting their conclusion, suffice to say that none of our funds have any exposure to iron ore at all.

The second article – “Mind the Gap!” – deals with the esoteric, yet very popular world of ETF's, or Exchange Traded Funds. In this article Amédi de Klerk and Daniel Malan discuss the concept of “concentrated cyclically leveraged market capitalization weighted indices” This concept explains why the current fad of ETF's is likely to end in tears, as most “financial innovations” do.

At RE:CM we are scared of financial innovations; we think innovation properly belongs in the realm of technology and out of the hands of self-interested investment bankers. On the subject of technology, it is a sector of the market that has fallen completely out of favour. In the third article, “The Fat Pitch”, Johannes Visser deals with three of the top holdings in the RE:CM Global Fund, Microsoft, Intel and Dell. The same stocks that pundits loved 10 years ago because they would change the world are today completely out of favour. After 10 years of changing the world, their share prices are unchanged and the market hates them; today, we are finding more and more to like about them. Johannes explains why.

In the fourth article “Listed Stock Exchanges – Bubbles and Busts” Paul Whitburn provides us with a potted history of stock exchanges, as well as a short summary of their business model. He also deals with how the market has valued them historically, which places today's valuations in context. Finally, he comes up with a surprising conclusion. Suffice to say that the stock exchange we own is not one well known for its high level of “financial innovation”.

Just as you thought you were going to get away with a whole RE:VIEW in which there was nothing about philosophy and process, Linda Eedes sneaks in with a piece. In “Picking Asset Managers, Avoiding Mistakes” Linda deals with what one should look for when evaluating asset managers. One clue: it is not where they generally want you to look!

We hope you enjoy this quarter's RE:VIEW. The author of each article has tried hard to explain an aspect of our investment culture to you. But, it is not a one way trade - in writing these articles each of us also learns something new. It is surprising how the act of writing something down makes you think about it in more depth than you otherwise would. These pages are a voyage of discovery not only for you; our analysts are also continuously learning. For that we would like to thank you: if weren't for your business, we wouldn't have the luxury of exploring our thoughts more deeply.

As always, good investing.

Piet Viljoen
Executive Chairman

THE DANGERS, PITFALLS AND OPPORTUNITIES OF INVESTING IN CYCLICAL BUSINESSES

“There are a few things I dismiss and a few I believe in thoroughly. The former include economic forecasts, which I think don’t add value, and the list of the latter starts with cycles and the need to prepare for them.

“Hey,” you might say, “that’s contradictory. The best way to prepare for cycles is to predict them, and you just said it can’t be done.” That’s absolutely true, but in my opinion by no means debilitating. All of investing consists of dealing with the future, as I’ve written before, and the future is something we can’t know much about. But the limits on our foreknowledge needn’t doom us to failure as long as we acknowledge them and act accordingly.

In my opinion, the key to dealing with the future lies in knowing where you are, even if you can’t know precisely where you’re going. Knowing where you are in a cycle and what that implies for the future is very different from predicting the timing, extent and shape of the next cyclical move. And so we’d better understand all we can about cycles and their behaviour”

Howard Marks

“You pay a very high price for a cheery consensus”

Warren Buffett

When making an investment decision, the two most important considerations are:

1. The value of the business.
2. The quality of the business.

Good quality businesses have a moat that management protects and builds

The value of a business is determined by the stream of cash flows that the business can generate into the future. Investors will arrive at a different value for the same business if they have a different view of the cash flow stream; and how different unknown and unexpected events can affect this stream. A good quality business has a competitive advantage, a “moat” or barrier to entry, which prevents or reduces competition. Management spends all their time protecting and building the moat to increase the value of the business. A business like this is less vulnerable to economic cycles, and produces a more stable cash flow stream.

Market cycles drive cyclical business earnings – management has less of an impact

In contrast, a cyclical business is a business where the earnings of the business are primarily determined by macro-economic gyrations, and management have less of an impact on profitability. When the economy is on the up, the business does fantastically well, but when the economic cycle turns, the business suffers. There are many examples of cyclical businesses. Construction, mining and shipping companies spring to mind. Such businesses generally do not have any form of competitive advantage. On top of this, they are generally capital intensive businesses.

During good times, favourable trading conditions for cyclical businesses arise when the demand for a business’s products or services are at high levels, and this is sometimes preceded by a temporary decrease in competition or a lack of competing supply. The mismatch between supply and demand allows the incumbent business to generate super profits and earn a return on capital well in excess of the cost of that capital. The problem is that these excessive returns attract competition into the market that ultimately brings additional supply. This increased competition erodes the incumbent’s profits until returns only cover the cost of capital. If market participants are greedy and too many competitors enter the market with dreams of super profits, supply can dwarf demand and market players revert to selling their products and services at profit margins that do not even cover the cost of capital. Some participants cannot survive these conditions and leave the market. This continues until too many participants leave the market and there is insufficient supply to meet the demand and so the cycle starts again.

What exacerbates this cycle is the absence of an economic moat. This absence facilitates easy access for competition when super profits are on offer. An economic moat can be defined as anything that allows a business to:

- retain a customer against competition; or
- supply a customer sustainably at a lower cost than the competition.

An economic moat allows the business to continue to generate super profits. For another recent view on economic moats see the article entitled “Managing the Moat” in Volume 17, July 2011. This is another reason why we would rather allocate your capital to a business with a wide economic moat than to a business without one. The wider the moat, the more resilient a business will be when there is a downturn in the cycle.

This cyclical effect is also known as “mean reversion”, where a business’s profits vary around a normal level reflecting the cyclical disparity in supply and demand with competition entering and then exiting the market. It is also not as simple as periods of poor results following periods of super profits but rather that periods of super profits cause the following period to be a period of poor results. The super profits attract competition which then erodes super profits until they are normal economic profits, and then profits that do not cover the cost of capital.

The pitfalls of valuing cyclical businesses require one to normalise the entire income statement

The pitfalls in valuing a cyclical business occur when an investor ignores the fact that the business is a cyclical business and ignores the cycle. Investors will be led to either over- or under-value a business when focussing on the more recent past and accepting the current situation as the ‘new status quo’. This in turns leads to a misallocation of capital and poor returns.

This error can be avoided by normalising earnings through the cycle. This is, of course, easier said than done. Normalising earnings is more than simply determining a normal profit margin and applying this margin to sales. The sales figure in the last financial period would also be a function of where the business finds itself in the cycle. As such, normalising earnings actually implies normalising the entire income statement starting with the revenue line.

To determine the value of future earnings streams, investors tend to ignore the balance sheet. In spite of the balance sheet being perceived as more stable than the income statement, the balance sheet items also move in line with the economic cycle in a cyclical business. The level of working capital required will change as the business cycle changes. Even the level of capital investment is affected by the position of the cycle. Just as investors are more likely to buy stocks when they are surrounded by good news, management are more likely to add capacity when the going is good than when times are tough. Moreover debt levels can rise as management uses debt to fund this additional capacity.

To illustrate these concepts, we consider two companies: Kumba Iron Ore and Grindrod.

Kumba Iron Ore was formed in November 2006 when the iron ore assets of Kumba Resources Limited were unbundled and listed separately on the JSE. Since then Kumba has outperformed the JSE by a factor of three and has produced fantastic financial results.

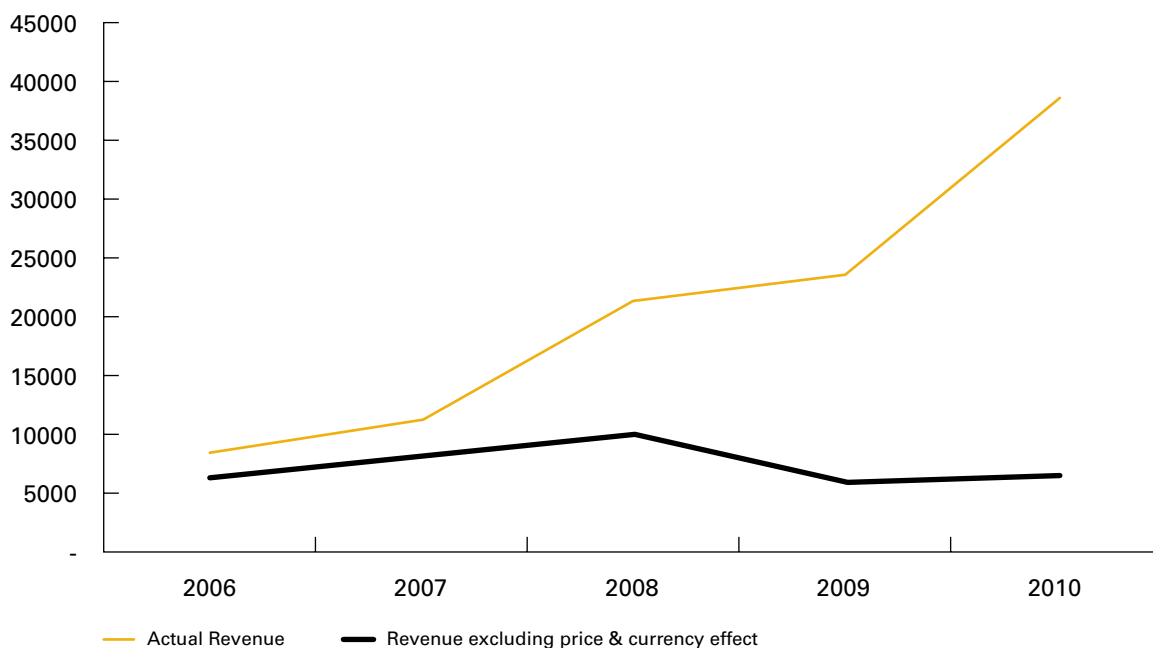
Looking at supply and demand through market cycles at Kumba

Unpacking the interim results to June 2011, we find that a trailing 12 month dividend per share of R42.70 is backed up by headline earning per share (HEPS) of R52.62. The current share price is R475.00, which implies that Kumba is trading on a historical P/E multiple of 9 and a 9% dividend yield. If this doesn’t get a value investor’s blood pumping nothing will, which begs the question: “Why has RE:CM not allocated your capital to this wonderful business?”

In short, it may not surprise you to learn that a low P/E ratio does not automatically mean that a company is trading at a cheap price because the company’s earnings may be high, depressing the P/E ratio. At RE:CM we spend a significant amount of time trying to understand the company’s normal earning power especially in the case of low quality cyclical companies. We then use this to derive a normal P/E ratio to determine if a company is cheap and a good investment.

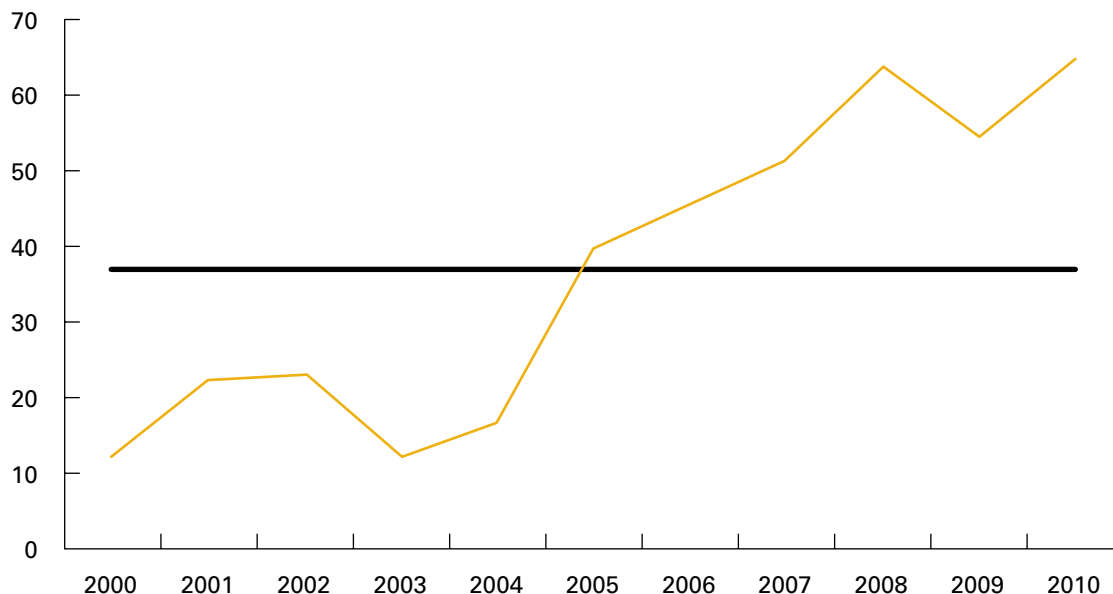
A cyclical commodity company’s normal earning power is not always easy to establish as the biggest driver of earnings is the underlying commodity price. A high commodity price affects earnings in two ways. The first is that it drives revenue, which makes the company appear to be growing faster than it actually is. The second is that the costs of mining are largely fixed in the short term and do not go up as quickly as revenue, which causes the profit margin to expand. These effects can be seen in the following graphs. They show that Kumba’s 2010 revenue would only be slightly higher than 2006 revenue if you exclude the impact of the increase in the rand iron ore price while the operating margin has risen from 20% to over 70%. In other words, the increase in the rand iron ore price accounts for 82% of the improvement in revenue.

Chart 1: Kumba – Revenue Analysis



Source: Company reports, RE:CM analyst

Chart 2: Kumba Operating Profit Margin History



Source: Company reports, RE:CM analyst

So how does one go about establishing what a “normal” commodity price should be? In our view, the marginal cost of production is the best indicator of a sustainable commodity price. Marginal cost of production is the cost that will be incurred to produce an extra unit of the commodity at the supply and demand equilibrium. To determine equilibrium, we need to look at demand and supply separately.

1. Supply

There is a saying that the cure for high prices is high prices. High prices make it feasible to develop iron ore mines that may not be considered at lower prices. This leads to additional supply coming on at a lower marginal cost of production. The table following illustrates this point.

Rio Tinto is spending US\$2.1bn on its Hope Downs 4 expansion including rail and power infrastructure, which will produce 15 million tons of iron ore per annum for nine years. Rio Tinto is currently receiving US\$150 per ton of iron ore and has managed to make 70% EBITDA margins in the iron ore division in the 2010 financial year. If you subtract interest at 5% and tax at 30% (effective rates according to their 2010 Annual Report) this results in a projected net income of US\$1bn and a payback period of only two years. Any sane businessperson would jump at the opportunity to invest in a project where they get their money back in only two years.

Table 1: Rio Tinto Hope Downs 4 Expansion

Production (mtpa)	15
Current Realised Iron Ore Price (US\$/ton)	150
Revenue (millions)	2,250
EBITDA (2010 EBITDA 70%)	1,575
Interest (US\$2.1bn*5%)	105
Pre Tax Income	1,470
Tax @ 30% (Rio Tinto 2010 tax rate)	441
Net Income	1,029
Cost of Project	2,100
Payback Period (Cost/Net Income)	2.0

Source: Company reports, RE:CM analyst

Iron ore requires massive infrastructure that slows down the supply response as mining companies have to develop the mine, railway lines and ports. This takes a long time and allows high prices to persist for longer periods relative to other commodities, where the supply response is much more elastic. Current forecasts indicate that the supply of sea-borne iron ore is going to remain tight for the next two years, but should be in surplus in 2014 (refer to Table 2). Iron ore mining companies are responding to price signals as fast as they can. Expect a lot more iron ore to be mined in future!

Table 2: Global Iron Ore Market (About The Turn, 11 July 2011)

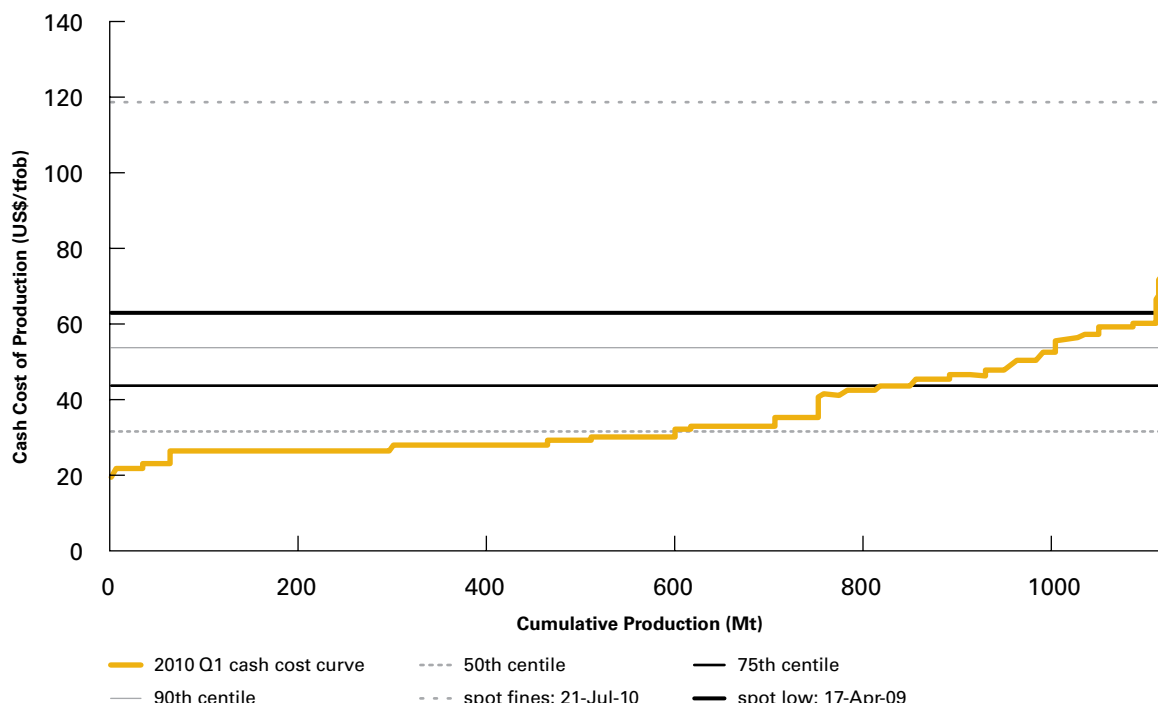
		2008	2009	2010	2011e	2012e	2013e	2014e	2015e
Global Crude Steel Production	Mt	1,305	1,206	1,392	1,497	1,577	1,678	1,777	1,887
YoY Growth	%	-1.6%	-7.6%	15.3%	7.6%	5.3%	6.4%	5.9%	6.2%
Global Iron Ore Demand	Mt	1,583	1,480	1,717	1,842	1,920	1,980	2,013	2,059
Global Iron Ore Supply	Mt	1,628	1,515	1,762	1,806	1,901	2,014	2,208	2,345
Global Balance	Mt	45.5	34.8	44.4	-35.6	-19.8	33.6	195.3	286.4
Total Seaborne Iron Ore Demand	Mt	846	907	984	1,113	1,185	1,252	1,269	1,295
YoY Growth	%	9.2%	7.3%	8.4%	13.1%	6.5%	5.7%	1.3%	2.0%
China Iron Ore Import Requirements	Mt	444	628	619	708	780	845	862	888
China as % of Seaborne Market	%	53%	69%	63%	64%	66%	67%	68%	69%
Total Seaborne Iron Ore Supply	Mt	848	909	985	1,021	1,104	1,176	1,333	1,451
YoY Growth	%	9.9%	7.2%	8.3%	3.7%	8.1%	6.5%	13.3%	8.8%
Seaborne Balance	Mt	2.5	1.8	1.0	-91.5	-80.9	-75.8	64.4	156.2

Source: UBS Report

2. Demand

On the demand side, China currently consumes 48% of the iron ore produced in the world and about 65% of all the sea-borne iron ore (source: World Steel Association 2011 year book). There are many stories of China building ghost cities for a million people which only have a population of 30,000 (Google China ghost cities). Steel is one of the major components of construction and infrastructure development and there is a concern that China's push to keep their economy going via government sponsored infrastructure development is leading to building for the sake of building. This makes many believe that the demand from China is not normal or sustainable, which could lead to a big decline in commodity prices. We have no idea whether the China optimists or China pessimists are right. But we do think that the current rate of demand is not sustainable over the long-term. Looking at the marginal cost curve for iron ore (Chart 3), it is evident that the current spot prices are far above the 90th centile production cost of about US\$55 per ton. This highlights the downside risk to the price of iron ore. A rather slight drop in demand of 10% would result in the price of iron ore declining to between US\$50 to US\$60 per ton.

Chart 3: Iron Ore, by Company (Q1 2010 data)



Source: UBS Global I/O Commodity Price Research 13 December 2010

Such a decline is possible even if supply considerations remain stable. As pointed out above, we expect supply to increase dramatically over the next few years. This will lower the marginal cost curve as most of the new supply is low cost from developments in the Pilbara, Western Australia. All in all this points to there being significant downside risk to the iron ore price.

To get to normal earnings for Kumba, we also have to estimate a “normal” operating margin. To do so, we can look at their own long-term numbers, compared to those of Vale SA, a Brazilian-based iron ore company that is also the biggest in the world. Both numbers point to long-term, sustainable operating margins of 35% for a good iron ore business.

Putting ‘normalised’ supply and demand together:

At a “normal” iron ore price of US\$55 per ton, a “normal” Rand/US dollar exchange rate of R8.50, current production and 35% “normal” operating margin, we can estimate Kumba’s normal earning power to be about R13.45 per share. This equates to a current, normalised P/E of 35 - very different from the indicated P/E of 9. This is why we believe that Kumba is not cheap and why we haven’t allocated your capital to this cyclical business.

Grindrod: the true valuation lies somewhere in the middle between two extremes

Another cyclical industry that has attracted its fair share of newspaper headlines recently is the shipping industry. Shipping rates have fallen dramatically over the last three years. These rates are determined by supply and demand just like every other price for a product or service. In 2008, the demand for ships to transport raw materials and crude oil was incredibly high on the back of demand by China for these raw materials. Ship owners and operators made large returns as demand far outstripped the number of ships available to transport the cargo required. These superior returns were noticed and new entrants entered the industry, adding numerous new ships to the supply side of the equation. While demand was still outstripping the supply of ships, the prices charged by ship owners and operators spiked to new highs.

A Capesize ship is a very large ship that carries about 100,000 deadweight tonnes. It is too large to pass through the Panama Canal or the Suez Canal and therefore has to pass around the Cape of Good Hope or Cape Horn. Users of Capesize ships were paying in the region of US\$80,000 per day on five-year charters. In 2007/08 the disparity in supply and demand for Capesize ships created a spike in the spot price for Capesize ship charters to over US\$200,000 per day!

The disparity between supply and demand lessened and then reversed as market participants reacted to the high shipping rates by bringing on an excessive amount of new ships. In 2010, shipping rates on Capesize ships had plunged to below US\$10,000 per day. These have subsequently recovered to roughly US\$18,000 per day. The problem is that the breakeven price on many of these Capesize ships is around US\$30,000 per day. The situation in the Very Large Crude Carrier (VLCC) category is not much better. There is more than one report of ship owners of VLCCs on certain routes essentially paying customers to use their ships. The graph below illustrates the volatility in the price of Capesize ships.

Chart 4: Baltic Exchange Capesize Index



Source: Datastream

Grindrod is a shipping and logistics company listed on the Johannesburg Stock Exchange. In the latest Interim Results to June, Grindrod showed a 34% decrease in profits. Grindrod management highlighted poor performance from the shipping division as one of the main reasons for the decline in profits. Profits from the shipping segment declined by 81% for the latest six months compared to the corresponding prior year.

Grindrod provides us with a nice working example to demonstrate how the perceived value of a cyclical business can change if care is not taken to normalise the effects of the cycle. This example will only take into account Grindrod's shipping business. Over the past five years, management have cleverly used the super profits they generated through the extreme shipping cycle to diversify into unrelated businesses, which has made it less of a pure-play shipping company.

The 2008 financial year was the peak year for the shipping industry, and a very good year for the shipping segment of Grindrod. Using this as one's base year (not normalised), an investor would arrive at a very generous valuation of this shipping business. At the time, the shipping business was able to generate Earnings before Interest and Tax (EBIT) margins of greater than 30%. Using this as normal financial performance in one's valuation calculations, would result in a value for the shipping segment in excess of R26 per Grindrod share. The average share price for Grindrod for the 2008 financial year was R21, offering a potential investor a 20% margin of safety on the shipping assets alone. Additionally, an investor would get the rest of the logistics, trading and infrastructure businesses free – which sounds like a good deal.

However, a quick attempt to normalise the earnings potential of the shipping business would have highlighted the potential misallocation of capital, had an investor acted on the generous valuation. A fair value of R11 per Grindrod share is the result of using a more realistic ‘through the cycle’ revenue number of R4.5bn as opposed to the R7bn generated in 2008. It is also based on an EBIT margin closer to the shipping segments average of 20% and the same multiple as applied in our 2008 case. At the other extreme, extrapolating current earnings generated by the shipping business arrives at the rather depressing valuation of R2.30 per Grindrod share. As always, the truth lies somewhere in the middle.

See the example in the table below:

Table 3: Grinrod Shipping Valuation Scenarios

	Normal	2008	Last 12 Months Trading
Sales	4,500,000	7,000,000	4,100,000
EBIT Margin	20.0%	32.0%	5.4%
EBIT	900,000	2,240,000	221,400
Multiple	6	6	6
Enterprise Value	5,400,000	13,440,000	1,328,400
Net Debt	280,300	1,022,022	280,300
Equity	5,119,700	12,417,978	1,048,100
Value Per Share	R11.01	R26.85	R2.30

Source: RE:CM analyst

Cyclical businesses may offer opportunities – but be careful of forecasts and be prepared

It is important to note that a cyclical business can sometimes be a good investment for your capital. But you need to be sure that you are investing in the trough of the cycle when others are fearful. This is not an argument for investing based on forecasting the macroeconomic cycle. Without the assistance of a crystal ball, no one is going to be able to call the exact trough or peak of a cycle with any sort of accuracy or consistency. This is simply highlighting the fact that a cycle turns. Favourable operating environments precede harsh operating environments, which evolve into favourable operating environments again. It is generally during the low portion of the cycle that Mr. Market steps forward and offers attractive investment opportunities.

One does not need to call the exact trough to take advantage of these offerings. The time to prepare for and to be aware of investment opportunities is when the cycle is high and investor sentiment towards a business is positive. The best preparation is the realisation that cycles do turn. RE:CM endeavours to be patient and wait for those times of negativity and fear that invariably come with business cycles and see what bargains the market presents.

Razeen Dinath and Richard Court

MIND THE GAP!

“A substantial rise in the market is at once a legitimate reason for satisfaction and a cause for prudent concern, but it may also bring a strong temptation toward imprudent action.”

Benjamin Graham in the Intelligent Investor

“And besides, from the purely practical aspect, why was that motor left in a junk pile? You’d think any greedy fool of an industrialist would have grabbed it in order to make a fortune.”

Dr Stadler in Atlas Shrugged by Ayn Rand

Most individuals want to be part of markets that make news for all the “right” reasons. Owning the most popular and well-known stocks in the most popular markets make for ultimate bragging rights at the local get together.

By devising an instrument called an ETF (Exchange Traded Fund), investment bankers and other suppliers of financial detritus have, true to form, made it easy for investors to acquire such ‘bragging rights’. They also came up with a unique selling point that is very catchy, namely that ETFs are a cheap way of investing. ETF’s relative cheapness (or lack thereof, as the case may be) is a completely different topic. Suffice to say: in life, you mostly get what you pay for!

Clever marketing and the relative ease of buying ETFs conceal significant risks

This article aims to explain the dangers of investing in popular markets through ETFs rather than finding individual, high quality, cheap businesses within those markets. It also aims to show that by climbing on this bandwagon and buying into these instruments at current (popular) levels may result in those ‘bragging rights’ dissipating much faster than one would dare guess! Specifically, we refer to a particularly dangerous index which some ETFs track – indices for which we’ve coined the phrase: ‘expensive concentrated cyclically leveraged market capitalisation weighted indices’. But more on this later.

In contrast, RE:CM finds businesses that display the characteristics that we as an asset manager covet the most in unpopular, underperforming markets. These characteristics are quality from a business strategy perspective and cheapness from a price to value perspective. No ETF has been devised for these investments. The RE:CM Global Fund (please compare its costs with any ETF) is taking advantage of the current opportunities.

ETFs that track the performance of expensive, cyclical and highly concentrated indices hide risks

Most stock market indices track the performance of a specific group – country or industry – of stocks. These indices are constructed by weighting each constituent (individual stock or company) by its market value. We call this market capitalisation. It is possible that a market capitalisation weighted index can include a few stocks that make up a very large proportion of the entire index. The danger that this holds is that the entire index performance is tied to those few stocks. For example, 99.5% of the entire Hungarian Index consists of the combined weight of 10 stocks. When an investor buys into an ETF, the performance of the ETF tracks the performance of the entire index with minimal return leakage. In the case of Hungary, an ETF can accomplish this by holding just 10 stocks. Tracking only a few stocks holds some risk, but when this stock concentration is combined with an expensive market and stocks that are cyclical the risks can increase substantially.

How do we define ‘expensive, concentrated, cyclically leveraged market capitalisation indices’?

Let us define the criteria of what we mean by ‘expensive, concentrated, cyclically leveraged market capitalisation indices’ by breaking the term into individual concepts.

1. **Concentrated** – the top 10 stocks make up at least 50% of the entire index.

2. **Cyclically leveraged** – all businesses follow certain cycles in their operations with some businesses more so than others. Those whose cycles cause deep troughs and high peaks are termed ‘cyclical’. They also tend to have high capex requirements. Typically, these stocks are in the following industries:

- energy,
- commodities,
- infrastructure,
- chemicals,
- shipping, and
- semi-conductors.

An index would be leveraged towards the business cycle where there is a high concentration of ‘cyclical’ stocks within its top 10 constituents. We consider a 30% ‘cyclical’ concentration in an index as ‘leveraged’.

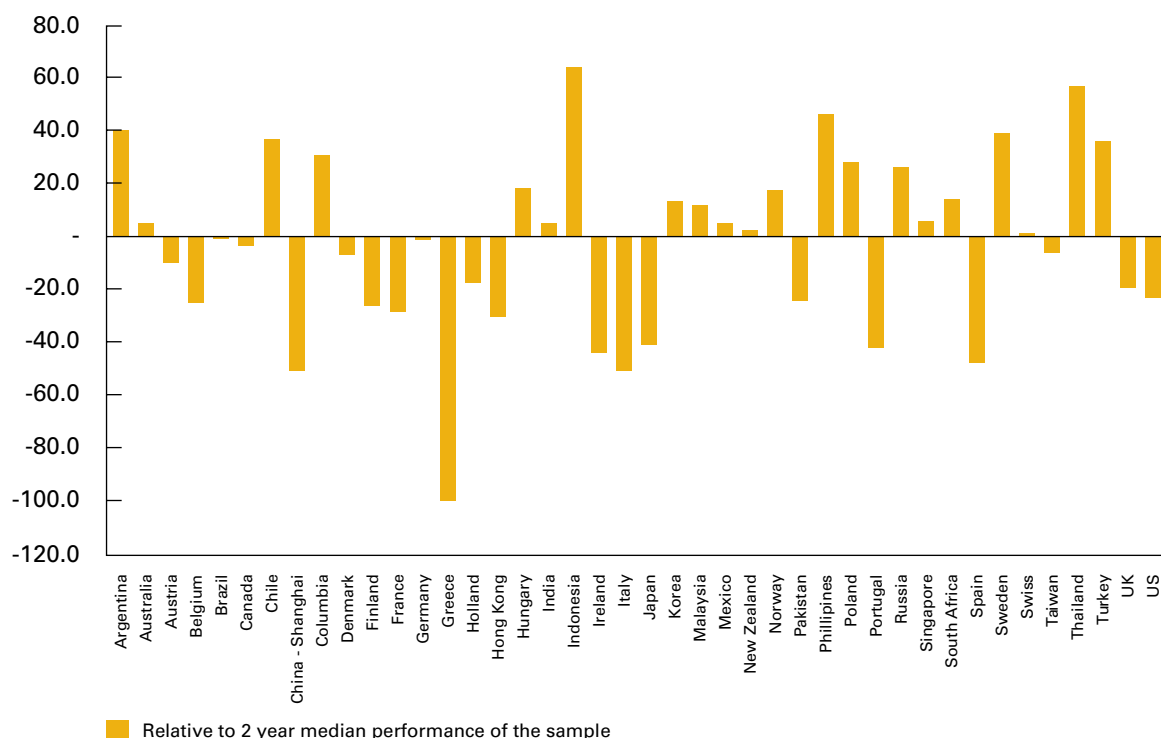
3. **Market capitalisation weighted** – where the constituents of an index are weighted according to their market values.

4. **Expensive** – where the price to book value ratio of an index is near or more than one standard deviation above its long term mean.

How do indices with a high concentration of ‘cyclicals’ perform relative to those with low concentrations?

Now that we understand what an ‘expensive, concentrated, cyclically leveraged market capitalisation weighted index’ means, we can identify such markets and their associated ETFs. An ETF, as an instrument, is extremely easy to buy into (of course the investment bankers want to make it as easy as possible for you to lose your money!). These instruments have become very popular with individual investors and industry flows confirm this. We think this spells trouble.

Chart 1: Country Index % Outperformance/Underperformance



Source: RE:CM analyst calculations

Chart 1 is a graphic illustration of each country’s index performance in US dollar terms over the past two-year period, compared to the median of all 42 countries. Some of the underperformers are located in developed markets such as the PIGS countries (Portugal, Italy, Greece, Spain), Japan, UK, US, France and Finland. Some of the indices that outperformed

are found in emerging markets such as Argentina, Chile, Indonesia, Philippines, Russia, Thailand and South Africa. If we separate the concentrated, cyclically leveraged indices from the less concentrated, cyclically leveraged indices in this sample and timeframe, we find that the same countries that underperformed were the countries with a low concentration of ‘cyclicals’ in their respective indices and the countries that outperformed had indices with a high concentration of ‘cyclicals’.

In our opinion, in many respects the world has returned to virtually the same levels of risk acceptance as in 2007 and we all know how well that turned out. Investors, being natural herd animals, tend to run shy following market collapses. A recovering market and government bailouts seemed to have prompted memory loss.

Let’s take a closer look at two markets in the sample that have concentrated cyclical leverage and have outperformed.

Chart 2: Argentina Price/Book Ratio



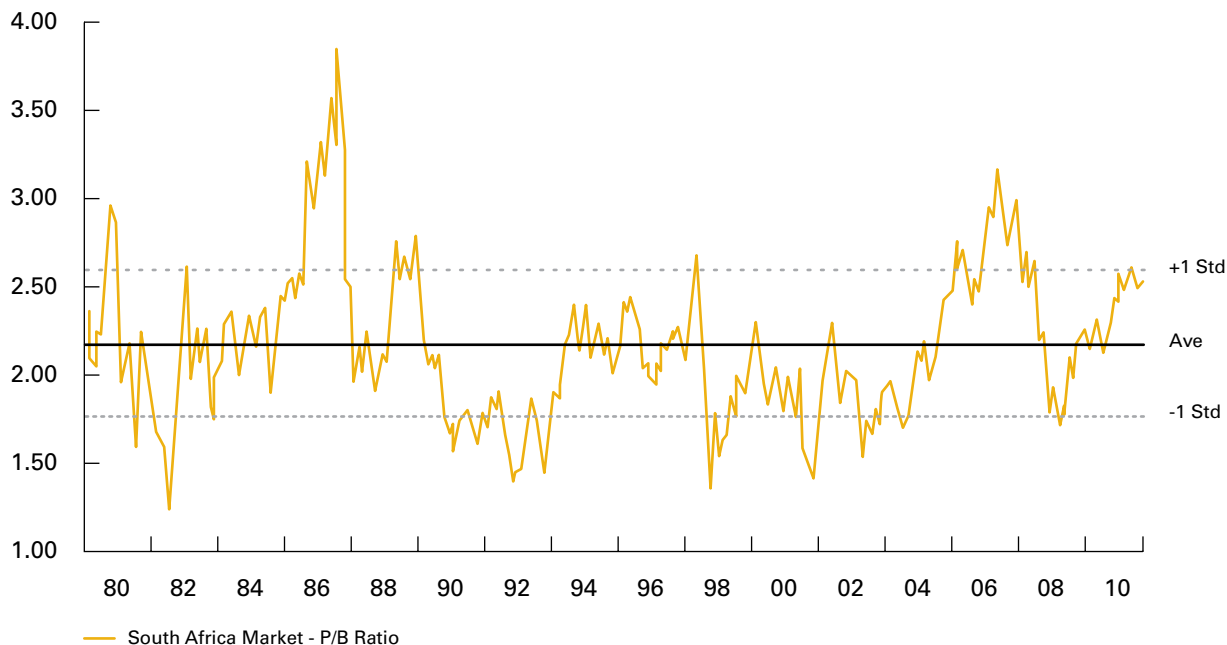
Source: Thomson Reuters Datastream

Argentina’s index is a prime example of an ‘expensive, concentrated, cyclically leveraged market capitalisation weighted index’ because it meets the following criteria:

1. It has a top 10 constituent weight of about 79% of the index.
2. Within the top 10 constituents there are no less than five ‘cyclicals’ with a combined weight of 35% of the entire index.
3. The index is market capitalisation weighted.
4. The market appears to be expensive, as its price to book ratio is high.

At these levels, investors are accepting a lot of risk in a cyclically leveraged market. What risk is the South African market showing if the Argentinean market is showing these risk acceptance levels?

Chart 3: South Africa Price/Book Ratio



Source: Thomson Reuters Datastream

The FTSE JSE All Share Index:

1. Has a top 10 constituent weight of about 59% of the entire index.
2. Has five 'cyclicals' with a combined weight of 34%.
3. Is market capitalisation weighted.
4. Appears to be expensive.

Again, at these levels, investors who are buying into the South African market are accepting high levels of risk.

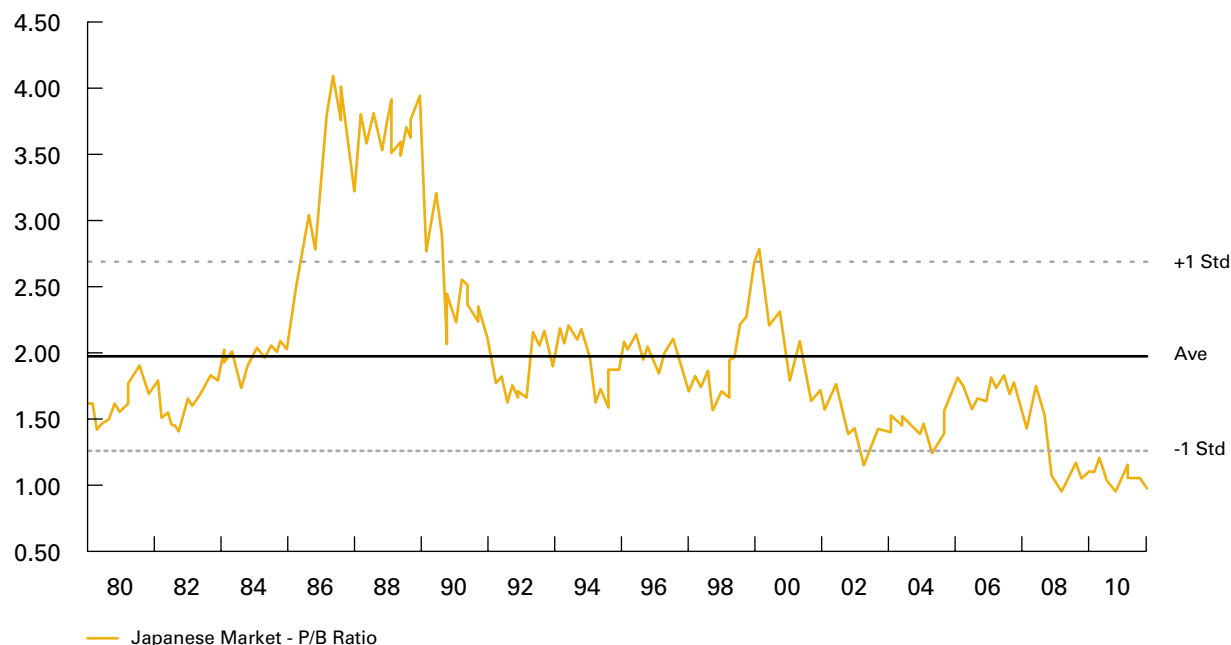
The underlying risks of ETFs that track these types of indices are often masked by the relative ease of buying into them. The ETF investor is unaware that they are indirectly buying into an 'expensive, concentrated, cyclically leveraged index' whose popularity is a direct result of their recent outperformance.

Opportunities exist in some underperforming 'non cyclically leveraged' developed market indices

By inverting, we deduct that an opportunity may present itself in indices that are not cyclically leveraged market capitalisation weighted. Importantly, they must also have underperformed and show signs of being undervalued.

Let's take a closer look at some of these markets.

Chart 4: Japan Price/Book Ratio



Source: Thomson Reuters Datastream

Japan's Nikkei Exchange:

1. Has a top 10 constituent weight of 30%.
2. Within the top 10 there are three 'heavy cyclical' stocks with a combined weight of only 9% of the entire index.
3. Is market capitalisation weighted.
4. Looks to be very cheap.

Compared to South Africa's index the Japanese index is not cyclically leveraged. In terms of its valuation, the Japanese market is at one standard deviation below its long-term average price to book multiple and therefore appears to be undervalued. In addition, the Japanese index has underperformed the past two year median performance of the sample by 40%.

This leads us to believe Japan offers our analysts opportunities for further business specific research. In fact, we are so excited about the investment prospects for Japan, that one of our analysts is spending the next two months in Tokyo to get to know the market better, and to hopefully identify some (more) Japanese opportunities for our global fund.

The PIGS (Portugal, Italy, Greece, Spain)

All of the PIGS indices have a high top 10 constituent weight in their respective indices ranging from 73% to 83%. This meets criterion one. At first glance, this high degree of concentration may seem a bit concerning. But a closer look shows that the largest top 'cyclical' constituent weight lies in Portugal with three cyclical constituents making up about 29% of the entire index and the lowest cyclical constituent weight is in Spain at about 7% of the entire index. This falls outside of criterion two.

Portugal falls just short of being cyclically leveraged. But what counts in its favour is that it has underperformed. In fact, relative to the past two-year median sample performance in US dollar terms, the PIGS countries have underperformed significantly. They are all market capitalisation weighted and therefore meet criterion three. If they are also undervalued, their relative underperformance coupled with their lack of cyclical leverage could make them more desirable markets for investors.

Chart 5: Portugal

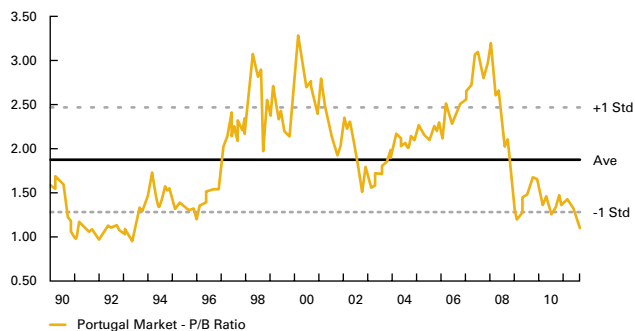


Chart 6: Italy

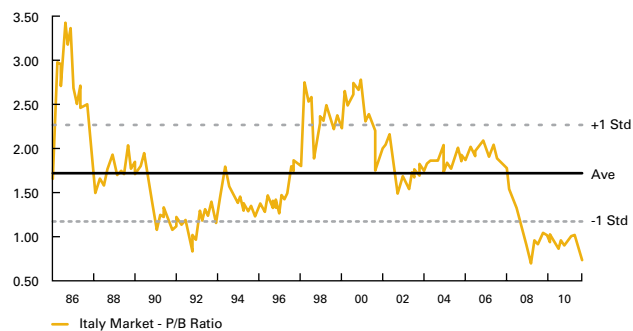


Chart 7: Greece

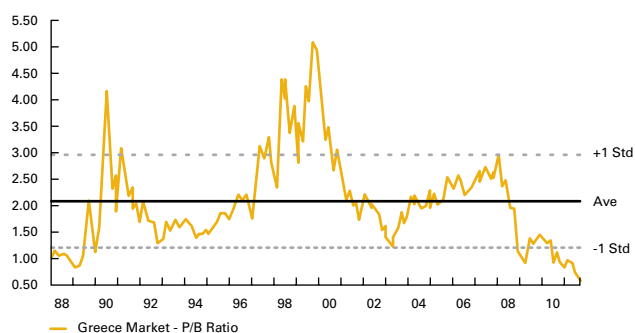
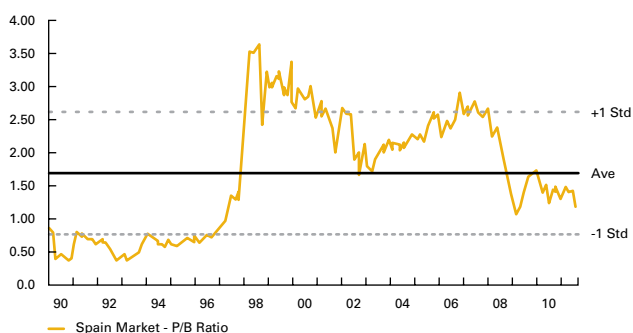


Chart 8: Spain



Source: All charts: Thomson Reuters Datastream

The charts above show that based on their price to book multiple, all of the PIGS markets appear to be undervalued with all but Spain, at more than one standard deviation below their long-term mean. This leads us to believe that the unpopularity of these markets coupled with their apparent undervaluation and lack of cyclical leverage may offer an attractive hunting ground for cheap and unpopular businesses.

There are more than a few opportunities for bargain hunters in world stock markets

There are dangers to investors in a world where most people appear to disregard gaps between price and value. But there are also more than a few opportunities for bargain hunters who have the stomach to hold their noses while scratching around the proverbial garbage dumps of the world's stock markets.

Amédi de Klerk

THE FAT PITCH

"The efficient markets hypothesis (EMH) is the financial equivalent of Monty Python's Dead Parrot. No matter how much you point out that it is dead, the believers just respond that it is simply resting! I wouldn't really care if EMH was just some academic artefact, but as Keynes noted, 'practical men are usually the slaves of some defunct economist'. The EMH has left us with a litany of bad ideas, from CAPM to benchmarking, and risk management to shareholder value. The worst of its legacy is the terrible advice it offers on how to outperform - essentially be a better forecaster than everyone else. It is surely time to consign both the EMH and its offshoots to the dustbin of history."

The Seven Immutable Laws of Investing.

1. Always insist on a margin of safety
2. This time is never different
3. Be patient and wait for the fat pitch
4. Be contrarian
5. Risk is the permanent loss of capital, never a number
6. Be leery of leverage
7. Never invest in something you don't understand

James Montier

"It is only when they go wrong that machines remind you how powerful they are."

Clive James

Over the past few years we have bought shares in a few technology businesses that we have come to understand and that have become attractively priced. These include Dell, which we bought in the heart of the financial crisis at the end of 2008 and which we wrote about in the article "Freebasing Free Cash Flow" in the October 2010 edition of the RE:VIEW. Another is Intel which we bought at the beginning of 2011. Despite their tech association, these companies have long-term advantages over their competitors:

- Dell has a direct sales model that its large competitors cannot imitate because of their substantial physical and vested interest in legacy distribution channels. This gives Dell a permanent negative working capital advantage, significant free cash flow and high returns on capital.
- Intel, because of its sheer relative size, stays ahead on the innovation curve by spending more on research and development each year than the total market value of its nearest competitor.

Provided that they do not pay too much, investors in businesses with characteristics like Dell and Intel have favourable odds of compounding capital at high rates for a long time, a sure way to generate good investment returns. Similarly, our most recent technology investment, the software giant Microsoft, is a top-notch business:

1. High Returns on Capital

Once developed, the incremental physical capital and cost to produce another unit of software is near zero – the equivalent of a blank CD and packaging at most. It makes sense, therefore, that software like the Windows Operating System and Microsoft Office, which enjoy close to 90% market share, should earn very high operating margins and returns on capital.

2. High Barriers to Protect Those Returns from Competition

Microsoft's initial success has been self-perpetuating with the software attracting users, then more software developers and then more users, which culminated in an ever-improving product which left competitors in the dust. Microsoft now

has an unrivalled budget and an army of programmers familiar with its platform. Each year it spends US\$10bn on research and development and US\$14bn on sales and marketing. It is hard to play catch-up against an entrenched skill set and sizable budget like this.

Even though Microsoft offers a vastly superior product, the price of the software is still minor in relation to the benefit that users, especially business users, get from it. This gives Microsoft pricing power. Free alternatives have been available for two decades yet customers still prefer to pay.

The fact is that the cost of switching from Microsoft's software is enormous. It takes computer users years to learn the intricacies of Microsoft Office and the Windows Operating System and this competence is cumulative. Especially for business users, Microsoft's core customer base, the opportunity cost of time invested in learning these products is mostly too high to switch to an alternative and learn it all over again.

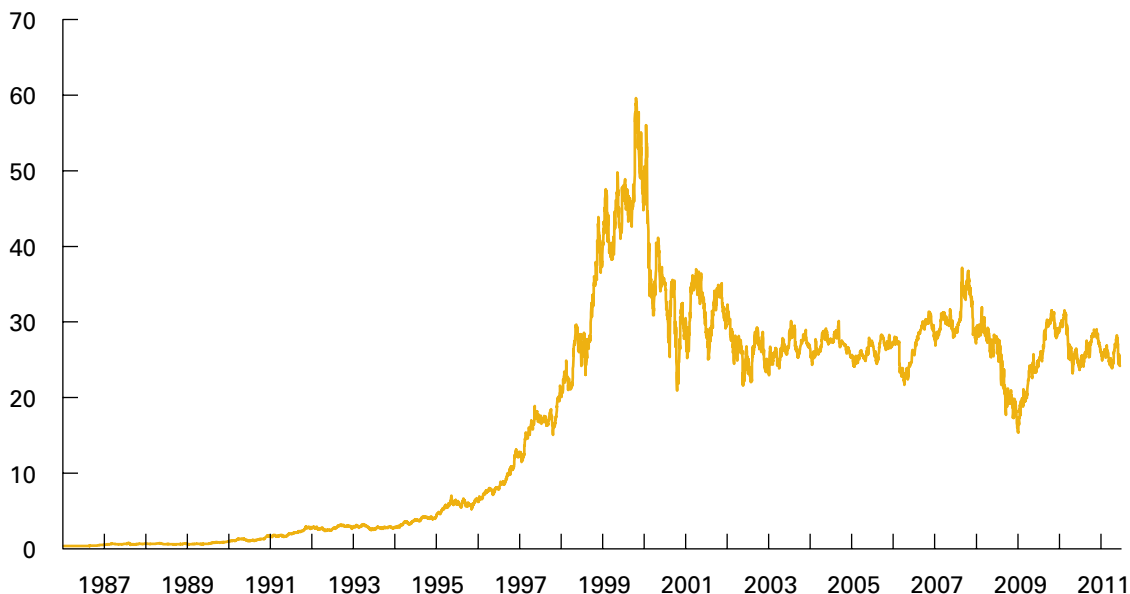
The compatibility of Microsoft Server, Microsoft's network tool for IT professionals, with Windows and Office, saves significant IT costs and headaches. Notably, Microsoft also offers a sliding scale price incentive to businesses to buy Server with Office and Windows. Microsoft Server has become the default choice as a network tool. This further embeds Microsoft in the business IT network and raises the total cost of switching from Windows and Office. It seems that switching today means switching an entire IT ecosystem.

These barriers are substantial. It would be an especially difficult feat for a competitor to create a product that is so much better than Microsoft's that customers would incur the significant costs of switching.

Investments in Dell, Intel and Microsoft have performed poorly for the last decade

Despite stellar operating performances, investments in Dell, Intel and Microsoft's have performed poorly over the last 10 years. Microsoft's share price went as high as US\$60 at the peak of the internet bubble in 1999 and then fell to US\$20 in 2000. Since then, despite tripling revenue and EBIT per share, Microsoft's share price has gone nowhere. Intel and Dell's share prices followed a near identical route and in fact decreased during the last 10 years.

Chart 1: Microsoft Share Price in US\$

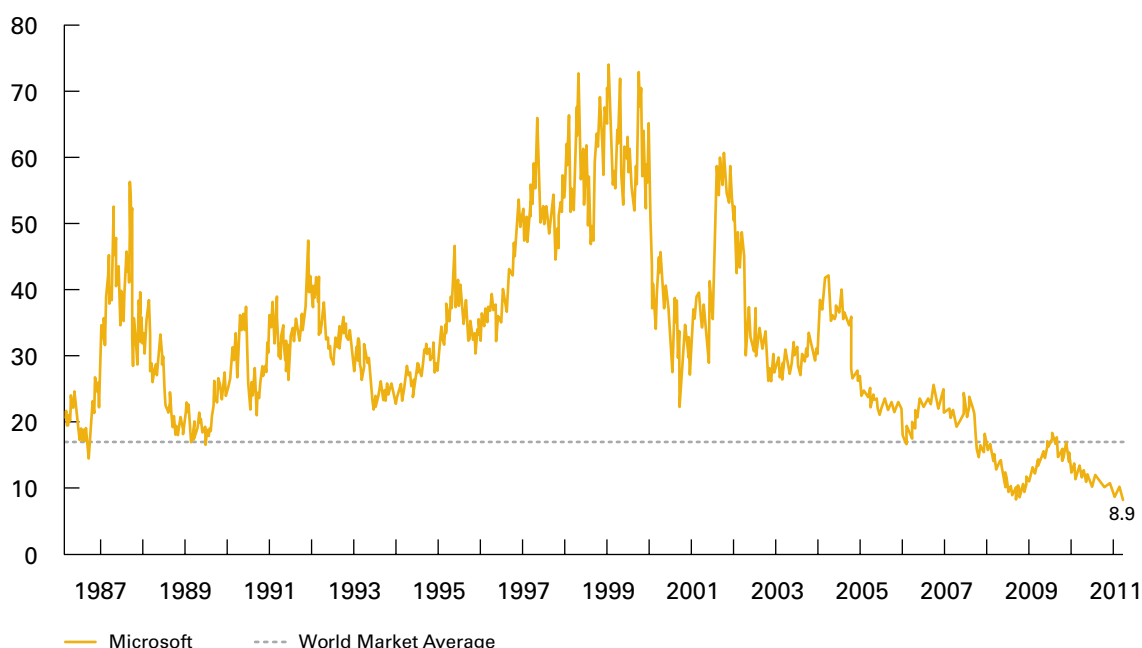


Source: Datastream

The over-valued extremes of the dotcom days are now gone

In 1998-2000, investors in Microsoft were paying 60 to 70 times earnings for an already sizeable business with substantial earnings, at one point valuing it at US\$634bn. These were the days when dotcom stocks were valued, not by the cash flows they produced but on the number of clicks and eyeballs. Even after the crash investors were willing to pay 30 to 60 times earnings. Ten years on and investors are valuing a business that generates three times the cash flows, for three times less at US\$205bn, willingly parting with their shares at less than 9 times earnings.

Chart 2: Price to Earnings Ratio for Microsoft and World Market Average



Source: Datastream, RE:CM analyst

Dell and Intel’s valuations followed a similar path with the market valuing them at well over 100 times earnings during the bubble, after which it drifted down as their profits caught up with their static to falling share prices. Currently, Dell and Intel’s Price/Earnings Ratios are 9.0 and 7.5 times respectively. Keep in mind that these valuation metrics do not adjust for the significant amount of cash sitting on the balance sheet, earning almost no interest.

It seems that investors have become frustrated at the share prices remaining stagnant for so long. Despite their strong operating performances these companies are now seen as lacklustre as their share prices ‘aren’t doing anything.’

The market is even going as far as to imply that Microsoft, Dell and Intel are substantially worse businesses than the average business (!). This is evident in Chart 2 which shows Microsoft trading at a substantially lower Price to Earnings Multiple than the historic average of the world market.

The “old” technology companies may be boring but this doesn’t detract from their core strength

The market seems to find these mature technology businesses somewhat boring. What drives sentiment even lower are some company-specific question marks which, as usual, are all about not being at the right place at the right time. Intel’s chips and Microsoft’s Operating System have not been able to capitalise on the growth in the smartphone market, while Dell has not taken advantage of the growth in tablets.

This does not detract from their core strengths which they are now applying in these new markets. Yet, “boring” with some negative sentiment thrown in, typically ends in depressed valuations when compared to high growth and positive opinion, regardless of the strength of the business model. This is evident in Table 1 which compares the valuation multiples of Dell, Intel and Microsoft to Apple, the market darling.

Table 1: Valuation Metrics of US Technology Businesses

	Market Capitalisation (US\$ bn)	Net Cash/Market Capitalisation	Enterprise Value/ EBIT	FCF Yield adjusted for cash
Dell	26	28.3%	4.3	14.0%
Intel	114	8.2%	8.3	7.6%
Microsoft	212	19.3%	5.9	13.0%
Average	na	18.6%	6.2	11.5%
Apple	375	7.7%	11.6	6.7%

Source: Bloomberg, RECM analyst

The market is valuing Apple’s Operating Profit and Free Cash Flow at almost two times that of the other companies’. In fact, the market currently appraises Apple as the most valuable company in the world, worth more than Intel, Microsoft and Dell combined.

As an Apple investor, therefore, one has to ask the following question: has the company erected barriers to entry so high that profits can endure and grow at a rate that justifies paying the current price?

Although Apple’s design and innovation is admirable, it is not automatically sustainable at the higher level for which the market is currently paying. Unlike Microsoft’s business software, the switching cost for a consumer device like Apple’s iPhone is much lower given the rapid product replacement cycle and ability to create a near substitute. Granted, the Apple “ecosystem” driven by iTunes is a strong barrier to entry, and there is thus a non-negligible chance that investors will make money if they buy Apple at current prices. But we are reminded of the old adage “no tree grows to the sky”. The risk of permanent capital loss in Apple is high enough to justify not investing at the current share price.

Behavioural finance has demonstrated in the past that humans tend to give up a certain gain for a chance of an even higher one. It is certainly telling that businesses that are fairly easy to understand can be so significantly under-priced, while businesses that are harder to understand can attract very high valuations. This phenomenon, sometimes referred

to as greed (and fear), manifests itself through the popular sentiment about a company. This is why RE:CM has learned to avoid popular stocks and rather fishes for bargains where the news is less favourable, preferably dreadful.

As contrarian, value investors, we don't find Dell, Intel and Microsoft boring. They are what we like to call "fat". On average they earn Free Cash Flows every year close to 10% of their average market capitalisation and with significant net cash on their Balance Sheet, close to another 20% of their average market capitalisation.

Dell, Intel and Microsoft each offer the rare opportunity of an outstanding business available at a bargain basement price - the so called "fat pitch". RE:CM has therefore allocated a sizeable portion of clients capital to these companies. Together they make up 11.3% of the RE:CM Global Fund and 5.9% of RE:CM's Global Flexible Fund.

Johannes Visser

LISTED STOCK EXCHANGES – BUBBLES & BUSTS

“If farming were to be organised like the stock market, a farmer would sell his farm in the morning when it was raining, only to buy it back in the afternoon when the sun came out.”

John Maynard Keynes

“An ambitious Scot, a convicted murderer, a compulsive gambler and a flawed financial genius, John Law was not only responsible for the first true boom and bust in asset prices. He also may be said to have caused, indirectly the French Revolution...”

Niall Ferguson

“Investing dying as computer trading, ETFs & dark pools proliferate”

CNBC

The world's first exchanges can be traced back to the 12th century in France. It wasn't until the 1600's that many unofficial markets were created where individuals would trade outside 'coffee houses'. This led to the first official stock exchange in Amsterdam in 1607 that created the world's first IPO - the Dutch East India Company. This was followed by the establishment of a secondary market to trade these so called 'partijen' or 'actien', as in 'a piece of the action' (appropriate in more ways than one). In the 1700's stock exchanges began in France, England and America where companies were able to raise capital and speculators became shareholders in limited liability public companies.

As exchanges were deregulated, competition increased, costs declined and margins tightened

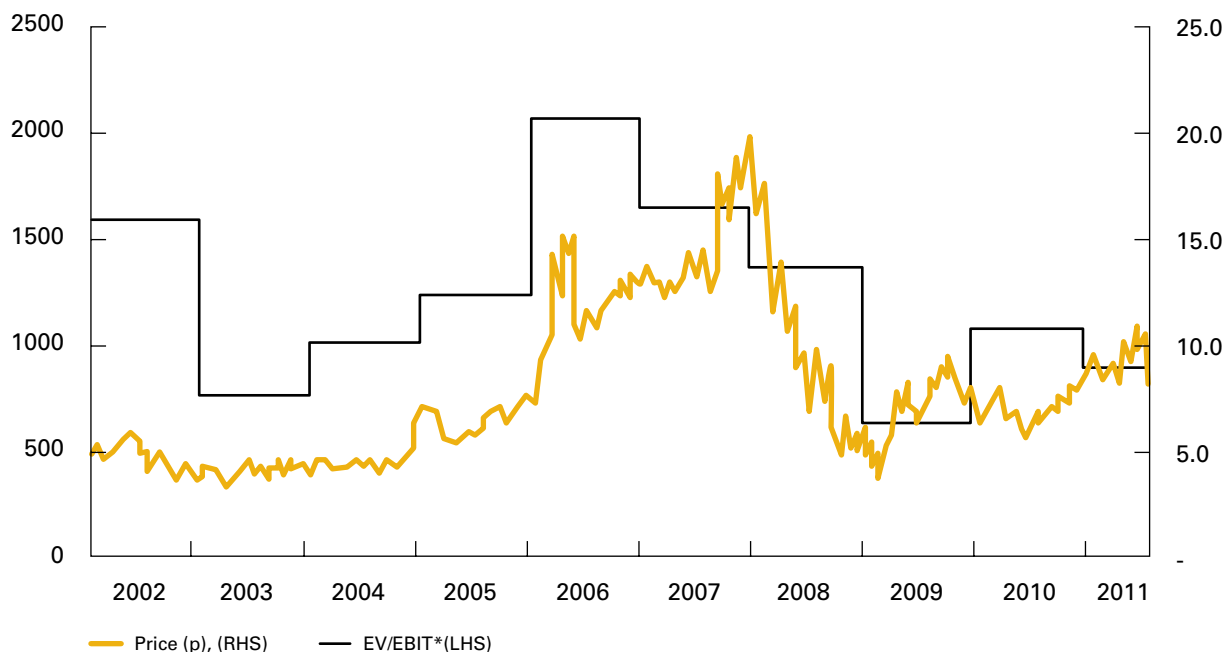
Global stock exchanges became highly regulated in the 1900's and the ownership structure was organised along the lines of mutual associations. Much later in 1990's-2000 many of these mutuals were de-mutualised and became listed public companies. On listing, the market viewed these companies as regulated monopolies that would generate abnormal returns, but with deregulation came competition.

This competition came from companies such as BATS Europe, Chi-X and Turquoise that were start-ups backed by banks (the biggest clients of the incumbent exchanges) - who wanted to reduce transaction fees in large liquid markets. This led to considerable market share erosion for these erstwhile monopolies. The market share of incumbent exchanges declined by 25% and left them with far less revenue from trading activities. The new competitors were able to build state of the art infrastructure allowing institutional investors to trade at very low costs, a requirement in today's world of high frequency trading. As investors, or rather speculators, tend to hold shares for shorter periods, transaction costs become more important. The ability to trade in a fraction of a millisecond at low cost supposedly gives speculators a competitive advantage in generating returns.

Listed stock exchange company valuations have changed as their environment has changed

Mr. Market has clearly had a tough time valuing listed stock exchange companies as they have moved from monopolies into environments that are more competitive. Below is the Enterprise Value (EV) relative to Earnings before Interest and Taxes (EBIT) of the London Stock Exchange (LSE) since listing in 2002. Shortly after listing it was valued at 16x EV/EBIT and only two years later the valuation declined to 7.5X EV/EBIT, as a high cost inefficient mutual became a more profitable listed company.

Chart 1: Historical Price (p) of the London Stock Exchange and EV/EBIT Multiple



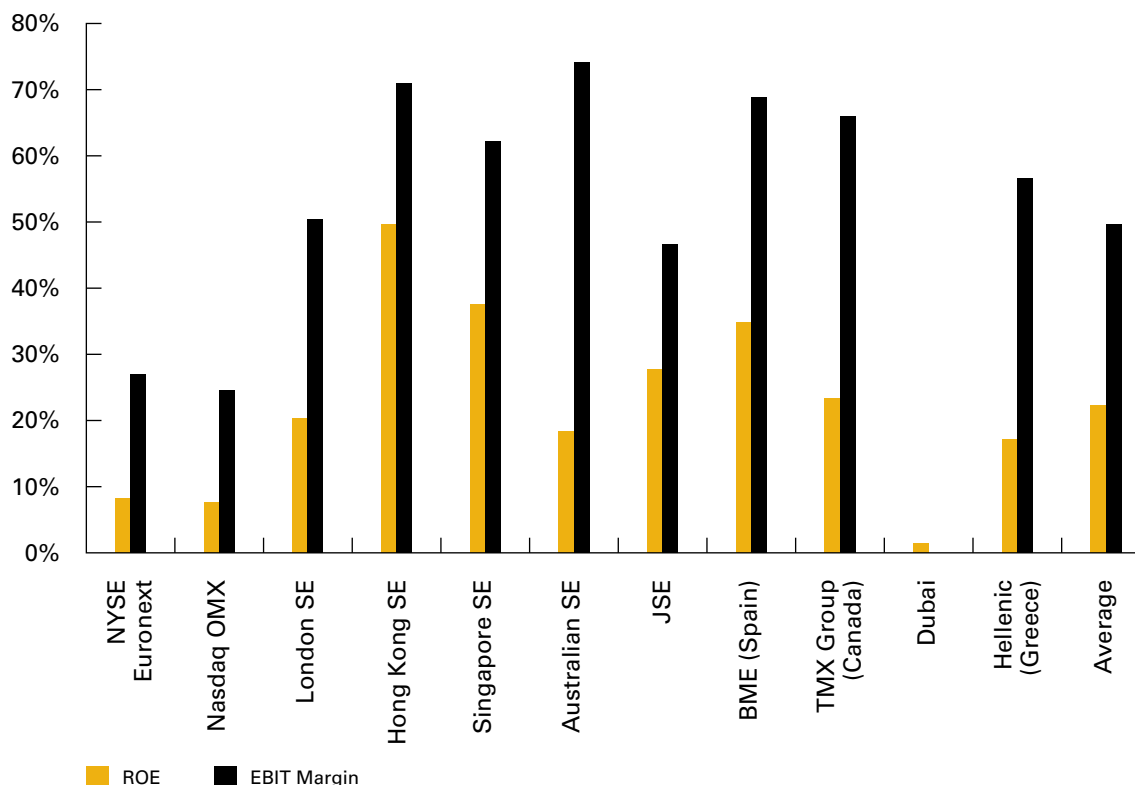
Source: DataStream and RE:CM analyst

Since 2002, the LSE has grown earnings per share at 14% p.a. with a small decline in earnings during the 2008/2009 credit crisis. The market however has valued the LSE at enormous premiums at times when it was considered to be a highly profitable monopoly. The rating subsequently returned to the long-term average of 10x EV/EBIT. Returns, as is the case with many other exchanges, remain excellent and the LSE continues to generate considerable free cash flow due to their low reinvestment needs.

On the next page is the current return on equity for a number of listed stock exchanges, which makes a clear case for competition entering these markets on deregulation. The NYSE Euronext and Nasdaq OMX were the first stock exchanges to experience competition and have had an erosion of margins and returns over the last few years. Size and liquidity are important to new competitors so the US markets, as the largest markets in the world, became the first markets to experience intense competition. There are some exchanges that continue to generate great returns with high margins notwithstanding new competition such as the LSE and TMX Group (Canada).

* EV/EBIT is a valuation multiple much like a P/E ratio, except that it takes the mix of debt and equity in a firm's capital structure into account in the numerator. A P/E ratio only references the equity portion of the capital structure.

Chart 2: Return on Equity (ROE) and Operating Margins of Listed Stock Exchanges



Source: DataStream and RE:CM analyst

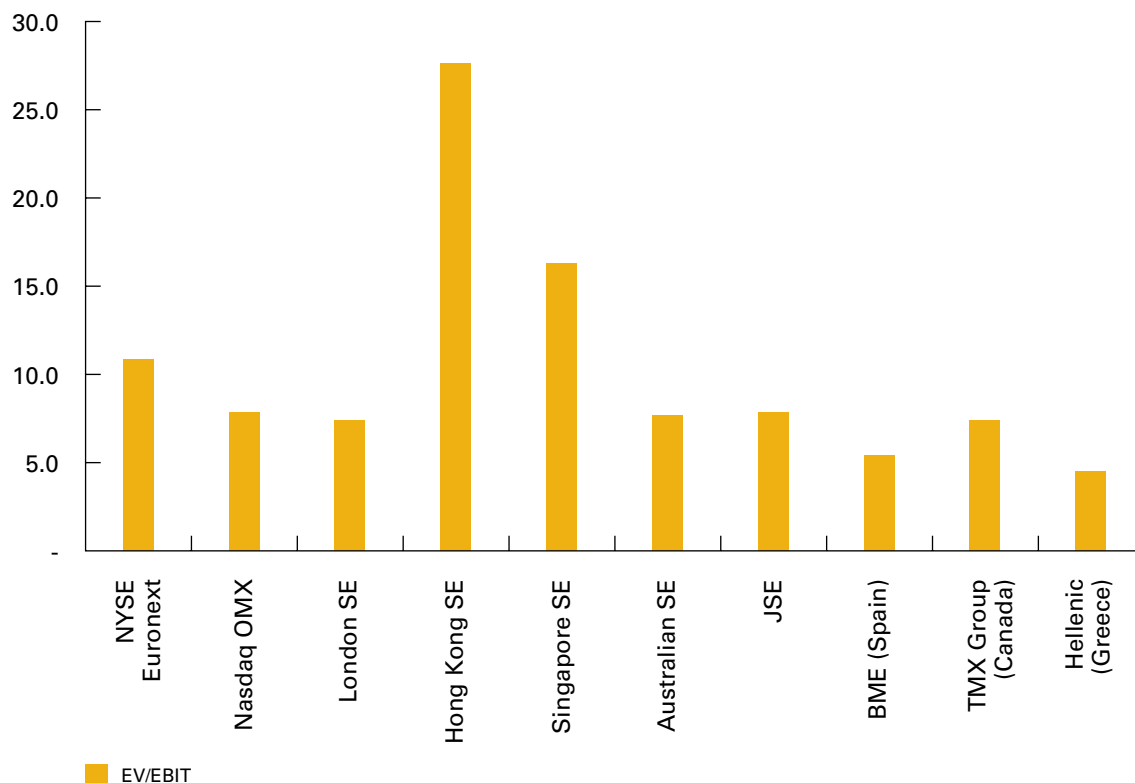
Over the last ten years there has been considerable acquisition activity as exchanges try to justify excessive multiples with geographic diversification, cost synergies and increased liquidity for clients. The problem is that many governments view their local stock exchanges as national assets and seem unwilling to sell these assets to other exchanges.

The most sought after stock exchanges are in Asia as their economies grow at far greater rates than the rest of the world. Investors perennially confuse high rates of economic growth with potentially high investment returns, and this attracts large capital flows. In turn, the large capital flows drive the prices of securities up in these regions, making them attractive for corporates who want to sell equity to the public via new listings. As an example of this; even companies from developed markets such as Prada and Manchester United have decided to search for better ratings on Asian exchanges. More listings and higher prices generate more trading activity, which is good for the earnings of exchanges.

Value investors would not be attracted to these overpriced stock exchanges that supposedly only have good times ahead (and are thus valued at very high ratings). Chart 3 provides the EV/EBIT multiples for all listed exchanges. More specifically, you will notice that the exchanges of Spain (BME) and Greece (Hellenic) look far cheaper on an EV/EBIT basis than the exchanges of Hong Kong and Singapore. You are probably thinking that if the EU is in trouble and the PIGS are bankrupt, these valuations are justified.

Quite simply, the stock exchanges in Europe have delivered returns well above their cost of capital, even during one of the most difficult economic periods for the EU.

Chart 3: EV/EBIT for Listed Stock Exchanges



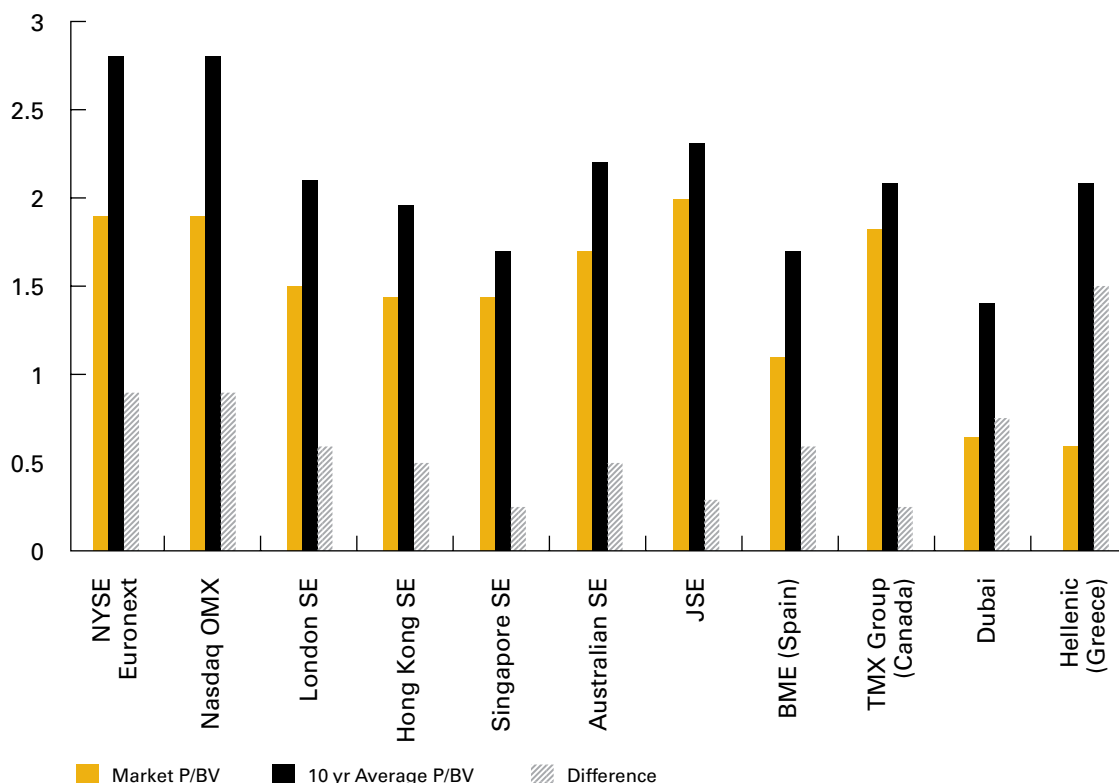
Source: DataStream and RE:CM analyst

How do stock exchanges generate revenue?

The current depressed earnings of these exchanges are well below the normal earnings power of the Spanish and Greek incumbents. To understand this we need to look at how stock exchanges generate revenue. Approximately 40%-60% of revenue is generated through equity trading with the balance earned from settlement, listing fees, data fees, derivatives and other services. Almost all of these stock exchanges charge fees as a percentage of the transaction value, so the greater the market capitalisation value of the stock exchange the greater the revenue from equity trading. If the P/BV of the market is in line with the long-term average you could assume that revenue is at approximately normal levels. But if the P/BV is substantially below the long-term average, revenue generated through trading would be below normal. This is because the average value of transactions is lower resulting in lower commissions for the exchange.

On the next page is an indication of the current P/BV of the various markets and the 10-year average P/BV.

Chart 4: 10yr P/BV of Local Indices, Current P/BV and the Difference Between the Long-Term and Current P/BV



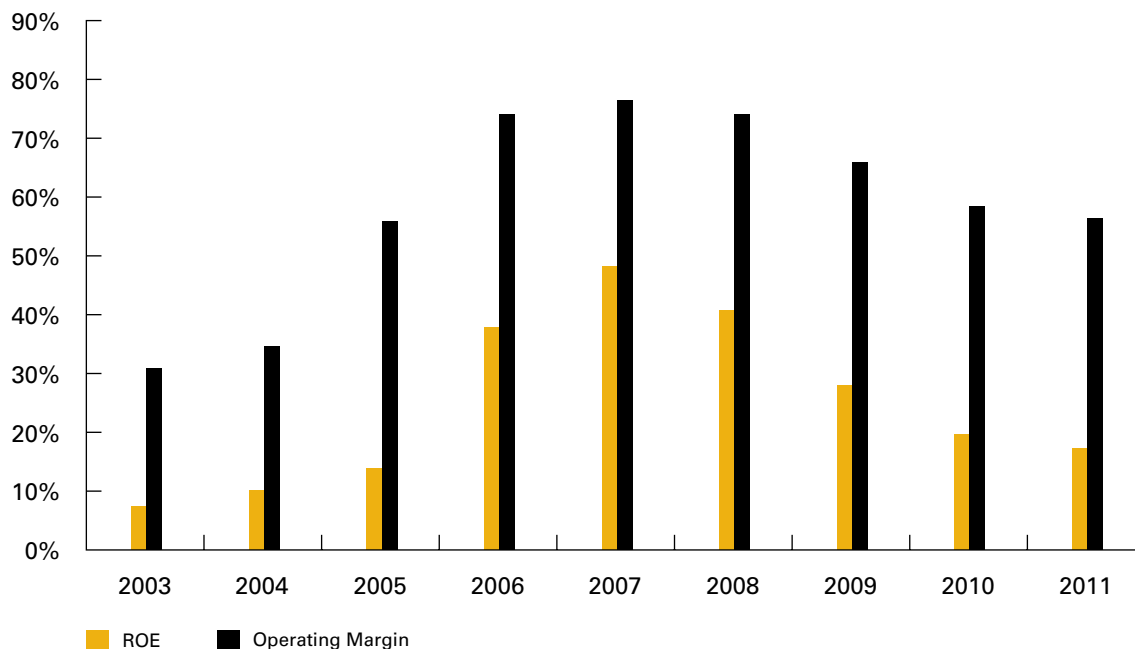
Source: DataStream and RE:CM analyst

The investment case for Hellenic Exchanges is improving

Many of these markets trade close to their 10-year average P/BV multiples besides Spain at 1x vs. long-term average 1.7x (41% discount) and Greece at 0.5x vs. 2.1x long-term average (76% discount). Reduced trading frequency has also affected revenue for these regions as investors look for better opportunities in growing emerging markets. This decline in market capitalisation has caused revenues for the Hellenic Exchange to decline from the peak in 2007 of €150mn (Athens market capitalisation €196bn) to revenue of €50mn (Athens market capitalisation €50bn). Declining revenue of 67% in 4 years would probably cause any other business to require additional capital or perhaps file for bankruptcy. But at this depressed revenue base the Hellenic Exchange generates an ROE of 17%, pays a total dividend of 6%, and has net cash reserves equal to 50% of its market capitalisation. Not bad for a business that is the barometer of Greece’s economic woes.

So how did the Hellenic Exchanges manage to survive this tremendous decline in revenue and generate operating margins of 56% and returns in excess of their cost of capital? The cost base of an exchange is predominantly employee costs so efficiency and overall labour costs had to be reduced. When the Hellenic Exchanges listed in 2003 they had 650 employees and costs as a percentage of revenue was 58%. Since 2003 the employee base has reduced to 260 people and the costs as percentage of revenue is now 40%, a reduction of 40% in absolute terms. The business has also become less reliant on equities trading and has grown other parts of the business such as derivatives, listing fees and other data services that generate annuity income. Thus the revenue base today is more diverse than in 2003, resulting in more consistent cash flow generation.

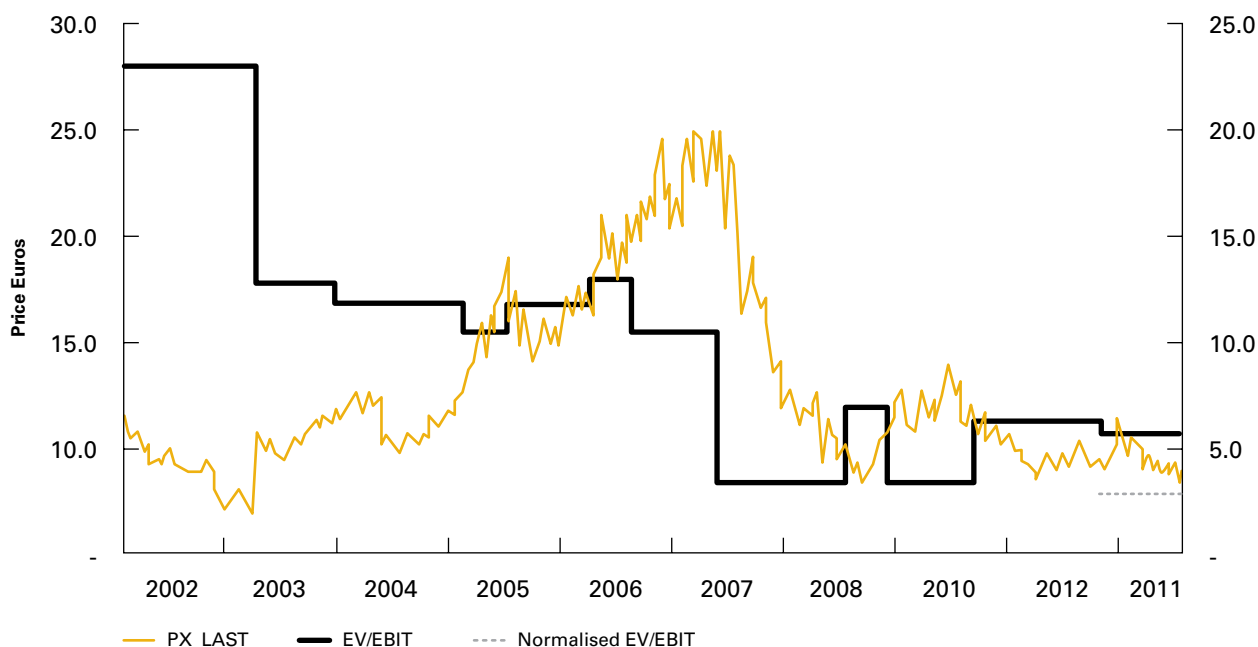
Chart 5: Hellenic Exchanges Historic Operating Margin and ROE



Source: DataStream and RE:CM analyst

Since listing in 2001 at €2.65 per share, the business has repaid a total of €7.18 per share in dividends. Mr. Market was willing to pay €23.5 per share for the company in 2007, but nobody seems to take notice now at the current price of €3.50 per share. From Chart 6 on the following page, it shows that when Hellenic Exchanges listed it was not very profitable but after a couple of years the business started to generate good returns and pay dividends. Since 2003 the median EV/EBIT multiple is 10.4x. This has fallen 50% to the current 5.2x and earnings are at a cyclical low. The normalized EV/EBIT assumes that the Price/Book Value of the Athens Stock Exchange normalizes to 1.5x price/book value (2.1x is the 10 year average). The value traded should increase for the stock exchange and revenues will normalise, while margins remain constant. At 3.3x EV/EBIT this is an asset that is cheap and at a cycle low, a rare event indeed.

Chart 6: Historical Price (€) Hellenic Exchanges and EV/EBIT Multiple



Source: DataStream and RE:CM analyst

What about increasing competition?

But what about the wave of competition that is about to arrive at every exchange? Well, if you were a competitor and had excess capital, the first market to enter would be the largest and most liquid markets. That way, if you are able to gain 25%-30% market share you should make a decent return on capital - otherwise BATS Europe and Chi-X would not exist. The markets of Hong Kong, Singapore and Australia must therefore seem extremely enticing. You can imagine from the headlines that no capital provider would want to go near Europe, let alone bankrupt Greece! So what would it cost to start an exchange in Greece? We estimate about €100mn made up of €50mn start-up infrastructure and an additional €50mn to licence and open an exchange as stipulated by the regulator. Assuming a 50% market share gain in cash equities trading – an aggressive assumption considering these new competitors only have 25%-30% market share in other regions. This will provide you with revenue of €5mn and PAT of close to €2.5mn giving the investors a return on invested capital in the region of 2.5%. In addition, the regulatory and tax jurisdiction of Greece together with the size of the market makes the region far less attractive. On top of this, you have to invest in Euro’s today, and most probably receive your future cash flows from your investment in Drachmas of uncertain - but likely much reduced - value.

So we think that competitors may enter at some stage but there are far larger and more lucrative markets to enter first that don’t have the stink, low returns and currency uncertainty of Greece. Hellenic Exchanges has a relatively diverse revenue stream and currently 100% of the cash market, so returns are good even though earnings are at a cyclical low.

As mentioned a key risk to owning Greek assets is the probability of EU expulsion and the return of the Drachma which would result in default, currency debasement and higher inflation. In fact, currency debasement is not new to countries around the world with all currencies having been debased over the past centuries. Default of sovereign debt has occurred recently in Argentina (2001) and Russia (1998).

Table 1:

	Currency Depreciation vs.US\$ Post Default (1 Year)	Stock Market Decline Pre Default US\$ (2 Years Pre)	Local Stock Market Performance Post Default US\$	Local Stock Market Outperformance Relative to MSCI EM US\$ Post Default
Russia	330%	93,10%	28%/annum (1998-2011)	19.6%/annum (1998-2011)
Argentina	285%	88,20%	26%/annum (2001-2011)	12.65%/annum (2001-2011)
Greece	0	85%	0	0

Source: Bloomberg and RE:CM analyst

Hellenic Exchanges offers quality, is currently unpopular and at a cyclical low

These defaults in both Russia and Argentina led to currency depreciation and a considerable decline of the stock market. The Athens stock exchange has already declined 85% and a currency devaluation and higher inflation would be expected if they exit the EU. Having said that the returns for an investor after Russia and Argentina defaulted were considerable, outperforming the MSCI Emerging Market Index by 19.6% and 12.65% respectively to date.

The Greek market is priced at 0.5X book value at present. One year Greek bond yields are trading at a yield to maturity of 135%, implying a 100% chance of default, with a 45% recovery rate post default. Post default, it thus seems the Greek market is trading at one times book. This level is not expensive by any stretch of imagination – we believe the Greek market could very easily follow the pattern of the Russian and Argentinean markets strong outperformance post default.

Although it might still be a bit too early to take a significant position in PIGS (Portugal, Italy, Greece, Spain) assets, RE:CM clients currently hold a small position in Hellenic Exchanges because we believe that it is a quality asset that is extremely unpopular with earnings at a cyclical low. As default becomes more certain for these countries, we expect to increase our exposure to them.

Paul Whitburn

PICKING ASSET MANAGERS, AVOIDING MISTAKES

"I would like you to imagine a national coin-flipping contest. Let's assume we get 225 million Americans up tomorrow morning and we ask them all to wager a dollar. They go out in the morning at sunrise, and they all call the flip of a coin. If they call correctly, they win a dollar from those who called wrong. Each day the losers drop out, and on the subsequent day the stakes build as all previous winnings are put on the line. After ten flips on ten mornings, there will be approximately 220,000 people in the United States who have correctly called ten flips in a row. They each will have won a little over \$1,000.

Now this group will probably start getting a little puffed up about this, human nature being what it is. They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvellous insights they bring to the field of flipping.

Assuming that the winners are getting the appropriate rewards from the losers, in another ten days we will have 215 people who have successfully called their coin flips 20 times in a row and who, by this exercise, each have turned one dollar into a little over \$1 million. \$225 million would have been lost, \$225 million would have been won.

By then, this group will really lose their heads. They will probably write books on "How I turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning." Worse yet, they'll probably start jetting around the country attending seminars on efficient coin-flipping and tackling sceptical professors with, "If it can't be done, why are there 215 of us?" By then some business school professor will probably be rude enough to bring up the fact that if 225 million orangutans had engaged in a similar exercise, the results would be much the same - 215 egotistical orangutans with 20 straight winning flips."

Warren Buffett in "The Superinvestors of Graham-and-Doddsville"

The outcomes from most activities in life, whether in sport, business or otherwise, are the result of a combination of skill and luck, yet most people tend to have a poor sense of the relative contributions of each. In the investment world, performance is the quantifiable outcome by which asset managers are judged – but how do investors determine if good performance is a result of investment skill, and is repeatable, or - as with the coin-flippers above - a result of random luck?

This differentiation between luck and skill is crucial in evaluating and choosing asset managers because, over the long term, good skill can overcome bad luck. However, good luck can only overcome bad skill over the short term.

The Legg Mason Capital Management Value Trust's after-fee return beat the S&P 500 index for 15 consecutive years from 1991 through 2005. The probability of the fund beating the market 15 years in a row was estimated by Michael Mauboussin to be 1 in 2.3 million¹. Bill Miller, the fund manager, once said: "As for the so-called streak, that's an accident of the calendar. If the year ended on different months it wouldn't be there and at some point the mathematics will hit us. We've been lucky. Well, maybe it's not 100% luck – maybe 95% luck". In evaluating Miller's streak, Michael Mauboussin of Legg Mason wrote: "Was Miller lucky along the way? Without a doubt. But as Stephen Jay Gould says, 'long streaks are extraordinary luck imposed on great skill.'" This article examines mistakes investors might make in choosing asset managers using performance as the only criteria, and ends with some suggestions on what to look for in identifying asset managers with so-called "great skill".

Performance is the key outcome but the measurement period matters

Despite the fact that many investors protest that performance is not the only way by which they evaluate asset managers, historical underperformance is still routinely quoted as the top reason why asset managers are fired. This obsession with performance is understandable and rational – it is after all the key measurable outcome of an investment process. However, vastly different conclusions might be drawn using the exact same track records depending on the time periods used for evaluation. For example, we looked at the returns of South African general equity funds over the seven years ending July 2011. This period includes four years of a strong bull market ending in early 2008, followed by

1. Michael Mauboussin

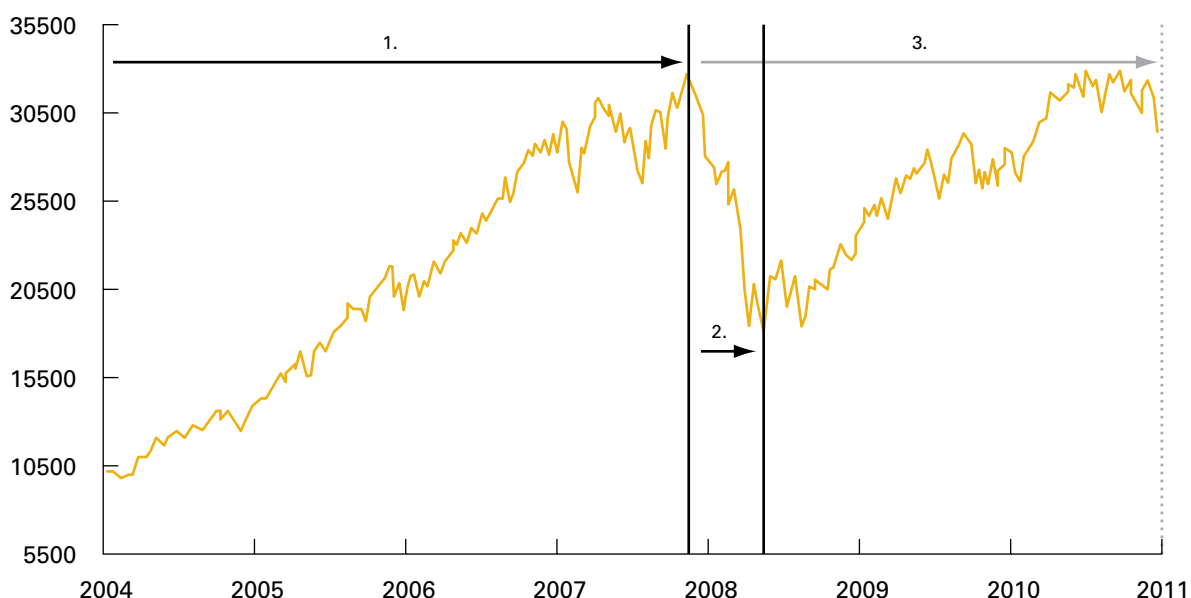
a strong bear market during the financial crisis, ending with a market recovery beginning in May 2009, and off its March 2011 peak in July 2011.

Short-term returns do not always translate into sustainable long-term performance

Looking at South African general equity funds, out of approximately 90 funds available to investors today, only 45 have a seven year track record – which halves the fund options available if a long-term track record is an investor’s starting point. We then examined the performance of these 45 funds over three distinct time periods:

1. The four years to March 2008 – a strong bull market.
2. The collapse between March 2008 and May 2009 – a strong bear market.
3. The peak of the market in March 2008, to the end of July 2011 – a market cycle including both a bear and bull market.

Chart 1: FTSE/ JSE All Share Index



Source: Inet Bridge

The comparison provides fascinating results:

Table 1 with Periods Corresponding to Chart 1:

	Period 1		Period 2		Period 3	
	May 04 to May 08		May 08 to Feb 09		May 08 to Jul 11	
	In Rising Markets	Rank	During Downturn	Rank	Downturn to date	Rank
Fund A	251,4%	2	-42,8%	43	3,7%	37
Fund B	240,2%	3	-41,4%	40	5,1%	36
Fund C	239,3%	4	-35,7%	31	0,7%	38
Fund D	227,7%	7	-41,7%	41	5,5%	35
Fund E	223,4%	9	-51,2%	45	-12,5%	44
All Share Index	250,1%		-40,4%		9,0%	

An investor looking to invest in a general equity fund in early 2008 after a strong run in the market may well have narrowed down their options by generating a table of the top 10 performing funds over the previous period. Most

investors would argue that three years is the minimum time period over which to evaluate performance, so by this logic, one might think that four years of strong performance should be enough evidence of skill in generating returns. Alarmingly, however, five of the funds that were in the top 10 for period 1 were at the very bottom of the pack during the downturn after that. What’s more, looking from the peak in March 2008, including a full market recovery, they remained at the bottom of the pack over the full market cycle. Indeed, from the peak in March 2008, 16% of the funds in the universe were still in negative territory at the end of July 2011, having not yet recovered from their declines during the financial crisis.

Conversely, looking below at the returns of some of the funds which were bottom of the pile in early 2008, a clear reversal of fortunes is evident, with the starkest example being the very worst performer in March 2008 ranking as the top performer for the two following periods!

Table 2 with Periods Corresponding to Chart 1:

	Period 1		Period 2		Period 3	
	May 04 to May 08		May 08 to Feb 09		May 08 to Jul 11	
	In Rising Markets	Rank	During Downturn	Rank	Downturn to date	Rank
Fund F	107,9%	45	-2,3%	1	67,5%	1
Fund G	129,6%	44	-26,7%	6	41,7%	2
Fund H	182,0%	30	-35,4%	28	26,5%	9
Fund I	186,1%	29	-29,4%	9	25,1%	10
Fund J	164,5%	43	-28,0%	7	23,4%	11
All Share Index	250,1%		-40,4%		9,0%	

Chasing short-term performance is dangerous

This exercise highlights one of the biggest mistakes an investor can make: chasing past performance. Unfortunately, fund flows confirm that it is not usually sustained long term performance that investors are chasing, but far more “exciting” performance over the short term.

In another example, John Bogle highlights the dangers of this behaviour in his book, “The Little Book of Common Sense Investing”.

Table 3 on the following page shows the top 10 performers among the 851 US equity funds in existence during the technology bubble of 1997 to 1999. These funds, focused on internet, telecommunications and technology stocks, generated an average return of 55% per year during this period – a mouth-watering cumulative return of 279% for three years! However, when the bubble burst during the three years after that from 2000 to 2002, every one of these funds plummeted into the bottom 60. On average, the one-time top 10 funds in the bull market were outperformed by 95% of their peers during the following bear market. For those investors chasing impressive short-term returns, it was a nasty result.

Table 3: Picking the Short-Term Winners: Annual Returns 1997 - 2002

Fund Name	1997-1999		2000-2002	
	Rank*	Time-weighted	Rank*	Time-weighted
Rydex OTC	1	65,8%	841	-37,1%
RS Emerging Growth	2	62,5	832	-31,2
MorganStanley Capital Op	3	59,5	845	-40,7
Janus Olympus	4	58,5	791	-27,4
Janus Twenty	5	54,8	801	-28,6
Managers Capital Appreciation	6	53,3	798	-28,2
Janus Mercury	73	51,5	790	-27,2
Fidelity Aggressive Growth	8	51,5	843	-39,1
Van Wagoner Emerging Growth	9	50,0	851	-51,7
WM Growth	10	49,7	793	-27,9
Average		55,0		-34,0

*Based on 851 funds with more than US\$100mn of assets

Source: John C. Bogle

Furthermore, fund returns were vastly different to actual investors’ returns in that investors typically only invested after seeing the alluring 279% achieved during the soaring bull market, and in doing so, missed out on most of the upside. However, what they did not miss out on was the full brunt of the downside which followed, with most investors experiencing significant permanent capital losses overall.

Another example of the perils of chasing short-term performance can be found closer to home looking at the South African small cap boom between 1995 and 1998. Firstly, out of the seven small cap funds that are still in existence today, five of these were only launched in 1997 or 1998, close to the peak of the market. It took more than five years for the small cap index to recover to these levels after the market collapsed. This is a good reminder that the best time for marketers to sell a specialised fund (after recent strong performance) is usually the worst time for investors to buy a fund.

The lessons learned from both the local and global examples above are as follows:

1. Tabulating returns does not differentiate between luck and skill.

Time and again, bursts of strong performance attract considerable inflows from investors lured by impressive short-term track records, with disastrous results as it becomes apparent that these returns are unsustainable, and quite possibly due to luck rather than skill.

2. Tabulating returns does not tell an investor anything about how and when the returns were generated.

Investors should have a clear idea of the profile of returns over time - how and when they were generated - to establish whether this profile is consistent with the asset manager’s philosophy. Identifying an asset manager’s strengths and weaknesses is also vital if investors are looking to combine different asset managers for the benefits of diversification. Looking at fund returns over time in the form of a line graph, relative to peers or the fund’s benchmark, is a simple method an investor can use to gain more insight into when the asset manager generated the returns.

3. Picking asset managers based on how they’ve performed in one market environment, particularly a strong bull market, can lead to mistakes.

As Warren Buffett famously said: “It’s only when the tide goes out that you learn who’s been swimming naked.” Evaluating performance based on one market environment alone, particularly a strong bull market, does not take into

consideration that all market cycles, regardless of their length, include both bull and bear markets. Asset managers are responsible for growing and protecting capital – and both these aspects of performance need to be evaluated carefully.

4. How managers perform in bear markets has a significant impact on their returns over a full market cycle.

At RE:CM we often say: “The winner is not the one who makes the most when markets go up, it’s the one who loses the least when markets go down.” Protecting capital during market declines is not only a very important first objective for most investors, it is crucial to meeting the overall objective of generating superior returns above inflation over the long term. In our opinion, investors often do not place enough emphasis on the importance of protecting against declines. For example, even if an investor achieved an impressive 20% per year for three consecutive years, a single market decline of 42%, similar to that of the All Share Index from May 2008 to February 2011, would be enough wipe out all those returns in one fell swoop. To assess an asset manager’s ability to protect capital, an investor should consider statistics such as the fund’s maximum drawdown since inception. In addition to this, an investor could examine a line graph of fund returns versus the market index or fund peers, focusing particularly on periods of market decline. In the exercise above it is clear that how general equity funds performed over the full market cycle (period 3) was more closely related to their performance during the decline (period 2) than to their performance during the strong bull market (period 1).

Evidence of a good investment process is key

So if performance alone is not very helpful, how do investors go about identifying skill in asset managers? The key is to focus on the source of good returns rather than on the returns themselves – that is, a good investment process, consistently applied. A good investment process will ultimately lead to good results in the long run, and most importantly to results that are repeatable from one market cycle to another.

In identifying evidence of a good investment process, the following attributes are worth considering:

- **An Investment Approach that can be Explained in Plain English:**

Asset managers should be able to explain their investment approach in simple, straight-forward language. Leaving hard-earned capital with a manager through the full market cycle requires considerable trust on behalf of the investor, especially through periods of short-term underperformance. This trust is very difficult to build if the investor doesn’t fully understand how the manager is investing their capital throughout the cycle.

- **A Long-Term Orientation:**

A good investment process should ignore short-term market fluctuations which are unpredictable and often irrational. The process should focus on delivering good returns over a time horizon consistent with that of the investor - the long term. Many managers claim to have a long-term orientation, but an easy way to check this is through relatively low portfolio turnover. For instance, if the annual turnover of a fund is 20%, this suggests that the entire portfolio is turned over every five years, a good proxy for the manager’s investment horizon.

- **A Distinctive Philosophy:**

Successful fund managers typically follow a distinctive investment philosophy throughout a full market cycle. Crucially, they should be able to demonstrate that they have applied this philosophy consistently over time. And preferably over multiple market cycles, rather than changing horse midway through the race to try and “time the market” or chase short-term market movements. Market timing may work out well every now and again for investors who “called the coin-flip” correctly, but it’s highly likely that this luck will run out at some stage with dire consequences for investors. Asset managers should invest their clients’ capital, not speculate with it.

· **Asset Managers Who Invest Alongside Their Clients:**

Asset managers should commit their own capital alongside their client's capital. When the markets fall, managers who are significantly invested in their own funds with their own capital at risk are more likely to make the right decisions with their investors' capital, rather than cut their losses to protect their careers in the shorter term.

In conclusion, focusing on protecting capital in downturns and sticking with asset managers over full market cycles may not seem terribly exciting in comparison to the thrill of chasing what's "hot" in the market. But, quite frankly, investing is not supposed to be exciting. We agree with Paul Samuelson when he said: "Investing should be dull ... Investing should be like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas, although remember – it's not easy to get rich in Las Vegas!"

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