

Volume 19  
Portfolio & Investment Insights  
January 2012

# RE-VIEW



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# Contents

Introduction	2
Table of Returns	4
<b>Performance and Portfolio Review</b>	
RE:CM Money Market Fund	5
RE:CM Global Flexible Fund	7
RE:CM Flexible Equity Fund	10
RE:CM Australia Equity Fund	13
RE:CM Global Fund	16
<b>Investment Insights</b>	
Discovery: Proving the Power of Incentives	19
Resisting the Lure of the Siren Song – Glamour Versus Value Stocks	25
Japan: a Stock Picker’s Dream	30
Exploring the European Doldrums	37

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# Introduction

2

For investors, 2011 was a tumultuous year. The Japanese tsunami, European financial crisis, and floods in Thailand all contributed to massive volatility. The fact that, by the end of the year, the MSCI World Index was down by only 5% was probably a surprise to many given all the negative news flow. But this headline number masks a couple of big moves. Emerging markets were a disaster. The MSCI Emerging Market Index was down 20.1% for the year, against a flat S&P 500 Index. Most surprisingly, the BRIC (Brazil, Russia, India & China) markets were down more than the PIIGS (Portugal, Italy, Ireland, Greece & Spain) markets. South Africa was not spared – despite widespread optimism at the start of the year about our admittance to the high growth BRIC club, the JSE All Share Index ended the year in line with those markets – minus 18% in US dollar terms. As Groucho Marx said: "I don't care to belong to a club that accepts people like me as members". In investment terms, we agree!

Over the past year, our funds all did relatively well in a very tough environment. Longer term, they have all shown good absolute (very important) and relative (less important, but still relevant) returns. One of the main reasons for this is that we have consistently avoided the more risky parts of the market. We cannot claim any prescience for this though. All we have done is to stick to our principle of buying only undervalued and predominantly good quality assets. Assets are generally only priced below fair value when there is widespread investor pessimism driven by market dislocations and negative sentiment.

Because we are naturally attracted to such areas in our search for cheap assets, many observers describe our style of investing as risky. We disagree – and the low volatility and limited downside that our funds have displayed historically, proves this. Of course, such a discussion hinges on how one defines risk. If risk is defined as investing in unpopular and troubled industries and companies, then our process is "risky". But if risk is defined as the propensity to lose money, then our process indeed has very low risk. Be that as it may, we intend to stick with what has worked – buying the securities of good businesses priced below fair value.

Our current view on markets is that they continue to face tremendous headwinds. On the one hand,

in developed markets there is too much debt in the system, and deleveraging needs to take place. This can happen in one of two ways – firstly, asset values can be written down to what they are actually worth. This will result in severe economic distress and widespread business failure. However, it will be quick, and the global economy can start to recover sooner. Alternatively – and this seems to be the path chosen by the fiscal and monetary authorities worldwide – reflationary policies can be followed, in the hope that economic growth bails out the holders of dodgy assets (mainly banks, both of the central and other kinds). We fear such a course of action will just delay the inevitable, possibly distorting things even further. Fortunately, the prices of many good quality assets in these markets already reflect the difficult times we are facing, and make good candidates for investment purposes.

On the other hand we have the emerging markets, which are all in a much better fiscal and monetary position, but whose economic fortunes are closely linked to those of the developed markets. In addition, their strengths are widely recognised and priced into their securities. On top of this is the "Chinese wildcard". Our sense is that the price of capital in China – effectively free – is distorting economic activity there. We believe there is significant investment risk in assets exposed to the theme of "Chinese growth". As such, our funds exposure to emerging market assets continues to be low. By the way, if you want to know what's happening in China, just take a look at a chart of the equity market, don't listen to all the bullish "analysts".

But apart from highly uncertain macroeconomics, we feel that the biggest risk to market prices is the increasing lack of trust that financial markets are engendering. When the wife of the Swiss central bank governor feels she needs to supplement her income by trading currencies (of all things!), one can't help but feel despair for the level of ethics in business. A large portion of the price (P) that investors pay to acquire a unit of earnings (E) of investee companies (i.e. the P/E ratio) is determined by their trust in Management's integrity and their trust that the accounts accurately reflect the business' operations. When this trust is diminished, the P/E ratio will decline. We feel this process has further to run.

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Before we get too pessimistic though, at RE:CM we have a high level of optimism about the market's ability to overcome obstacles. As long as we remain conservative (sometimes in the face of heavy criticism) and continue only to invest in assets which offer a large margin of safety coupled with a high level of business quality, we think we can continue protecting and growing (in real terms) our clients' capital, regardless of market conditions.

To this purpose we would like nothing more than "discovering" a few more Discoveries – the topic of Wilhelm Hertzog's first article in this RE:VIEW. Discovery has been one of the top holdings in our South African accounts for quite some time, while generating good returns for our clients. Wilhelm explains why this is so and why he is still pounding the table on it.

In the second article, Linda Eedes talks about glamour stocks and value stocks – and why we prefer the latter, despite the former's ability to make us all feel good. As Warren Buffet says – one pays a high price for a cheery consensus, and Linda explains why we all tend to like – and invest in – a good story. She then goes on to show why this is not always a good idea.

The third and fourth articles speak to where we have been committing quite a bit of capital in the accounts where mandates allow us to do so. Japan and Europe are both out of favour, and no one has any good stories to tell about them. But Johannes Visser has just spent two months in Tokyo getting to know the market better, and has quite an interesting take on the country in the third article.

In the last article, Daniel Malan and Razeen Dinath summarise their view on Europe after their recent visit to the area. Needless to say, both geographies offer tempting investment opportunities for value investors such as ourselves.

In line with our view that the property market will give investors a significant buying opportunity within the next five years, we recently added significant property expertise to our investment team through the appointment of John Rainier. John was previously the CEO of Fountainhead property trust, and before that he was with Allan Gray. At the same time, we bid a fond farewell to Rodger Walters. Rodger was one of our senior analysts, and has added a tremendous amount of value to the business and our clients' portfolios over the years he was with us. He leaves us to find new challenges and we wish him all the best in his endeavours.

As always, we hope you enjoy this edition of the RE:VIEW. After reading it, please have a look at our website [www.recm.co.za](http://www.recm.co.za). Lindsay Botha and her team have gone to a great effort to update it, and make it even more user friendly. You are now even able to "tweet" your favourite articles – and "like" us on Facebook! We might not like the investment prospects of web 2.0, but we think the product has definite merits!

Good Investing

Piet Viljoen  
Executive Chairman

# Table of Returns

For the period ended 31 December 2011

## Total Returns of RE:CM Funds (annualised after fees %)

Fund	Inception	1 Year	3 Years	5 Years	Since Inception
RE:CM Global Flexible Fund (ZAR)	Apr-03	10.9%	11.9%	8.1%	15.9%
CPI + 8% p.a. (ZAR)		14.1%	12.9%	14.8%	13.7%
RE:CM Flexible Equity Fund (ZAR)	Mar-05	2.8%	13.5%	7.5%	16.8%
FTSE/JSE ALSI (ZAR)		2.6%	17.3%	10.6%	17.1%
RE:CM Global Fund (USD)	Mar-06	5.8%	13.6%	4.4%	5.0%
MSCI World (USD)		-4.8%	11.8%	-1.8%	0.5%
RE:CM Global Feeder Fund (ZAR)	Mar-07	28.1%	7.9%	n/a	4.1%
MSCI World (ZAR)		16.1%	5.7%	n/a	-0.3%
RE:CM Australia Equity Fund (AUD)	Mar-10	-6.1%	n/a	n/a	-1.5%
ASX 300 Accumulation Index (AUD)		-11.0%	n/a	n/a	-6.1%
RE:CM Money Market Fund (ZAR)	Oct-10	5.6%	n/a	n/a	5.9%
STeFI Call (ZAR)		5.3%	n/a	n/a	5.8%

## Major Market Returns (annualised, in US dollars)

Index	6 Months*	1 Year	3 Years	5 Years
S&P 500	-4.8%	0.0%	11.7%	-2.6%
FTSE 100	-9.5%	-6.1%	10.2%	-6.6%
Nikkei 225	-9.9%	-12.2%	3.8%	-5.2%
MSCI World	-10.1%	-4.8%	11.8%	-1.8%
MSCI Emerging Markets	-20.1%	-20.4%	17.4%	0.3%
FTSE/JSE ALSI	-16.0%	-18.8%	20.1%	2.4%

## Major Currency Returns (annualised, against the US dollar)

Currency	6 Months*	1 Year	3 Years	5 Years
South African Rand	-16.3%	-18.0%	5.6%	-2.2%
Euro	-10.6%	-3.2%	-2.5%	-0.1%
UK Sterling	-3.1%	-0.4%	2.1%	-4.6%
Japanese Yen	4.7%	5.5%	5.7%	9.4%
Swiss Franc	-10.4%	-0.4%	4.4%	5.8%
Australian Dollar	-4.8%	-0.3%	13.1%	5.6%

Source: RE:CM, Micropal, Bloomberg, NAV-NAV, Gross income re-invested

\*Not Annualised

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# RE:CM Money Market Fund

**The RE:CM Money Market Fund aims to preserve capital, provide overnight liquidity and generate a yield in excess of the STeFI call rate.**

## Fund Details

Fund Size	R1.1bn
STeFI Benchmark	Daily Call
Annual Fee	0.15% (Excl VAT)

## Top 5 Holdings (%)

Nedbank step-up Notes	19.6%
Investec step-up Notes	15.6%
ABSA step-up Notes	11.6%
ABSA 32-Day Call Notes	10.7%
Standard Bank Fixed Deposit	7.1%

## Investment Results

The local and global interest rate market continued to be affected by the European sovereign debt crisis. Additionally, the US Congress narrowly avoided a potential technical default by extending the debt ceiling. This did not prevent the debt from being downgraded by one of the major rating agencies. Europe, Greece and Portugal also continued to avoid default, with Italy entering the sovereign debt crisis fray alongside the other struggling European economies. Surprisingly, despite all these major credit events, interest rates declined globally, as developed economy central banks tried to kick start economic growth by lowering policy rates. On the home front, short-term rates were volatile over the past six months due to the economic uncertainty created by the European sovereign debt crisis. Interest rates for 12-month deposits declined by almost a full percentage point from June to December 2011. Initially, the market was confident that short-term interest rates would be hiked by the Monetary Policy Committee (MPC) in the last quarter of 2011 due to rising inflation. Ultimately, inflation did breach the upper target band of 6%. But after the MPC signalled more caution following poor GDP growth in the third quarter, short-term rates fell from their mid-year high levels.

For the six-month period the Fund generated a return of 2.8%, better than the STeFI Daily Call benchmark return of 2.6%. As at the end of the year, the Fund generated the top yield of all money market funds in South Africa, namely 5.72%. Importantly, this return was not generated by taking on more risk. We only invest in the highest quality securities. The higher return was generated by implementing a non-consensus view during the middle of the year that interest rates would not be increased. In addition, our sizeable holding of step-up securities rewards fund investors for staying invested and not trading in and out of assets. Most importantly, the Funds low fee enhances its return.

## Management Actions

The Fund increased its investment in floating rate instruments from R375 million to R645 million. R525 million of the R645 million is invested in step-up deposit instruments which we explained in RE:VIEW Volume 17. The step-up instruments have an increasing income yield on a monthly and quarterly basis and they have helped the Fund to generate higher income yields. The Fund has increased its exposure to three step-up deposit counterparties from two in July.

The balance of R120 million was invested in a 32-Day Call Deposit instrument. This instrument generates higher income and provides an opportunity for better liquidity should the Fund need it. This instrument generates a SAFEX overnight yield plus a spread. This instrument is effectively a one-month deposit instrument that generates between 10–20 basis points more than the common money market deposit instruments.

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The RE:CM Money Market Fund has increased its floating rate exposure from 35% to 59% as these instruments generate better income returns and are low risk in nature. For the first time since inception, the Fund invested in a corporate money market instrument. The total exposure in SABMiller is only 2%, even though it is a AAA-rated short-term counterparty. The Fund will continue to only invest the highest quality counterparties.

The Fund currently has a duration of 69 days. The money market yield curve has steepened as the market is beginning to forecast interest rate hikes in 2012. However, if the European debt crisis fears continue to take centre stage in 2012, it may force the MPC to keep rates low despite rising inflation.

Thompson Ganyeka, Piet Viljoen  
Portfolio Managers

# RE:CM Global Flexible Fund

**The aim of the RE:CM Global Flexible Fund is to generate returns in excess of inflation over the long-term, at below average levels of risk. In the short-term, the fund aims to limit capital losses.**

## Fund Details

Fund Size	R1.1bn
Benchmark	CPI + 8%
Performance Fee	20% above/below CPI + 8%
Annual Fee	1% annual fee excl. VAT

## Portfolio Diagnostics

	Fund
P/E Ratio	16.3
Dividend Yield	1.7%
Volatility	7.7%
% Maximum Drawdown*	-11.5%
% Positive Months	73.5%
% Turnover Rate **	28.4%
Concentration of Top 10 Holdings	43.2%

\*Life of Fund

\*\* Trailing 12 months

TER is 1.55%. Inclusive of the TER's herewith, a performance fee of 0.22% was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

## Investment Results

Investors in this Fund have compounded their savings at 15.9% per annum after fees since inception in April 2003. This compares favourably with the benchmark return of inflation plus 8% which equates to 13.7% per annum. From July to December 2011 the Fund price increased by 7.8% after fees, just ahead of the benchmark return of 6.6%.

We consider the result of the past six months as highly credible against the backdrop of the JSE All Share Index (ALSI) gross return of 2.1% and the MSCI World Index gross return of -10.1%. These headline index returns hide very significant negative outcomes at individual asset levels, with many share and bond prices down substantially in emerging markets, cyclical businesses, basic commodities and the troubled western European region.

## Fund Composition

Please refer to the table and the pie chart on the next page. Key changes since June 2011 are:

1. South African equity exposure declined from 42% to 33%.
2. Global equity exposure increased from 33% to 47%.
3. Overall equity exposure increased marginally from 75% to 80%.
4. Exposure to assets denominated in currencies outside South Africa increased from 40% to 50%.

Most of these changes happened during July and August and as a result, the dramatic weakening of the rand since September has been a key contributor to the Fund results during the past six months. The significant switch from domestic to global assets was not simply a view on the currency, and it didn't happen overnight. We informed our actions by observing meaningful price-to-value opportunities in assets outside South Africa that we understand well enough to have valued. We gradually implemented this over an 18-month window period. That, combined with increased flexibility and our clients trusting us to invest in a wide global opportunity set, is what led us to reposition the Fund.

In short, the global 'risk-off' trade resulted in dramatic sell-offs. We largely avoided those and successfully navigated these troubled times to date. The Fund is currently invested predominantly in the equity of a diversified group of cheap, high quality, unlevered businesses and cash.

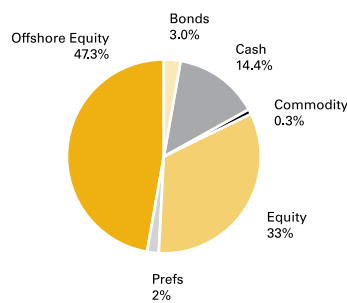
## A Note on Non-Equity Asset Classes

Non-equity asset classes such as property, bonds and direct commodities have not featured prominently in the Fund over the past nine years. During this time all three have significantly underperformed

### Top 10 Positions (%)

Sun International	6.5%
Johnson & Johnson	5.7%
Microsoft Corp.	4.6%
BP	4.5%
Old Mutual Plc	3.9%
Harmony Gold Mng	3.9%
Discovery Hldgs	3.8%
Anglo American Platinum	3.6%
Carrefour	3.4%
Berkshire Hathaway	3.4%

### Asset Allocation



equity market returns. Both property and direct commodities have however significantly outperformed cash, while South African government bonds have marginally beaten returns from cash.

From 2003 to 2005 the Fund carried an approximate 5% exposure to listed local property that delivered strong absolute returns and was then sold in late 2006 and early 2007. During the course of 2011 we allocated 1.2% of the Fund capital to two select opportunities in the listed South African property market, which in terms of exposure is akin to just dipping your toes in.

In 2004, the Fund carried a small opportunistic exposure to South African government bonds that yielded an attractive rate of return over a short ownership timeframe. In 2008, during a short-lived window of opportunity, we acquired small positions in senior medium-term foreign denominated debt securities of Old Mutual PLC and Consol Glass. We held these till maturity and realised outsized returns when the credit markets stabilised. In 2010 the portfolio managers allocated 4% of the Fund capital to senior medium-term debt securities of African Bank at an attractive 5% real yield. These corporate debts mature in 2015 and have to date delivered a meaningful yield enhancement to your returns on cash.

The small direct commodity exposure is the Fund's remaining exposure to a direct holding in gold. This position delivered an outsized excess return and the portfolio managers partially disposed of it during late December. We now consider selected South African gold stocks more attractive than the underlying commodity.

Our research capabilities in the property sector have been bolstered by the addition of John Rainier, who adds more than 20 years of relevant expertise to our investment team. In addition we continue to invest in building on our existing research capabilities in global credit markets.

There have been some encouraging signs of late but our conviction remains that we cannot find reasonable value in the bond (sovereign or corporate), property or direct commodity markets anywhere in the world. The Fund continues to carry a relatively small exposure to these asset classes. We believe that a day will come when these assets will once again offer acceptable returns that will compete with a much better success rate for the attention of your savings. As always we have no idea when, if and how it might happen, but we are working diligently to be ready, willing and able to invest – when it makes sense to do so.

### Management Actions

Capital Allocations	Capital Realisations
Amplats	Tiger Brands
Microsoft	Wellpoint
Carrefour	Johnson & Johnson
Vodafone Group PLC	Tokyo Gas
Berkshire Hathaway Class A	Discovery

The table above summarises the five largest purchases and sales for the Fund in the second half of 2011.

We completely sold out of Tiger Brands following a holding period that started at RE:CM's inception in 2003. We always look for and appreciate a long term partnership with such a fantastic value compounding business, but at the prevailing price it no longer offers attractive returns to long term investors. Our investment philosophy and process compels us to say 'goodbye until we meet again'.

Tiger Brands deserves special mention as a 'hall of famer'. This business continues to generate excess economic returns on shareholders' capital year in and year out. It also spawned three other quality JSE listings in the food wholesaler/brand operator Spar Group, the poultry producer Astral Foods and the consumer pharmaceuticals business Adcock Ingram. The latter remains represented in the Fund and has been a significant contributor to our investors' returns over the past couple of years.

Our largest purchase by value, Amplats, represents a cheap and high quality South African investment idea, somewhat of a rare occurrence over the past 18 months.

To make space for cheaper ideas, the portfolio managers sold portions of selected offshore holdings (such as Wellpoint) following strong price outperformance. In particular we established positions in new ideas such as the US-listed tech giant Microsoft and French-listed food retailer Carrefour. Vodafone Group PLC and Berkshire Hathaway were additions to established positions in the Fund when their share prices declined to very attractive levels during the past six months.

Our investment thesis for Microsoft revolves around the fact that 20% of the current market capitalisation of the company is held in cash and that it generates prodigious and reliable amounts of free cash flow every year. This is used wisely (in our opinion at least) to reduce the share count at price to value ratios that are value accretive to the remaining shareholders. At current prices, we are paying less than ten times the annual free cash flow to be a part owner in this great business. Microsoft used to be a market darling (who remembers that?), but with Steve Jobs' legacy and in Apple's lengthy and sexy shadow, it has been relegated to the back benches. At RE:CM we love sitting down and taking a very good look at the back benches, because we know from experience that this is where prospective value is most abundant.

The value of any product can truly be tested when a competitor offers an alternative for free. Microsoft has not only endured free competition; it has thrived

by making its key Office product suite independent of its own operating platform while simultaneously reinventing the platform. How do you compete against a company that can go toe to toe with a free offering, and still win convincingly?

Carrefour's share price has been a victim of its exposure to the well-known problem regions of western Europe, and a trend over recent years away from hypermarkets (Carrefour's traditional strength) to convenience formats. The weak share price hides the value of the underlying leading market position in many food retail markets, a cash flow cycle that generates negative working capital and a long legacy of excess economic returns and reasonable capital allocation decisions.

At the current share price one can buy the entire group for little more than the value of its properties. The excess returns generated by the retail business come almost for free. The strong presence of a leading activist shareholder in Bernard Arnault, who owns 15% of the Company, should ensure the continued scrutiny of capital allocation decisions against the institutional imperative.

#### **Investment Return Expectations**

For the first time since its inception in 2003 the Fund owns more global equity than South African equity. This repositioning is consistent with our research convictions and disclosures to you over the past 18 months that:

1. South African assets are generally expensive and we are struggling to uncover sensible price-to-value investment opportunities.
2. We have found a good line-up of cheap high quality investment opportunities in markets outside South Africa.

We estimate the current price-to-value ratio of the equity portion of the Fund to be just above the 70c in the rand mark. This represents a healthy margin of safety of 30%. In addition, we are excited by the increased quality of the underlying businesses that make up the Fund. These two factors combined represent what this Fund is designed for – to protect and grow our clients' life savings in real terms.

Daniel Malan - Portfolio Manager

# RE:CM Flexible Equity Fund

10

**The RE:CM Flexible Equity Fund's aim is to outperform the FTSE/JSE All Share Index (including income) by 2.5% per annum over the long term, with lower than average risk of capital loss and with less volatility than the Index.**

## Fund Details

Fund Size	R1.3bn
Benchmark	ALSI
Performance Fee	20% above/below ALSI +2.5%
Annual Fee	0.5% annual fee excl. VAT

## Portfolio Diagnostics

	Fund	ALSI
P/E Ratio	15.6	13.4
Dividend Yield	2.2%	3.0%
Volatility	14.0%	18.2%
% Maximum Drawdown*	-27.1%	-40.4%
% Positive Months	66.7%	65.3%
% Turnover Rate **	17.9%	n/a
Number of Holdings	41	164
Concentration of Top 10 Holdings	42.0%	55.4%

\* Life of Fund

\*\* Trailing 12 months

TER is 0.59%. Inclusive of the TER's herewith, a performance fee of 0% was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

## Investment Results

Amid the upheaval in global economies and markets over the past six months, the South African equity market and the Flexible Equity Fund both delivered notably muted returns – in the low single digits. While the Fund achieved better returns than the market for both the past six months and the full 2011 calendar year, the outperformance was by a slim margin. We expect to achieve better results through a full cycle, in both absolute and relative terms.

The underperformance of the mining and resources sectors (which we commented on six months ago) continued in the second half of the year. The notable decline in commodity prices in the second half of 2011 would probably have impacted even more on the prices of local mining shares if it wasn't for the sharp depreciation of the rand, which accompanied the commodity price decline. Within this broad sector, platinum miners suffered the worst. Six months ago we mentioned that we had started allocating capital to this sector in the first half of 2011, and we have increased the Fund's investment in the sector since then.

The theme of emerging market consumption has proven a powerful one over the past year, and the consumer goods and retail sectors on the JSE seem to have benefited from this. We avoid investing based on themes, and have struggled to find value in most of the stocks listed in these sectors for some time now. As a result, the Fund has had limited exposure to these sectors over the past year. In the short term, the momentum and positive news flow has favoured these sectors, but history and our own experience have shown that such environments are best avoided if one's focus is on generating superior long-term returns at low levels of risk.

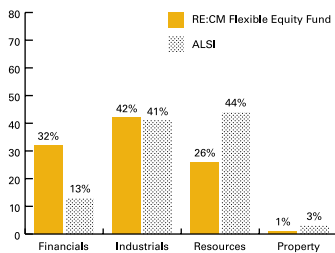
## Management Actions

At the top of the list of purchases during the past six months is Lonmin and Anglo American Platinum (Amplats) – two of the "big three" platinum miners. We commented on our purchase of Amplats in our last fund commentary. The investment case for Lonmin is much the same: poor recent history and a weak short-term outlook for the European automotive market has served to drive platinum and platinum mining share prices to levels that we consider attractive from a longer term perspective. The fact that the South African platinum miners control such a large share of global platinum production and reserves also makes for a sector that is structurally more attractive than many other sectors of the mining industry. If the South African platinum mining industry runs into production trouble, platinum prices are likely to reflect the resulting supply constraint because of the importance of the South African resource base to the global market. This is not the case for most other mining industries in South Africa.

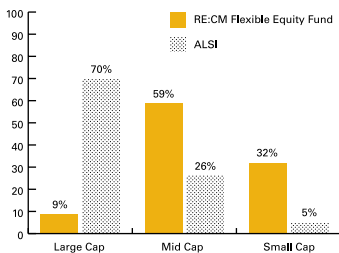
### Top 10 Positions (%)

Sun International	7.6%
Discovery Hldgs	5.6%
Old Mutual Plc	4.9%
Anglo American Platinum	4.9%
Harmony Gold Mng	3.6%
Hosken Consolidated	3.2%
Metropolitan Holdings	3.2%
Omnia Holdings	3.1%
Telkom SA Limited	3.1%
Lonmin Plc	2.9%

### Sector Split



### Equity Allocation



There have been a few other notable purchases during the past six months, but we have not concluded purchasing these stocks, and accordingly will reserve comment until a later date.

On the disposals front, Tiger Brands stands out for two reasons. Firstly, it is by far the largest disposal by rand value, and secondly, this is the first time in many years that RE:CM clients own no Tiger Brands shares whatsoever. Tiger Brands is a wonderful business, but it appears to us that its share price has been swept up in the emerging markets consumption theme (mentioned above) to levels that we no longer find sensible. This has compelled us to sell out of the stock completely.

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We also sold some shares of Harmony Gold during the period. With the rand gold price reaching all-time highs late in 2011, Harmony's share price was impacted positively. We made use of this opportunity to decrease the Fund's investment in Harmony, but it is still a top ten holding in the Fund.

### Good Ideas That Worked

#### Tiger Brands

#### Old Mutual

As mentioned, Tiger Brands has been a perennial feature of RE:CM client portfolios, featuring as a top 10 holding of the Fund six months ago. It has delivered very good investment returns over time – including the last six months. The current share price however represents a premium to our estimate of intrinsic value, and as such we have sold out of Tiger Brands completely.

Old Mutual has been a feature of RE:CM client funds since the latter part of 2008. Ever since, Old Mutual has constantly been engaged in an effort to clean up the legacy of its aggressive offshore acquisition trail in early 2000. It scored a notable success on this front late in 2011 by announcing the sale of its Skandia business for what we consider to be an attractive price. This caught the attention of the market, which marked up Old Mutual's share price substantially. This transaction serves as some confirmation to us of our view that the businesses within Old Mutual have been consistently underpriced by the market for the past three and a half years. Management appears to be doing a good job of realising that value for shareholders.

### Good Ideas at the Time

#### Telkom

#### Amplats

#### Lonmin

Developments at Telkom over the past six months have not been encouraging, and the stock price has reflected this. We have been disappointed with the way in which Telkom's 8ta mobile network has been rolled out. Failing to secure adequate distribution channels prior to launching such a critical product to the market (and spending the amount of marketing money that Telkom has) seems odd to us. We

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have revisited the Telkom investment case, and based on this, have revised our estimate of intrinsic value downwards. This has resulted in some selling of Telkom shares in the Fund, but based on the price to (revised) fair value relationship, it is still a holding in the Fund.

12 It is too early in the investment life cycle to call the platinum miners that we have purchased for the Fund a 'Good Idea At The Time', but their inclusion in the Fund has held back investment returns over the past six months. This is of course typical of value investing: value investors tend to be 'too early' in buying stocks, failing to pick the bottom, and consequently suffering from the negative momentum associated with unpopular stocks in the early phases of investing in them. The platinum sector has definitely been subject to such negative momentum in the latter half of 2011. We

are however confident of our assessment of the longer term economics of the businesses, and are not concerned about such-short term temporary losses of capital.

#### **Return Expectations**

By our estimates, the equities in the Fund are currently in aggregate priced at about 78% of fair value, or a discount of 22% to fair value. This represents a slight improvement from six months ago, but is still not compelling value. The continued substantial cash holdings in the Fund reflect the fact that we are not finding widespread value in the South African stock market.

Wilhelm Hertzog  
Portfolio Manager

# RE:CM Australia Equity Fund\*

**The aim of the RE:CM Australia Equity Fund is to outperform the S&P/ASX 300 Accumulation Index over the long term, with lower than average risk of capital loss and less volatility than the Index.**

\*This Fund is not FSB approved and therefore not available for distribution in South Africa.

## Investment Results

In 2011 the Fund returned -6.1% versus the benchmark's -11.0%. Contributing to the outperformance was an average cash holding of 22% and positive returns from several of the fund's mid-sized positions. Working against the Fund were relatively poor returns from larger positions as well as the particularly dismal performance of two new high conviction ideas: APN News & Media and Billabong International, which we discuss below. Our lead on the market since inception has declined slightly since we last reported in July. As co-investors alongside our clients we are dissatisfied with this outcome.

13

## Fund Details

Fund Size	A\$1.4mn
Benchmark	ASX300 Accumulation Index
Performance Fee	20% above/below ASX 300 Accumulation Index
Annual Fee	0.8% annual fee excl GST

## Management Actions

The table below lists the five largest capital commitments and realisations during the period under review.

Capital Allocations	Capital Realisations
Billabong International	Woolworths
Harvey Norman	Coca-Cola Amatil
News Corporation	News Corporation
Perpetual	Billabong International
Metcash	Goodman Fielder

## Portfolio Diagnostics

	Fund	ASX 300 Index
P/E Ratio	12.9	12.0
Dividend Yield	5.0%	4.9%
Volatility	15.4%	32.5%
% Maximum Drawdown**	-10.2%	-15.4%
% Positive Months	42.0%	33.0%
% Turnover Rate***	39.5%	n/a
Number of Holdings	25	292
Concentration of Top 10 Holdings	44.9%	52.3%

\*\*Life of Fund

\*\*\*Trailing 12 months

Billabong was our largest investment because after the initial purchase, we committed further capital after the share price declined. Following a recent review of the investment case, however, we reduced our exposure to zero. This decision was not taken lightly, and is based on prior RE:CM experience where the integrity of shareholders' equity is in such doubt that an immediate sale and unencumbered reassessment is most prudent.

Harvey Norman, along with other domestic bricks and mortar retailers, is currently experiencing low cyclical conditions. Stocks are unpopular as the market waits for poor trading to be reflected in earnings. At the current share price, Harvey Norman is priced at the value of its property portfolio, implying a zero valuation on its retail and highly profitable franchise operations.

News Corporation appears both a purchase and a sale. During the past six months, we more than doubled our position at the time the 'phone hacking scandal' materialised and the stock sold off considerably. This transaction took place only days before the company began its own aggressive buyback following a decision to withdraw their bid for the balance of BSKYB. As the stock ran up to pre-scandal levels, we reduced our exposure appropriately.

Perpetual is one of the cheapest stocks in the Fund and we have continued to buy as the share price declined from the high 20s to below A\$20. Interestingly, the share's total return for the six months is an inaccurate reflection of the change in intrinsic value over the period due to a substantial capital return made via a share buyback. Acquiring 8% of outstanding shares at a 40% discount to fair value is accretive to shareholders choosing to abstain from the buyback. We believe the stock is cheap and unpopular due to cyclically challenging conditions – namely the poor performance of equities, high correlation among stock prices and the concomitant outflows from actively managed equity funds.

Metcash is a new position in the Fund and one that we intend to increase if given the opportunity of lower prices. Metcash is one of three listed players accounting for the bulk of the domestic food and grocery distribution industry. However, where Woolworths and Coles tend to battle it out in urban areas, Metcash is purely a distributor and uses its scale to distribute product to convenience stores, independent retailers and Australia's less dense regional and remote rural areas.

We sold out of Woolworths completely after revising down our estimate of fair value. This followed further insight into the reasons behind and unlikely sustainability of its high trading margins – currently well above long-term averages and perhaps the highest in the developed world. Similarly, we exited Coca-Cola Amatil after extensive comparative analysis was done on global bottlers as part of research for the RE:CM Global Fund. Our briefly held position in Goodman Fielder was liquidated after revising down our fair value to a level consistent with our original estimate of downside value. This followed a review of normal margin assumptions, which we had previously overestimated.

### Good Ideas That Worked

#### Telstra

Telstra was our best performing stock over the period. Its modest capital gain and substantial dividend yield far outstripped the market over both six months and one year. The stock has likely been bid higher due to an increasing appetite for yield and confidence in the dividend's (immediate) sustainability. That said, the stock is no longer particularly cheap.

### Good Ideas at the Time

#### APN News & Media

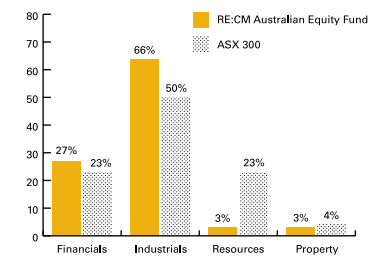
#### Billabong International

At the time of purchase, APN appeared more than reasonably cheap, being offered on a low multiple of cyclically low earnings. Since the stock has nearly halved from our original purchase, we must consider whether we have made a mistake or whether the stock is simply even cheaper today, being an average business, and trading as it does on a price-to-earnings ratio of five times the normal earnings.

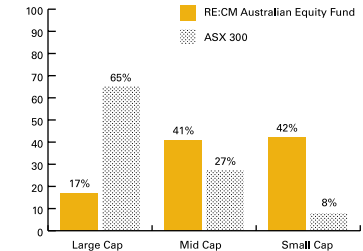
### Top 10 Positions (%)

Sonic Healthcare	6.9%
Perpetual Trustees Australia	6.2%
Macquarie Group	4.9%
Aristocrat Leisure	4.7%
Harvey Norman Holdings	4.5%
Cabcharge Australia	4.2%
National Australia Bank	3.8%
Telstra	3.2%
APN News and Media	3.2%
Newscorporation Class A	3.2%

### Sector Split



### Equity Allocation



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Our view is that things will return to normal, but when exactly we cannot know. By this we mean the domestic economy will recover, and with it consumer sentiment, consumption, and corporate advertising spend. In such an environment, carriers of advertising can price their services appropriately and margins invariably improve. Our primary concern in this exercise of patience should be APN's ability to suffer shocks to its trading profit while still comfortably meeting fixed charges – interest on borrowings, and lease charges on property and outdoor advertising space.

### **Billabong International**

With Billabong we believed we had found a business with valuable brands and pricing power, trading in cyclically challenging times, and unpopular due to a significant strategic shift being undertaken by management. The move to being a vertical retailer, rather than a pure wholesaler, would put immediate pressure on reported figures, but reap long-term rewards. One did not need to be an overt believer in the promised rewards for the stock to be considered cheap at the price. Our analysis acknowledged the Company's high leverage, but fell short of sufficient stress tests for scenarios where trading deteriorates. This, perhaps inevitably, transpired toward year end. The market has repriced Billabong shares for the significant risk posed by its potentially having to rely on the kindness of strangers, and the dilution that may occur from an emergency capital raising.

Management are still citing unseasonal weather and global macro uncertainty as primary blame factors. They have not yet suggested that excessive risk taking and poor judgement of appropriate gearing levels are the true cause of the Company's dire circumstances. This suggests a fault with our own stock selection and in managing a concentrated,

benchmark unaware portfolio, poor selection of even one position is unacceptable. It would be inexcusable, furthermore, if we did not make every effort to learn from this experience.

### **Investment Return Expectations**

The Fund is now priced at 74c in the dollar or a 26% discount to fair value, including the underinvested (cash) position. This thinking implies that cash is inherently fairly valued, when in fact this is not necessarily the case given the flexibility it offers in dealing with a potentially more favourable opportunity set in the future, that is lower valuations. As always our cash position is a result of our bottom up stock selection and weighting. Of the numerous quality businesses listed in Australia, the only ones that we have understood sufficiently to value with confidence and that are cheap enough to own are presently included in the fund. Our list of insufficiently cheap stocks continues to grow and we look forward to owning them at the right price.

The discount is higher than in July (18%) due to a combination of lower market prices and changes to Fund composition and fair value estimates. As significant investors in the Fund alongside our clients, we are excited by the prospective returns implied by this level of undervaluation. We will continue our efforts in identifying good ideas that will deliver a good outcome for clients in 2012.

Chris Boehmke, Piet Viljoen & Daniel Malan  
Portfolio Managers

# RE:CM Global Fund

**The RE:CM Global Fund's aim is to outperform the US\$ MSCI World Index (including income) over the long-term with lower than average risk of capital loss and with less volatility than the index.**

16

## Fund Details

Fund Size	US\$275mn
Benchmark	MSCI World
Performance Fee	20% above/below MSCI World +2.5%
Annual Fee	0.5% annual fee

## Portfolio Diagnostics

	Fund	MSCI World
P/E Ratio	9.7	16.2
Dividend Yield	1.5%	2.1%
Volatility	12.7%	19.3%
% Maximum Drawdown*	-33.3%	-53.7%
% Positive Months	60.3%	55.6%
% Turnover Rate **	31.5%	n/a
Number of Holdings	81	n/a
Concentration of Top 10 Holdings	38.8%	10.5%

\*Life of Fund

\*\* Trailing 12 months

## Investment Results

The RE:CM Global Fund has returned 5% per annum (in US dollars) since inception, comfortably growing the capital in real terms. Over the same period the MSCI World Index, including dividends, has returned 0.5% per annum. For the period under review (1 July 2011 - 31 December 2011) the Fund returned -3%, while the Index produced a return of -10.1%. Once again the Fund has proved its mettle during tough times: generally when markets go down, the fund goes down less. The last six months was no exception.

These satisfactory returns were achieved through Management avoiding most fads and fashions. A year ago, many investors thought emerging markets were the place to be, due to their strong growth prospects and the developed world's debt problems. It's now one year later and emerging markets have underperformed (even the European markets), while the US market has delivered good returns. In addition, the US dollar has been one of the strongest currencies globally, despite the USA being downgraded by S&P. Fortunately, the Fund was positioned primarily in US stocks and the US dollar. We however didn't foresee this outcome. All we did was to invest where prices (and, by implication, expectations) were low. Historically, we have found that low expectations lead to good investment results.

## Management Actions

We initiated new positions in Carrefour, Total, Coca-Cola Hellenic, Amplats and Kao Corp. Carrefour is a French retailer, with significant emerging market exposure. It is trading at very low valuations – reminiscent of the valuations at which South African retailers were trading at 10 years ago. We cannot forecast the immediate prospects for Carrefour, but at current prices, we don't think we're taking much risk.

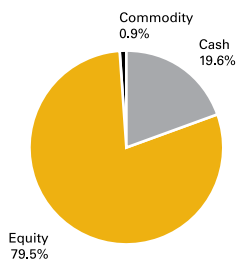
Due to continued strong inflows into the Fund (it has grown by in excess of US\$25 million over the past six months), coupled with price weakness, Portfolio Management has increased the holdings of existing positions in the following companies: Berkshire Hathaway, Hamamatsu, BP, Old Mutual, Titan, Harmony, Dell, Intel, WellPoint and Wells Fargo.

As a result of the new purchases and additions, the Fund's exposure to Europe has almost doubled to just less than 10%. We continue to find very attractively priced securities in that geographic area. As always, it takes turmoil to produce bargains, and Europe is enjoying its fair share of turmoil. One of our biggest purchases by value was Coca-Cola Hellenic – the largest independent Coke bottler by revenue globally. It services a range of developed and emerging markets, and happens to be listed in Greece. Its three biggest markets are Russia, Italy and Nigeria, but the company has exclusive agreements with Coca-Cola and Nestlé to bottle and distribute their products in 28

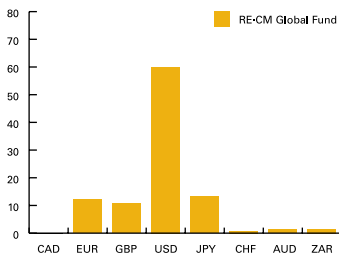
### Top 10 Positions (%)

Johnson & Johnson	6.0%
Berkshire Hathaway	4.9%
BP Plc	4.8%
Wellpoint Inc	4.3%
Dell Computer Corp.	3.9%
FamilyMart	3.9%
Intel	2.9%
Harmony Gold Mining	2.8%
Vodafone Group	2.8%
Titan Cement	2.5%

### Asset Allocation



### Currency Exposure



regions. In short, it's a global powerhouse available on a free cash flow yield of 10%.

We have reduced exposure to Johnson & Johnson, Vodafone, Wal-Mart, Tokyo Gas and H&R Block. The SPDR Gold ETF position has also been somewhat reduced. The following companies were sold out of entirely: Heineken Holdings, Sonic Healthcare, ADP, Coca-Cola Company and Oracle.

In general, most sales took place due to stocks approaching or reaching fair value levels. It will come as no surprise to our investors to see that most of the sales took place in what are colloquially termed 'defensive' companies. Although we do not invest on the basis of themes, it is interesting to see how the current turmoil in the global economy has caused investors to flee to the perceived safety of 'defensive' assets. In the process their prices have been bid up to such an extent that they can no longer be regarded as 'safe'.

A net result of our actions over the past six months has been an increase in exposure to European, UK and Japanese assets, and a reduction in exposure to US assets. Direct exposure to emerging markets remains at negligible levels, although many of our investee companies have large businesses in the emerging markets. Again, this has not happened due to a macroeconomic view or forecast; it is simply due to price/value relationships. The undervalued assets happened to be domiciled in the developed markets. The cash portion of the Fund has remained at around the 20% level. Although cash has very low returns these days due to the monetary policies being followed by most central banks, we regard the main value of cash to lie in the optionality it conveys upon the holder thereof. If and when asset prices decline, holders of cash can generally deploy the cash on favourable terms. In our view, risks in markets remain elevated, and we feel reasonably confident that such opportunities will present themselves from time to time.

As at 31 December 2011, we calculate the Fund to be trading at 68% of fair value. We think 32% is a more than acceptable margin of safety, that will reduce the odds of a permanent loss of capital if some of the negative outcomes that people are worrying about, occur. Importantly, this pricing is more favourable than any of our South African funds – again illustrating the cheapness of global assets vis-a-vis South African (or emerging market) assets.

### Good Ideas That Worked

Visa

Astellas Pharma

Wal-Mart Stores

Familymart

The stocks that produced good returns for the Fund over the past six months are something of a mixed bag. They consist of a US financial company (!), Visa; a Japanese pharmaceutical company, Astellas; and two retailers – one US-based, and one Japanese-based. (Wal-Mart and Familymart) The one comment that is applicable is that defensive companies (i.e. pharmaceuticals, food retailers etc.) perform well

when markets are weak, as they were during the second half of 2011. But this fact is becoming widely recognised, to the extent that defensive companies are gradually becoming more expensive, and their investment merits are declining. Most of the new investment ideas in the Fund over the past year are in more cyclical industries. As investors become more fearful about the global economy, they tend to sell off the cyclical companies as a sort of knee-jerk reaction. This provides valuation based investors with a long-term investment horizon, with a good buying opportunity.

It's probably worth pointing out that the Fund's turnover has increased to over 30% for the past year. This does not mean we have suddenly become traders. It is a result of the abovementioned trend in the market, where defensive stocks are becoming more expensive. Traditionally, the Fund has been heavily invested in defensive shares, as they were very cheap in the period leading up to the financial crisis, and performed very well after the crisis. But a continuation of this trend over the past six months has forced Portfolio Management to start reducing exposure to these types of companies. At the same time, more cyclical stocks are becoming cheap. Specifically, mining companies have underperformed the broad market since 2003, to the point where they are becoming attractive candidates for investment purposes! It's probably too early to get aggressive, but for the patient long term investor, there are opportunities.

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#### Good Ideas at the Time

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Hellenic Exchanges

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Titan Cement

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Hamamatsu Photonics

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It probably comes as no surprise that the two worst performing stocks in the Fund were companies listed in Greece. We have relooked at the investment assumptions behind our valuations of these companies, and are satisfied that they remain cheap and worth owning. The main risk in owning companies that are domiciled in countries which might depart the EU are that their hard currency (i.e. Euro) denominated debt becomes hard to service through weak currency earnings. This could cause a permanent impairment of value. We have satisfied ourselves that neither company is significantly exposed to this risk. In the article "European Doldrums" in this RE:VIEW, Daniel and Razeen go into more detail on the investment merits (and risks) facing these companies.

Hamamatsu has been a long-term holding for the Fund. We did reduce our exposure when the price approached fair value more than a year ago, and the recent decline enabled us to buy back our original opposition. This is a company with a strong durable competitive advantage (patents) that it continues to invest in, on a much larger scale than its competitors.

Piet Viljoen  
Portfolio Manager

#### RE:CM Global Feeder Fund

The RE:CM Global Feeder Fund will invest in our RE:CM Global Fund, a Global Asset Allocation portfolio with specific focus on generating long-term real capital growth at below average levels of risk. There is no initial fee. The annual management fee is 0.3% excl. VAT. For further information please refer to the factsheet available on our website. [www.recm.co.za](http://www.recm.co.za)

# Discovery: Proving the Power of Incentives

'Call it what you will, incentives are what get people to work harder.'

Nikita Kruschev

19

## Discovery is a good business that has also been a good investment for RE:CM clients

Discovery Holdings Limited ('Discovery') has been a substantial investment for RE:CM investors for over four years. The outcome to date has been very satisfactory: Discovery has delivered good real returns for RE:CM clients and the investment has performed substantially better than the South African market since we first invested in the business, as Chart 1 shows.

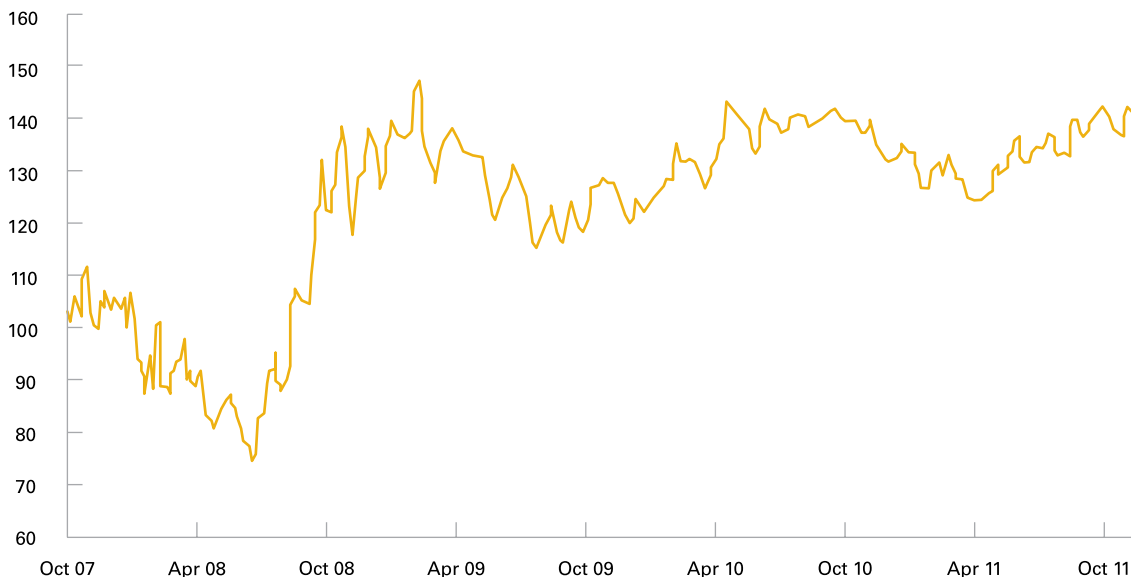
Because Discovery is a significant holding in RE:CM client portfolios, we thought it may be useful to explain our thinking about this investment.

## The Group's core focus on incentives has played a fundamental role in their success

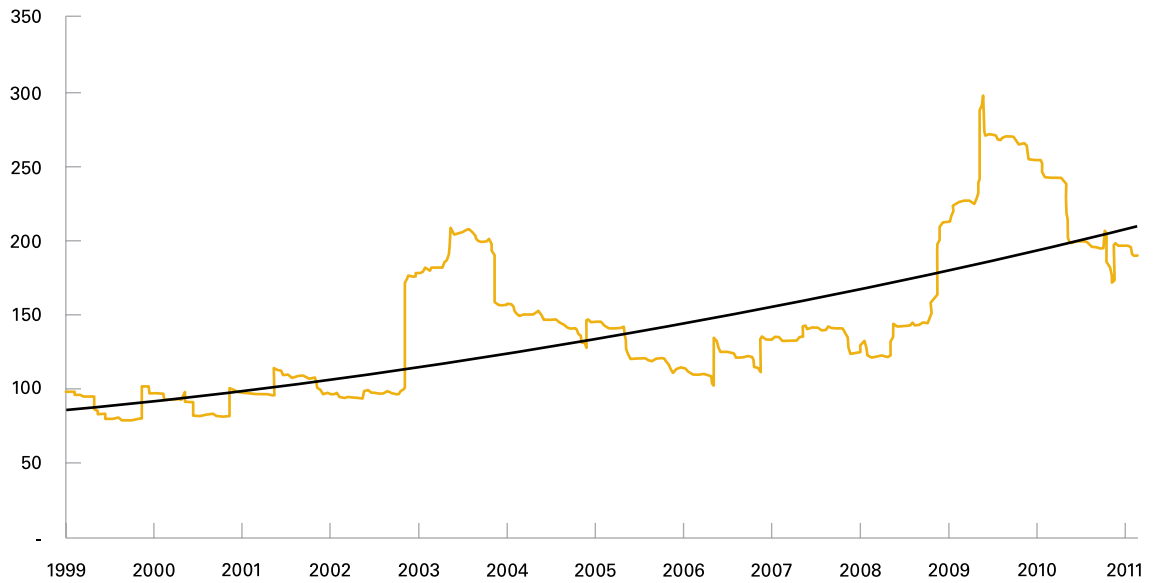
Discovery consists mainly of two businesses: a medical scheme administration business (Discovery Health) and a life insurance business (Discovery Life). The Group has developed a number of new businesses over the years, with varying degrees of success. All of the Group's businesses operate on the same core concept – giving people incentives to live and behave more responsibly by rewarding such behaviour with tangible benefits. At RE:CM, we are also firm believers in the power of incentives to drive human behaviour.

Discovery's ability to exploit this core concept has resulted in considerable financial success for the Group. They qualify as a high quality or core stock in our universe based on the following four characteristics:

Chart 1: Discovery's Total Return Relative to the FTSE/JSE All Share Index



Source: Datastream, RE:CM analyst

**Chart 2: Discovery's Earnings-Per-Share Growth Relative to the FTSE/JSE All Share Index**

Source: Inet, RE:CM analyst

1. The Group is of sufficient size.
2. It has a listed history of over 10 years.
3. While there has been some acquisition activity lately, Discovery's management have never engaged in what we would consider to be company transforming acquisitions.
4. The Group has grown earnings per share and dividends per share faster than the South African market since listing in 1999. Chart 2 shows Discovery's earnings per share growth relative to that of the South African market since listing.

#### **Discovery has delivered better financial results than its peers**

Besides outperforming the market on the measure of growth in earnings per share since listing, Discovery has also delivered superior financial performance to that of its peers in the local long-term insurance sector. The key measure on which we base this assessment is return on embedded value ('ROEV').

Embedded value is an actuarial measure of the present value of all future profits expected to be earned from the existing policies that an insurance business has written, plus the value of the net assets (or net worth) of the business. It doesn't take into account any new business that the insurance company may write in future. ROEV expresses the change in embedded value during a specific year as a

percentage of the embedded value at the beginning of that year, after taking into account dividends that were paid out. Chart 3 shows the average ROEV for Discovery and its most comparable peers for the past 10 years. We leave Old Mutual out of this comparison due to its greater offshore focus than the other South African life insurers.

#### **Discovery's ROEV has also been more stable than that of its peers**

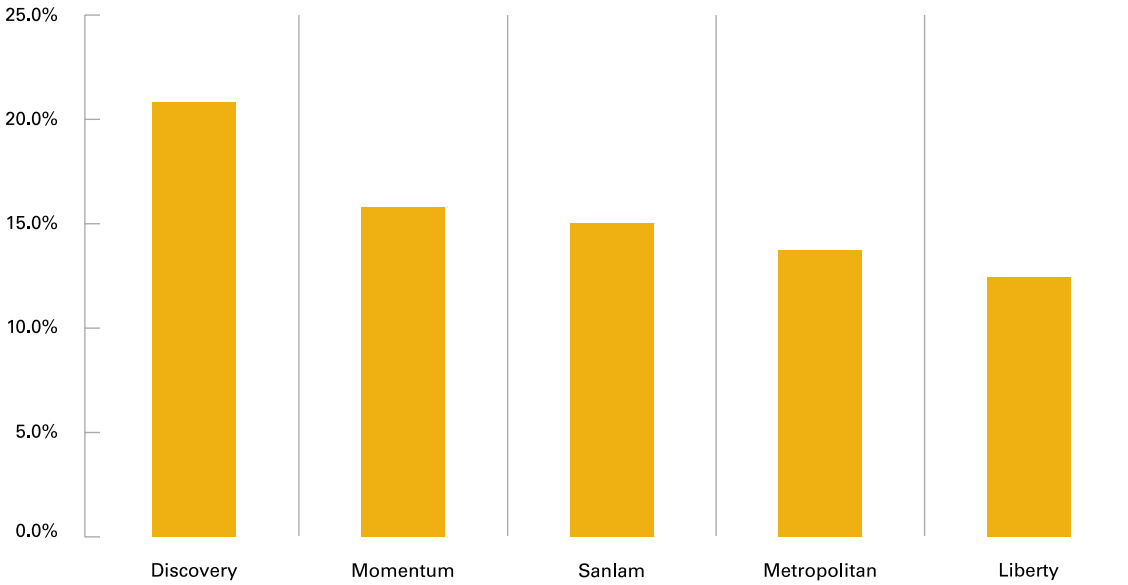
In addition to earning a higher average ROEV than its peers, Discovery's ROEV figures have been more stable than that of its peers for the past five years. Chart 4 illustrates this.

In the first few years after listing, Discovery's ROEV fluctuated widely. This was due to rapid growth in new business volumes on the positive side, and a settlement reached with regulators in 2002 on the negative side. The settlement affected Discovery Health's expected profitability and served as a material drag on embedded value growth for the year.

It is also worth noting that Discovery's average ROEV for the past five years has actually been higher than the average level for the preceding five years.

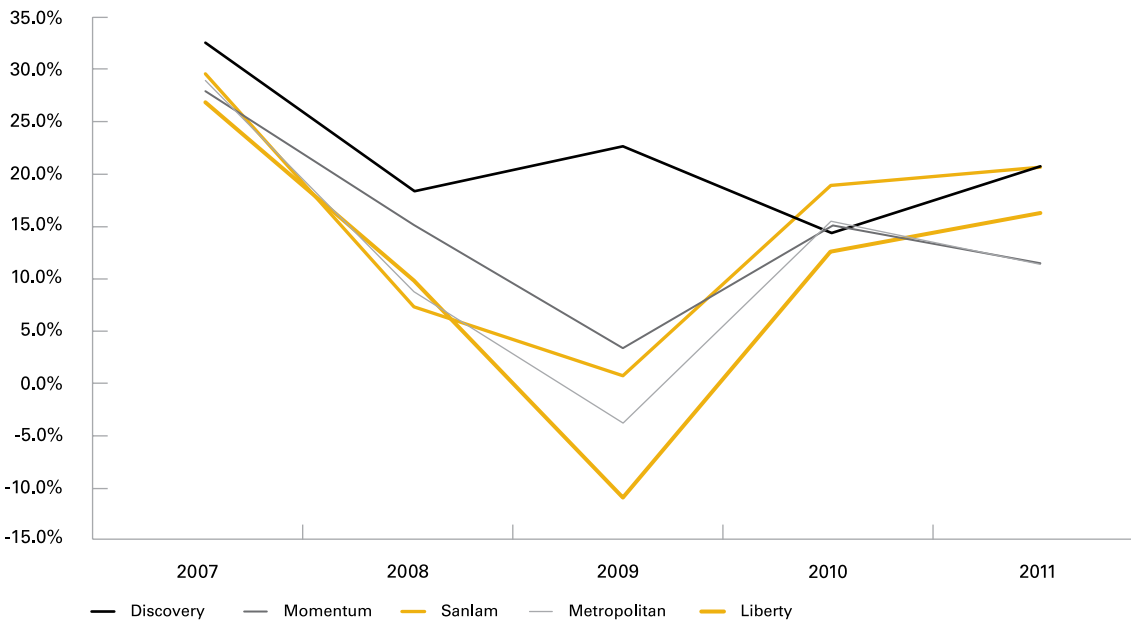
The primary reason for Discovery's greater ROEV stability is that the bulk of the Company's

**Chart 3: 10-Year Average ROEV of South African Life Insurers**



Source: Company reports, Datastream, RE:CM analyst

**Chart 4: ROEV of South African Life Insurers (2007-2011)**



Source: Company reports, Datastream, RE:CM analyst

embedded value is represented by the value of in-force business (VIF). This refers to the present value of expected future profits from existing business. In comparison, its peers have more of their embedded

value in the form of net worth, the bulk of which takes the shape of investments in financial assets and non-insurance subsidiaries. VIF is calculated based on assumptions. The interaction of changes

to those assumptions tends to result in VIF values that fluctuate less than the market values of financial assets.

Chart 5 shows the split between VIF and net worth in the embedded values of the various insurance businesses for the past five years. Please note that only four years of history is available for Momentum.

22

The fact that VIF is less volatile than net worth does not mean that VIF is necessarily a lower risk 'asset' than net worth. But in an environment of generally high South African asset prices, we believe that having more rather than less of an insurer's embedded value in the form of VIF rather than net worth is on balance a favourable proposition.

**Discovery's share price is still attractive**

Given the high and consistent return on embedded value that Discovery has generated, it makes sense to us that the business should be worth more than embedded value. At times, the market has shared this sentiment, but currently this is not the case. Chart 6 shows Discovery's share price relative to its diluted embedded value per share since January 2002. We exclude the first few years after listing, because the relationship between share price and embedded value was not as meaningful at the time,

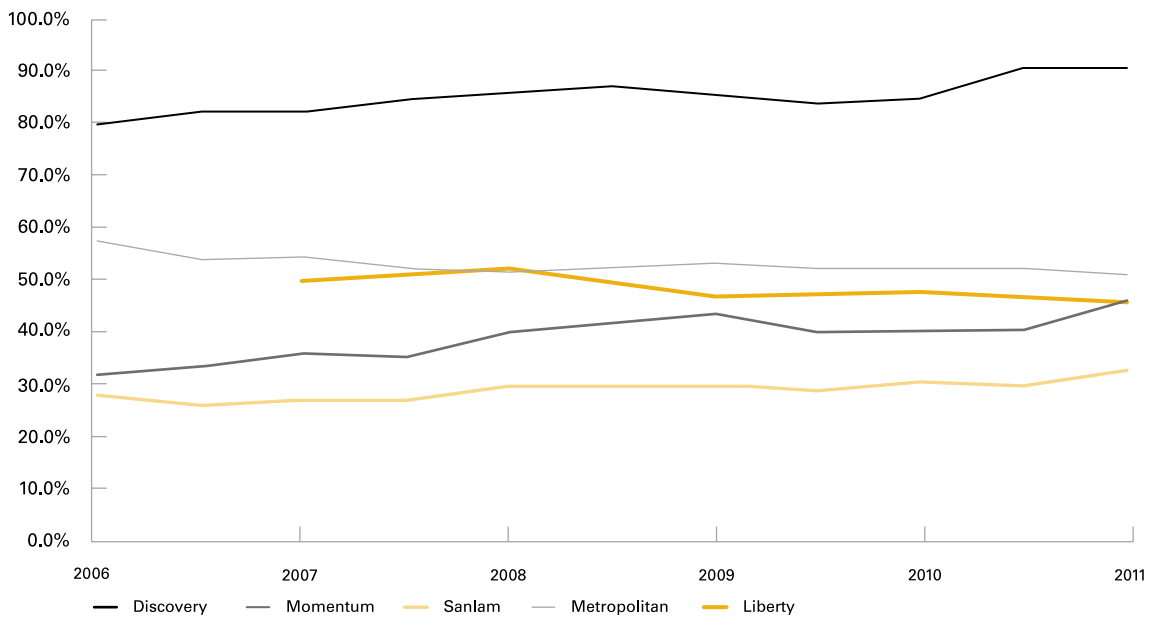
due to an overvalued share price and very high ROEVs.

**We believe the Group and its shares will continue to do well in the future**

Besides their favourable historical track record, there are various other factors that make us positive about Discovery's longer-term prospects:

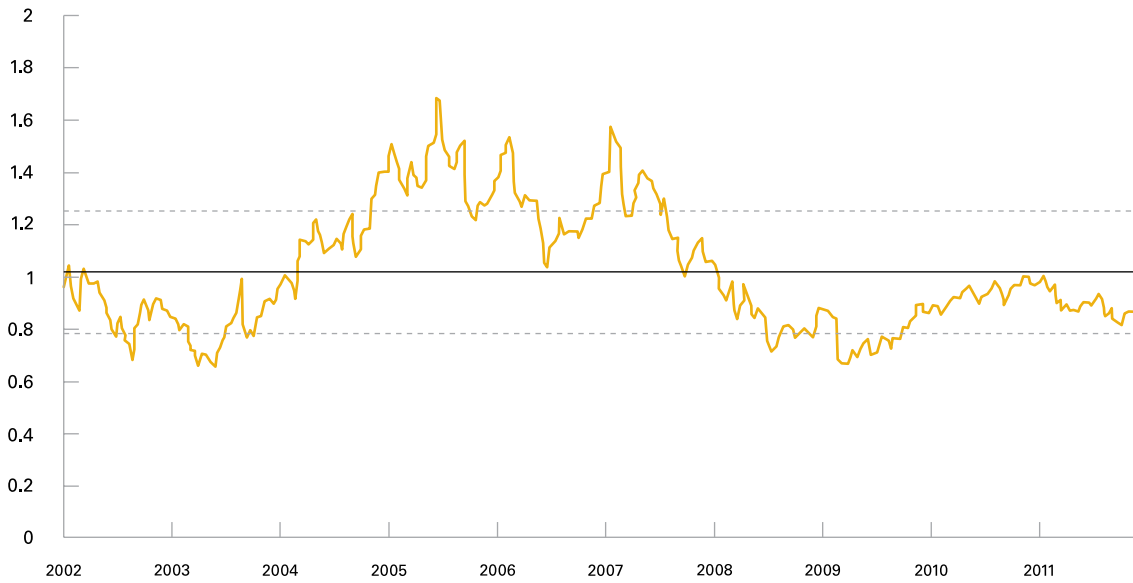
- The Vitality programme is a very powerful tool. Discovery was the first mover in building out a loyalty or incentive programme in the South African insurance market. Because of the programme's success, Discovery is now a very attractive partner for retailers or service providers who want access to a large pool of potential customers or clients. The Group can also use their bargaining power to negotiate the best deals for their Vitality members and other policyholders. This makes Vitality a very attractive proposition to potential policyholders and creates a network effect – the more people join the programme, the better the benefits, and the more attractive it becomes as a partner to retailers or service providers.
- Discovery has been cited as a world leader in incentivising healthy living (The Economist, 2011), and there are realistic opportunities to

**Chart 5: VIF as a Percentage of Embedded Value of South African Life Insurers**



Source: Company reports, RE:CM analyst

**Chart 6: Discovery's Share Price Relative to Diluted Embedded Value Per Share**



Source: Company reports, RE:CM analyst

implement the Vitality model outside South Africa. While Discovery's initial foray into the US failed, they have now rolled out Vitality as a stand-alone product there, effectively selling it to health insurers with some encouraging successes. They continue to offer the full suite of long-term insurance products coupled with Vitality in the UK, and there are signs of good progress in that market, despite early challenges. The Company recently entered China in a joint venture with Ping An, but it is too early to make any judgement on the success of this venture.

- New businesses like Discovery Invest and Discovery Insure (the new short-term insurance business) apply the same principles as the Vitality programme. These businesses have shown strong growth (especially in the case of Discovery Invest) and have the potential to become profitable businesses in the same way that Discovery Life became a phenomenal success within 10 years.
- Discovery Health continues to gain market share. The local medical scheme industry has been undergoing a process of consolidation for a number of years. This process tends to benefit larger administrators like Discovery. We expect this to continue.
- The proposed introduction of National Health Insurance (NHI) in South Africa will undoubtedly

impact the medical scheme administration industry. We think the impact of NHI on Discovery will be manageable, for the following reasons:

- The biggest losers from the introduction of NHI are likely to be medical schemes (and their administrators) targeting the lower income market. Discovery's core membership falls outside this market, and we believe these members are unlikely to be served entirely to their satisfaction by a NHI. This should minimise membership losses for Discovery.
- The introduction of NHI will most likely accelerate the consolidation process that is already under way in the medical scheme industry, which should benefit Discovery.
- A full-scale implementation of NHI will entail massive administration requirements and it's possible that private sector administrators may be appointed to administer the NHI. There is already a precedent of government appointing private market administrators, specifically in the case of the Government Employees Medical Scheme. Pricing on such a contract may however not be particularly attractive.

In a worst-case scenario, Discovery faces a mid-teens percentage decline in earnings compared to a 'business as usual' scenario (Bank of America Merrill Lynch, 2011 ), which we would not consider to be a disastrous outcome.

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Discovery's directors own about 20% of the Group, including the CEO's approximate 10% ownership. This dwarfs the shareholding (both in percentage terms and monetary value) of Directors in the peer companies. We like this alignment of interests with long-term shareholders. It gives us comfort that Management and Directors have an incentive to do the right thing for our clients, in the same way that they have managed to incentivise Discovery policyholders to do the right thing for themselves.

In summary, Discovery is a high quality business built upon a powerful core concept, and we believe

the Company will continue to prosper in the future. At the current share price, we think it is a sound investment, and we expect it to continue delivering good investment returns to RE:CM clients.

Wilhelm Hertzog

References:

Bank of America Merrill Lynch. (2011). 'NHI's impact on private healthcare'. 19 August.

The Economist. (2011). 'Getting on the treadmill'. Available from [www.economist.com](http://www.economist.com) (Accessed 12 December 2011).

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# Resisting the Lure of the Siren Song – Glamour Versus Value Stocks

In Homer's 'The Odyssey', the hero Odysseus is warned by the sorceress Circe of the Sirens, three dangerous mermaid-like creatures who use their enchanting music and voices to lure sailors to their deaths: 'You will come to the Sirens first of all; they bewitch any mortal who approaches them. If a man in ignorance draws too close and catches their music, he will never return to his fine wife and little children near him and to see their joy at his homecoming; the high clear tones of the Sirens will bewitch him. They sit in a meadow; men's corpses lie heaped up all round them, mouldering upon the bones as the skin decays. You must row past there; you must stop the ears of all your crew with sweet wax that you have kneaded, so that none of the rest may hear the song. But if you yourself are bent on hearing, then give them orders to bind you both hand and foot as you stand upright against the mast-stay, with the rope-ends tied to the mast itself; thus you may hear the two Sirens' voices and be enraptured. If you implore your crew and beg them to release you, then they must bind you fast with more bonds again.'

25

**Homer, The Odyssey (Shewring translation)**

'In the stock market, there is the irresistible excitement and lure of the hot stocks everyone is talking about at cocktail parties – the ones that are the darling of the talking heads on cable stock market shows, and the financial newsletters tell us that we must own. It is the wave of the future! It is a new paradigm! People believe that they'll miss a terrific opportunity if they don't own these super exciting stocks. It is not just average Janes and Joes who get caught up in the frenzy. When stocks climb, Wall Street research reports scream Buy. When stocks fall, the experts tell us to Hold when they really mean Sell.'

**Christopher Browne**

'Of all the dangers that investors face, perhaps none is more seductive than the siren song of stories. Stories essentially govern the way we think. We will abandon evidence in favour of a good story.'

**James Montier**

In the legendary book 'Security Analysis', still today widely regarded as the value investors' bible, Benjamin Graham and David Dodd (1934) argued that the prices of highly popular 'growth' stocks are often bolstered by high expectations. These prices can become vulnerable if expectations prove to be too enthusiastic. On the other hand, they argued that stocks that are out of favour are often under-priced in the market, and that smart investors can generate strong returns by capitalising on this. These unpopular 'value' stocks are often associated with companies that operate in mature industries or that face unfavourable circumstances. Numerous academic studies using data from both US and global markets have demonstrated that 'value' stocks tend to outperform the more popular 'growth' or 'glamour' stocks significantly over the long term. Yet, the allure of glamour stocks continues to seduce investors even though the drab stocks that are out of favour ultimately tend to produce far better returns.

In this article we look at stark examples of this phenomenon to:

- identify why there is such a substantial difference between growth and value stock returns;
- discuss the major errors investors make in assessing companies with favourable historic performance fundamentals; and
- explain why investors, despite overwhelming evidence to the contrary, continue to fall prey to the investment trap of choosing glamour stocks over value stocks.

## **The attractiveness of glamour stocks can be deceptive**

For decades, investors have been classifying stocks as being either 'growth' or 'value'. The most common form of the value versus growth classification is price-to-book (P/B) value per share. The rationale is as follows: A security's price supposedly represents the market's assessment of future prospects, while the book value represents an accountant's representation of the security's historical investment in productive capacity. The greater a company's prospects for future growth, the greater should be the ratio of its future prospects to its sunk investments. This means a high P/B

value per share equals high expectations of growth, whereas a low P/B value per share reflects low growth expectations.

The Brandes Institute (2008), a research institute affiliated to San Diego-based investment management firm Brandes Investment Partners, conducted a study in which they compared the fundamental traits of growth (or so-called 'glamour' stocks) versus value stocks on this basis. All the stocks trading on the NYSE and AMEX on 30 April 1968 were sorted into deciles based on their P/B ratios on that date. Stocks with the highest P/B ratios were grouped in decile 1 and those with the lowest P/B ratios were grouped in decile 10. This process effectively created 10 separate portfolios, each with 30 April 1968 as the inception date. They then tracked annualised performance for deciles 1 through 10 over rolling five-year periods from 1968 to 2006. The results of the study demonstrated that value stocks consistently outperformed glamour stocks in the US between 1968 and 2006, despite the market's expectations. The Institute found similar results for non-US stocks between 30 June 1980 and 30 June 2006. Numerous similar studies over the years by academics and practitioners alike have established that over time, value strategies consistently outperform growth investment strategies.

#### **Despite historical evidence, investors are drawn to the 'good stories' of glamour stocks**

However, despite this overwhelming evidence, investors find it difficult to resist the lure of glamour stocks and in particular, the siren song of a 'good story'. Nassim Taleb, author of *Black Swan* (2007) calls this tendency to be duped by stories the 'narrative fallacy'. He explains that: 'The (narrative) fallacy is associated with our vulnerability to overinterpretation and our predilection for compact stories over raw truths. It severely distorts our mental representation of the world.'

From a psychological perspective, investors find comfort owning the stocks of companies lauded as the success stories of the day. They may be influenced by favourable impressions of companies, optimism surrounding their continued prospects for success and impressive recent stock price performance. These notions are further fuelled by the media, with glowing mentions in newspapers and 'rock star' CEOs on the front covers of magazines.

#### **Performance metrics further enhance the appeal of glamour stocks**

In addition to a promising story, the preference for glamour stocks over value stocks appears sensible when looking at trends in operating performance. Consider the fundamental traits of decile 1 (growth stocks) and decile 10 (value stocks) from the Brandes study, summarised in Table 1.

Fundamentals for the average stock in decile 1 (growth) appear far more attractive than the average decile 10 (value) stock. In fact, the growth stocks score higher than the value stocks for every single operating metric. Furthermore, the total return of 52.9% for decile 1 (growth) stocks for the previous year dwarfs the 1.2% return of the decile 10 (value) stocks. From this perspective, growth stocks appear to be better investment prospects, with no ostensible reason to question their ability to continue delivering strong performance.

#### **The share price relative to intrinsic value is the key to determining future growth opportunities**

However, these metrics don't provide the complete picture. While the growth traits and trends may offer insight into the business, they don't account for the stock price an investor has to pay to acquire them. For value investors, a company's stock price relative to its intrinsic value is the primary consideration. The decile 10 value stocks had lower fundamental averages, but they were also far more attractively

**Table 1:**

	3 Yr Ave Net Income Growth	3 Yr Ave Operating Profit Growth	3 Yr Ave Sales Growth	3 Yr Ave Return on Invested Capital	3 Yr Ave Return on Equity	3 Yr Ave Return on Assets	Prior 1 Yr Ave Total Return for Stock
Decile 1 (Growth Stocks)	30.7%	28.7%	21.8%	14.6%	18.2%	7.8%	52.9%
Decile 10 (Value Stocks)	7.2%	6.9%	8.9%	5.7%	6.7%	3.8%	1.2%

Source: Brandes Institute, 2008

priced. In other words, the stocks for each business in decile 10 were trading at a significant discount to their intrinsic value, creating the opportunity for future price appreciation even given subsequent pedestrian operating performance. The impact on prospective returns works as follows: Glamorous companies may continue to perform well from a fundamental perspective, but their share prices already anticipate spectacular performance, which at best is realised or at worst, falls short of expectations. Drab companies may continue to simply plod along, but their share prices anticipate that they will continuously make mistakes and fail. All they need to do is get back to normal, and they are set to surprise investors on the upside.

The Brandes analysis showed that the average annualised return for the value stocks between 1980 and 2007 was 16.0%, compared to 6.8% for the growth stocks. This is a stark difference in returns for investors who failed to make the connection between expectations and valuations versus those who did.

**Be aware of share prices that reflect overly optimistic expectations about the future**

To further illustrate these potential pitfalls when choosing between value and glamour stocks, we

consider the five largest companies in deciles 1 and 10 as at 30 June 1998, demonstrated in Table 2.

Typically, based on the metrics in Table 2, most investors would feel more comfortable allocating capital to the decile 1 growth companies. The historic three-year average return on invested capital for these stocks was 20.7% compared to 3.6% for their counterparts in decile 10. The outlook appeared uncertain if not downright disastrous for the value stocks, while decile 1 growth companies looked to be 'sure-things'. At the time, many of these growth stocks were regarded as permanent stalwarts for an investor's portfolio. Crucially however, their stock prices already reflected these high expectations. Many investors ignored Warren Buffett's advice that 'You pay a very high price in the stock market for a cheery consensus' (Forbes Magazine, 1979).

**Correct pricing will determine whether an investment is worth the effort or not**

The growth stocks in Table 2 had an average annualised return of 1.4% over the next five years to 30 June 2003. On the other hand, the value stocks delivered an average, annualised return of 14.7% over the same period – more than 10 times the return of the growth stocks. The growth stocks

**Table 2:**

Decile 1 (Growth Stocks)	3 Year Average Net Income Growth	3 Year Average Operating Profit Growth	3 Year Average Sales Growth	3 Year Average Return on Invested Capital	3 Year Average Return on Equity	3 Year Average Return on Assets
Microsoft	-1.8%	8.2%	12.6%	19.8%	19.9%	15.5%
Wal-Mart Stores	14.5%	15.3%	16.5%	13.9%	21.7%	9.7%
Pfizer	53.6%	47.8%	37.3%	26.7%	37.3%	18.1%
Johnson & Johnson	22.0%	15.4%	11.2%	22.9%	27.2%	16.1%
Coca-Cola	2.5%	2.5%	2.3%	20.2%	29.6%	14.8%
Decile 10 (Value Stocks)	3 Year Average Net Income Growth	3 Year Average Operating Profit Growth	3 Year Average Sales Growth	3 Year Average Return on Invested Capital	3 Year Average Return on Equity	3 Year Average Return on Assets
Vodafone Group	-421.3%	-272.5%	-22.7%	-4.8%	0.4%	42.6%
Time Warner	-286.2%	8.3%	1.8%	17.3%	1.3%	100.0%
Deutsche Telekom	-240.2%	-165.7%	-3.3%	5.3%	0.8%	10.9%
AT&T	-204.6%	-20.2%	12.0%	5.8%	1.0%	-5.6%
Liberty Media	48.0%	-32.7%	-35.4%	-5.6%	1.0%	26.8%

Source: Brandes Institute, 2008

may have had great stories behind them, but subsequent five-year returns were sobering. On the other side of the spectrum, the value stocks may have previously shown disappointing growth rates – for example, four of the five decile 10 stocks had triple digit negative averages for three-year net income growth – but the subsequent five-year returns suggest that their intrinsic values were not reflected in their stock prices in 1998.

As value investors, we believe that the difference in stock performance between 1998 and 2003 came down to one thing: price. The glamour stocks were highly priced relative to their value due to overzealous expectations. Value stocks, on the other hand, were priced low relative to their value due to very low expectations. Looking only at the metrics failed to take into account that an investor's starting point relative to valuations is the chief determinant of future returns. It is also worth noting that the results for this five-year period were not abnormal. During the 23 rolling five-year periods that the Brandes Institute examined between 1980 and 2007, value stocks outperformed growth stocks 20 times, or 87% of the time. From this analysis we can conclude that a great company may not be a great investment if you pay too high a price for it, and a poorly performing company may in fact turn out to be a sound investment if you pay a low enough price for it. As Christopher Browne (2007) said: 'Risk is more often in the price you pay, than the stock itself.'

#### **Acting on a 'fear of missing out' (also known as FOMO) can have disastrous consequences**

Fortune Magazine published an article in August 2000 titled '10 stocks to last the decade... a buy-and-forget portfolio.' Written in the midst of the tech bubble frenzy, the article begins by empathising with investors who have recurring nightmares about 'the ones that got away'. It goes on to identify 10 stocks that 'should put your retirement account in good stead.' The recommended stocks were the hot stocks of the day, many of them tech, biotech or telecommunications stocks. These were the type of stocks you'd have felt very comfortable owning at the time given their illustrious records of soaring share prices and earnings growth. The article was littered with optimistic analyst forecasts of continued success and earnings growth. No mention was made of the excessive prices they were trading on at the time and the risk of those expectations not being met.

Needless to say, the consensus forecasts, as they most often are, turned out to be wrong. Not

all the companies performed miserably – some even generated continued earnings growth. These companies were however set to disappoint because of unrealistic expectations. Two of the firms, Enron and Nortel Networks, went bankrupt. Univision was bought out 68% cheaper with their debt 12 times their annual cash flow at the time. Only one stock out of the ten was a successful investment – the biotechnology company Genentech – realised a return of 127% for investors who invested in 2000 when it was bought out by Roche in 2009. The stocks in the portfolio and their subsequent returns are demonstrated in Table 3.

**Table 3:**

10 Stocks to Last the Decade	Return (Aug 2000 – Nov 2011)
Nokia	-87.8%
Nortel Networks	-100.0%
Enron	-100.0%
Oracle	-56.0%
Broadcom	-77.7%
Viacom	-38.4%
Univision	-67.9%
Charles Schwab	-69.9%
Morgan Stanley Dean Witter	-81.6%
Genentech	127.4%
Total Return	-55.2%

Source: Datastream, 2011

The total return for the portfolio from August 2000 when the article was written to November 2011 would have been -55%. This is a prime example of how the siren song of popularity can so easily distort investors' perceptions of value with disastrous consequences.

#### **Behavioural biases are the main reason behind this phenomenon**

Behavioural biases that prompt investors to overpay for winners (companies with great stories and seemingly bright futures) and underpay for losers (companies that are boring, unknown, ignored or unloved) are rooted in human psychology. These behavioural errors include short memories and the tendency to assume recent performance is an indication of future performance, the fear of regret or missing out ('FOMO'), and the fear of losing money. These errors are discussed extensively in the RE:VIEW article 'Conquering our biggest investment problem: ourselves' (RE:VIEW Volume 14, October 2010).

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Bruce Greenwald, a professor at Columbia University's Graduate School of Business and Research Director at First Eagle Funds, further differentiates between the biases mentioned above that affect all investors and those that affect professional investors alone. He argues that portfolio managers never lose their jobs for average performance or for holding the same securities as the rest of the group. If portfolio managers deliver poor performance within the context of a falling market, they are less likely to be held accountable. However, if a portfolio manager takes a chance and buys stock in a company that nobody else wants or holds, the payoffs are skewed. Says Greenwald: 'Should the company recover and the stock rise, the praise is real but short-lived. If the company does poorly and the stock falls, everyone remembers that you chose the "dog."' (2001) Thus, for professional managers, the saying 'safety in numbers' applies, further incentivising them to invest in the popular, glamour stocks of the day.

### **Trust a disciplined investment process over instincts for sustainable investment returns**

All the examples above emphasise the importance of the price-to-value relationship. It can be important to forecast earnings and growth rates and to determine which companies will improve profitability and rapidly grow sales. But it is definitely more important to spot basic undervaluation. As value investors, at RE:CM we consistently focus on attractive prices as a starting point, and by doing so, try to put the odds in our investors' favour for delivering excess returns. We are ever mindful that as human beings we too

are susceptible to falling prey to the behavioural issues we are attempting to exploit. As such, we try to eliminate gut feel, intuition and emotion as far as possible when we select investments. Instead, we prefer to trust our investment process that has thus far proven to be disciplined enough to protect us from our poor investment instincts.

Linda Eedes

29

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# Japan: A Stock Picker's Dream

'The possibility of sustained decreases in business value is a dagger at the heart of value investing (and is not a barrel of laughs for other investment approaches either). Value investors place great faith in the principle of assessing value and then buying at a discount. If value is subject to considerable erosion, then how large a discount is sufficient?

30

Should investors worry about the possibility that business value may decline? Absolutely. Should they do anything about it? There are three responses that might be effective. First, since investors cannot predict when values will rise or fall, valuation should always be performed conservatively, giving considerable weight to worst-case liquidation value as well as to other methods. Second, investors fearing deflation could demand a greater than usual discount between price and underlying value in order to make new investments or to hold current positions. This means that normally selective investors would probably let even more pitches than usual go by. Finally, the prospect of asset deflation places a heightened importance on the time frame of investments and on the presence of a catalyst for the realization of underlying value. In a deflationary environment, if you cannot tell whether or when you will realize underlying value, you may not want to get involved at all. If underlying value is realized in the near-term directly for the benefit of shareholders, however, the longer-term forces that could cause value to diminish become moot.'

**Seth Klarman, Margin of Safety**

**Chart 1: Topix Price Index (1973-2011)**



Source: Datastream

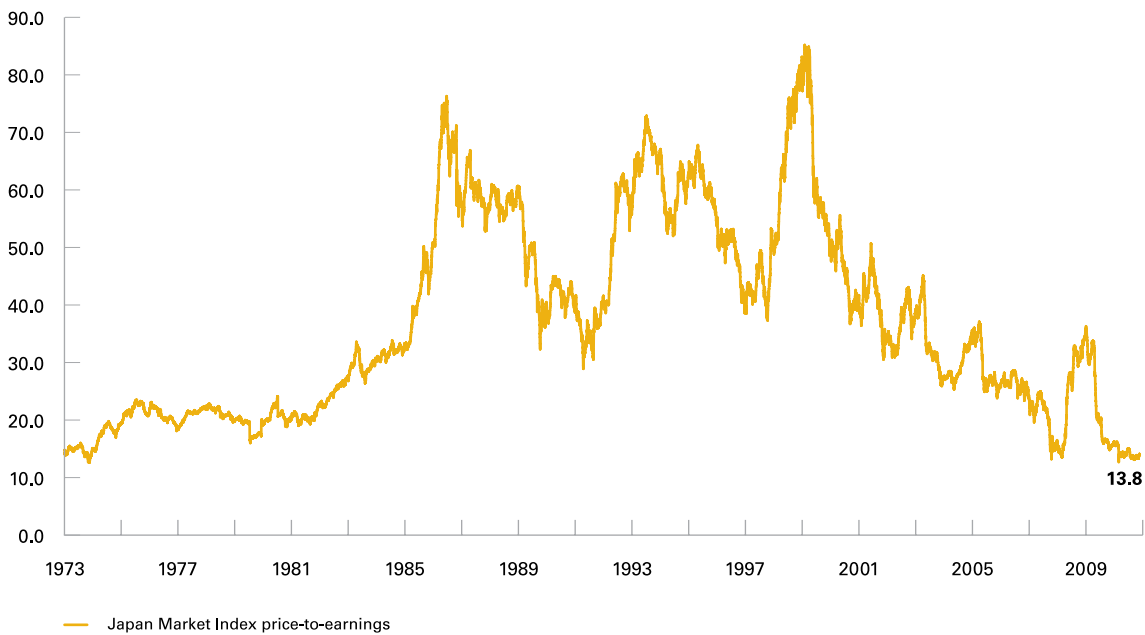
**Chart 2: Japan's Market Index – Price-to-Book (P/B) Ratio (1980-2011)**



31

Source: Datastream

**Chart 3: Japan's Market Index – Price-to-Earnings (P/E) Ratio (1973-2011)**



Source: Datastream

A persistent decline of bubble valuations since the late 1980s and the commencing of deflation have produced negative returns for Japanese investments over the past 25 years. As shown in Charts 1-3, the price level of the Topix Index recently

reached a level last seen in March 2009 and early 1984, while valuation multiples are at 40-year lows.

With attractive absolute valuations, we believe that Japan offers an excellent buying opportunity.

Accordingly, RE:CM investors have been participating in the Japanese stock market, where their mandates allow. The consensus view, however, is that Japan is a perpetual value trap.

In this article we investigate the macroeconomic arguments against Japan and also consider some unique micro characteristics of the Japanese stock market as it pertains to active bottom-up investors.

### **There is a strong case against investing in Japan**

The case against investing in Japan consists of a combination of the following arguments:

- Deflation persists and there is no catalyst for inflation. The Bank of Japan (BOJ) won't act or can't act.
- The fiscal situation will prompt a Greek-style government default.
- Japan has poor demographics and consequent negative future real GDP growth.
- Structural/cultural elements are responsible for Japan's economic woes.
- Following from the arguments above, there is an implicit view that profitability or return on equity (ROE) will remain low forever, which justifies the current low valuations.

### **Deflation will persist and there is no catalyst for inflation**

Despite recent merit for monetary expansion, there seems to be no direct incentive or disincentive for the powers at the BOJ to change course. In a country where bureaucrats are more unloved than investment bankers, perhaps for good reason, the BOJ's status as an independent institution certainly gives the impression of bureaucratic nirvana.

However, the view that the BOJ would have significantly changed the predicament of the past 20 years by being more aggressive in expanding the monetary base, similar to the approach currently taken by the Federal Reserve, appears somewhat one-sided. Richard Koo et al. (2008) points out that monetary expansion, contrary to academic thinking, is ineffective when it does not affect the demand for funds. Instead, balance sheet deleveraging explains the nature of Japan's long recession. Corporates cut back borrowing because they carried an enormous amount of debt following the burst of the bubble, not because of passive monetary policy. In fact, companies continued paying down debt despite near zero interest rates.

The BOJ is unlikely to opt for monetary expansion before governor Shirakawa's term comes to an end in 2013. But even then, there is no guarantee that his successor will favour monetary expansion, even if the Liberal Democratic Party that is pushing more aggressive candidates forms a coalition government with the ruling Democratic Party of Japan.

As has happened often in Japan's history, global forces may be the catalyst for change. Elevated US inflation, which appears likely following the Fed's approach to effectively give up inflation targeting, may force the hand of the BOJ to prevent further Yen strength.

One can only speculate what exactly it will be that triggers inflation. The fact is Japan's economic fundamentals, contrary to the past, now support inflation:

- Japan required deflation or a weakening yen to bring prices in line with the rest of the world. This adjustment has now taken place. The price of a basket of goods and services in Japan is no longer expensive relative to the rest of the world.
- The currently low levels of profitability and valuations of Japanese businesses discourage capacity expansion, encourage rationality and constrain deflation.
- A financially strong private sector has the capacity to borrow which makes monetary policy relevant again.
- The Japanese Government's fiscal position incentivises it to inflate.

### **Japan's fiscal situation will prompt a Greek-style default**

In our view Japan's fiscal situation is not as bad as it seems. Some market participants predict economic Armageddon. The doomsayers emphasise the high debt to GDP ratio, the on-going budget deficit, the risk of rolling over the substantial short-term debt and ultimately the capacity of Government revenues to service interest payments if Government bond yields spike. There are however a number of factors that indicate that Japan's fiscal situation is less dangerous than it may appear:

- The official Government debt figure is overstated. If foreign exchange reserves are subtracted, debt is almost half the quoted figure.
- Government revenues actually have much more capacity to service interest payments on this

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lower net debt figure in the case of a spike in bond yields.

- It is important to understand that Government's high debt came from a budget deficit that was caused by too much saving by the private sector rather than overspending by Government. It took the private sector many years to pay down its debt and in the meantime the conservatively financed Government, which was still running a large current account surplus through Japanese businesses, had to step in to prevent an economic catastrophe. Edward Chancellor (2011) has shown that Japan's fiscal deficits have been matched exactly by private sector surpluses. Japan's fiscal deficits will contract automatically once the private sector starts spending again, which, given the significant amount of deleveraging that has now occurred, seems imminent. Nominal GDP growth and rising asset prices will automatically improve the annual budget balance and erode the nominal value of debt. The (net) debt-to-GDP ratio seems likely to improve in both numerator and denominator.
- Japan's economy as a whole is not highly leveraged. The consumer is strong, business is awash with cash and the banking sector is well capitalised. This offsets the fiscal deficit and builds safety into the system.
- More than 90% of Japan's debt is held domestically. Historically, countries that defaulted were reliant on foreign capital that then fled.

In the light of the points above, it seems unlikely that there will be a serious crisis in Japan, even though it's uncertain when and how the necessary adjustment takes place. Meeting interest payments will become more challenging when inflation rises or if the Government has to borrow more from foreign investors. Still, such a 'crisis' period is likely to be temporary and is really the desirable income. That is to say, higher bond yields are inevitable if inflation rises, but also implies higher returns to equity investors.

#### **Japan has poor demographics**

Much has been said about Japan's negative population growth and its impact on labour growth and real GDP growth. Although Japan's population growth is marginally negative currently, population forecasts are renowned for being inaccurate. Furthermore, population growth only impacts GDP growth over the very long term. A decrease in working hours per employee has been much more significant in explaining Japan's real GDP growth over the recent past than population growth. Also, rethinking the pension system may even have

a positive impact on labour growth. Ultimately, there is no way to accurately forecast long-term population and labour growth.

In addition, it is well established in various studies (Dimson, Marsh and Staunton, 2002, Ritter 2005, Siegel 2008) that there is no relationship between stock returns and per capita GDP growth. This applies to both developed and developing countries and holds true over time periods as long as 100 years and more. So even if investors have a crystal ball that can correctly predict GDP growth, there would be no reward investing on this basis.

In investing, the price you pay is the most important consideration. When it comes to growth, a sustainable competitive advantage at the company level makes growth valuable to investors. If there are no barriers to entry, competition will enter until economic profits at a company level are zero and until growth adds no value to the collective stock market, even if there is growth in the economy. The presence of high quality businesses matters more for stock returns than GDP growth.

#### **'The Japanese way' is the cause of lower profitability today**

Most capitalists view the conduct produced by a Japanese economic system as procrastination. The western capitalist system allows market forces to take their course quickly. In such a system companies fail, restructure or gear up, all in the name of shareholder returns or laissez faire capitalism. Fascinatingly, the Japanese system seems to favour society rather than shareholders.

The Japanese economy advanced through a centralized allocation of resources and a determination to continuously improve – making things better and cheaper. Success wasn't measured by profitability. Global market share or sales and profits mattered more than the return on the money spent to create them. The system, and in particular strategically important industries, was sustained through indirect financing that provided semi-permanent capital at a low cost. This was made possible by the presence of a main bank system and relationship-based shareholders, including parent stakes, cross holdings and bank holdings. The system supported and encouraged Japan's unique labour management characteristics, such as lifetime employment, internal promotion and pay-by-age seniority. These elements have contributed to a belief among western-style capitalists that capital is under-appreciated by Japanese management teams who regard companies as 'theirs'.

These limitations on shareholders however do not actually explain the declining profitability in Japan over the past 30 years. As Alexander Kinmont of Milestone Asset Management points out, the same system has existed during periods of both high and low profitability.

Structural and cultural elements are likely to cause only marginally lower profitability. Considering the miracle-like wealth created by Japan's economic system over the past 50 years, it seems like a very small price to have paid.

One must also be careful to assume that all is rosy at western companies. Short-termism or pro-cyclical capital allocation are often the most value destructive forces at any business and are common at western companies.

Still, reform is needed in Japan and enacting new laws takes time. Crucially, it cannot happen without the collective will of the various business communities, the ruling party and the entrenched bureaucracy. Reform in Japan has been underway for the good part of a decade and there is clear evidence of positive incremental change, which paves the way for further change:

- The large amount of bank holdings and cross holdings in the system that hampered activism in the past has declined substantially. Foreign market ownership is now a sturdy 25%, compared to only 5% 20 years ago. Even though the new shareholders are not organised as a group, their presence often prompts management teams to listen to what shareholders have to say.
- There are more external directors on company boards which increase the chances of better business practices and capital allocation.
- More management teams target returns on capital as opposed to just sales and profits.
- More companies are benchmarking against global peers.
- International Financial Reporting Standards (IFRS) is on its way in, despite recent delays.
- Proxy voting is made public.
- Activists, corporate governance groups as well as corporate scandals like the one at Olympus all create awareness among Japanese corporations and regulators.
- Competition from China and Korea, a strong yen and the rising cost of equity are all forcing corporate Japan to consider long-term sustainability.

### Lower profitability in Japan is permanent

Return on equity (ROE) rates for the market as a whole are currently low. At just above 6%, it is below the rate that investors typically require before investing in the Japanese equity market. With the Japanese stock market trading below book value, investors are saying that the decline in profitability is permanent. But this does not seem to be the case.

**Table 1: A Breakdown of Japan's ROE by Decade**

	1960s	1970s	1980s	1990s	2000s
ROE %	10.25	11.47	10.98	5.72	6.35
Net margin %	2.30	1.60	1.90	1.60	2.53
Asset turnover	1.11	1.20	1.29	0.97	0.90
Financial leverage	4.20	5.10	4.70	3.60	2.80

Source: Ministry of Finance Corporate Survey, Morgan Stanley Research

The root cause of the decline in profitability since the 1970s and the 1980s is the recession brought on by the fall in asset prices following the burst of one of the greatest bubbles in stock market history. Table 1 show that the clean-up required a momentous effort in filling balance sheets or financial deleveraging that, along with consequent deflation, is the direct explanation for the fall in profitability. For companies that bought significant amounts of land or real estate at the peak, it has been a particularly hard slog. Suffice to say, Japanese management teams have been paying down debt for the past 20 years and now sit on piles of cash.

In addition, deflation and in some cases yen strength have caused asset efficiency to decline, leading to lower ROEs. Persistent inflation would lift asset turnover, encourage corporate borrowing and improve profitability.

It appears that a substantial part of the decline in profitability is temporary. Simply gearing up to optimal levels and buying back shares to arbitrage the huge gap between the low cost of debt and the high cost of equity is an easy way for corporate Japan to boost ROEs.

Despite the fuss, Japan's macro-environment actually appears desirable, both from an absolute perspective, with the necessary adjustments now having taken place, and relative to the US and Europe. The chances of already low profitability and low valuations falling even further are slim. Having

both low profitability and low valuations gives the Japanese stock market downside protection and ample upside potential.

**Future investment returns are not at the mercy of 'macro' factors**

Even if we didn't have these strong counter arguments, a negative macro outlook would not rule out investment.

A purely quantitative value strategy, simply buying the cheapest stocks, has significantly outperformed the Japanese market and generated positive returns despite deflation. In his book 'Value Investing: Tools and Techniques for Intelligent Investment' James Montier (2009) shows that between 1990 and 2007 a buy-and-hold value strategy in Japan based on the lowest price-to-book stocks, generated a return of 3% per annum versus a market return of -4% per annum. With overvalued stocks abundant, short sellers also had a great opportunity. According to Montier, a strategy of shorting overvalued stocks in addition to the buy-and-hold strategy generated a remarkable return of 12% per annum.

RE:VIEW readers may also remember the 'Bento Box', a quantitative deep value investment strategy we implemented in September 2008. At the time, the 'Bento Box' consisted of a basket of 26 Japanese companies trading at a 20% discount to current net working capital or so called "net nets". Since then the Nikkei is down 37% in yen and down 12% in US dollars, while the 'Bento Box' is up 1% in yen (excluding dividends of 3% per year) and up 42% in US dollars. Although the measurement period of three and a half years is fairly short, it may provide additional evidence that buying a very cheap diversified position beats the market.

At RE:CM we typically do not pursue deep value quantitative strategies such as the 'Bento Box'. Normally we consider businesses individually, analysing each business model. Specifically, we avoid poor quality businesses and avoid looking purely at the balance sheet for value. It is noteworthy that the activist approach of unlocking balance sheet value has thus far failed spectacularly in Japan given what appears to be a weaker market mechanism. Understanding the dynamics of each business is crucial in avoiding value traps. In other words, we believe stock selection can add value over a purely quantitative value approach.

The following factors are a major boon for bottom-up stock pickers in the Japanese market:

**1. Market Inefficiency**

Japan's investment universe is very broad with close to 3,750 listed companies. There are about 10 times more listed companies in Japan than in South Africa. The Japanese market is also deeper than most markets that often are dominated by a few large names. For example, the top 10 stocks in South Africa make up a mammoth 60% of the aggregate stock market value and the top 20 make up 75%. In Japan, the top 10 companies make up only 17% of the aggregate stock market value and the top 20 companies only 25%.

**Table 2: Market Efficiency in South Africa and Japan**

	South Africa	Japan
Number of listed companies	392	3,743
Top 10 shares as % of aggregate stock market value	61%	17%
Top 20 shares as a % of aggregate stock market value	75%	25%
Number of companies not researched (no sell side coverage)	160	2,740
% of aggregate stock market value not researched	2%	17%
% of aggregate stock market value 'poorly' researched (1-5 sell side analysts)	7%	15%

Source: Bloomberg, Datastream, 2011

In addition, with 'relationship-based' shareholders for the most part taking care of businesses' financing needs, the number of financial participants has been relatively small and the financial services industry extremely underdeveloped relative to other first world countries. One doesn't see 'Occupy Wall Street' type protests or sentiments in Japan and for the same reason it is ironic that Japan's system has taken so much criticism. In addition to being structurally small, a 20-year bear market has also noticeably thinned the industry. It is telling that only about 5% of the considerable household assets in Japan are invested in the equity market. Consequently, with a small amount of resources chasing the Japanese market, it is vastly under-researched.

Most sell side firms research approximately 200 companies each, while the biggest, Nomura, researches around 600. Coverage frequently overlaps as firms focus on the larger stocks that generate the most trading revenue. Of the 3,743 listed companies in Japan, close to 2,740 (or 73%) are not covered by any sell side firm. This represents

close to a fifth of the aggregate stock market value, compared to only 2% for the South African market. Another 17% of companies in Japan, representing 15% of the aggregate market value, are also not well covered, with only one to five sell side analysts researching these companies. On the whole about 88% of companies – a third of the total market value – are either not well covered or not covered at all.

There appears to be very limited competition in finding price-to-value discrepancies in Japan. It's quite remarkable that the stock market of the world's third largest economy is so under-researched. This neglect is a positive sign in itself – capital is typically most scarce in the markets that are most attractive.

## 2. The Availability of High Quality Businesses

Deflation usually causes business values to diminish. At the same time, businesses that are protected from competition can grow profits and therefore intrinsic value, regardless of deflation. Fortunately Japan has many world-class companies that have done exactly that. According to our estimates there are about 400-500 high quality companies that are not covered by sell side analysts. This is more than the total amount of companies listed on the JSE Main Board and the Alternative Exchange combined. Besides, in South Africa, 70% of the top 10 companies and more than 50% of the aggregate stock market value consist of resources shares – cyclical commodity businesses with little pricing power that are nearly impossible to value with conviction and therefore troublesome to invest in.

## 3. Low Valuations

The most important driver of stock returns is the price you pay. Currently valuations are at a 40-year low and very attractive in absolute terms. This bodes well for future returns. Net cash, a cold hard number, makes up a substantial part of the net asset value of many Japanese businesses, providing considerable downside protection. Attractive valuations alone are enough of a reason to buy Japanese equities at the moment.

In conclusion, a sensible approach appears to be to invest based on how a business is priced relative to a conservative estimate of its normalised economic returns. In Japan this may involve excluding from

the valuation profits earned on the assumption of improved 'macros'. Demanding a wide margin of safety between price and value and investing in high quality companies is another way for investors to lower the risk and increase the odds of earning a satisfactory return.

Both the macroeconomic and microeconomic factors seem to support investing in Japan. The macroeconomic situation appears reasonable to us and certainly not as bad as market valuations are implying. It seems that the majority view against Japan may be lingering prejudices following a 20-year bear market. In addition, the inefficiency of the Japanese stock market offer a dream-like opportunity for the bottom-up value investor, regardless of the macroeconomic future. Ultimately there are high quality, cheap, neglected and growing businesses in Japan. Buyers of these assets stand a good chance of earning positive absolute returns, even if deflation persists. Such investors are essentially getting a free option on the macro-economic situation improving, which, given the laws of economics, seems likely to happen.

Johannes Visser

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# Exploring the European Doldrums

'For myself, I am an optimist – it does not seem to be much use being anything else.'

**Sir Winston Churchill**

'All in a hot and copper sky,  
the bloody Sun, at noon,  
Right up above the mast did stand,  
no bigger than the Moon.

Day after day, day after day,  
we stuck, nor breath nor motion;  
As idle as a painted ship,  
Upon a painted ocean.'

**Samuel Taylor Coleridge, Rime of the Ancient Mariner**

'I always lay it down as a safe proposition that the man who has to break open the baby's bank toward the last of the week for car fare isn't going to be any Russell Sage when it comes to dealing with the old man's money.'

**John Graham**

Our investment philosophy acknowledges that panic and fear can lead to the mispricing of assets. Panic and fear is currently more apparent in Europe than anywhere else, specifically in Portugal, Ireland, Italy, Greece and Spain (collectively and lovingly known as the PIIGS). The price-to-book (P/B) ratios for Greece and Italy, illustrated in Chart 1, highlight this quite clearly. These economies are in the doldrums and they may stay there for a long time. As a result we decided to 'take a good look' at the European Market.

## **Being away from the noise gives us useful insight**

We decided to screen for quality businesses within the European markets that appear cheap enough to warrant further attention. Ireland appears to be the most distressed market, and there are not that many quality businesses there. Portugal also lacked quality listed businesses, but we identified numerous potential quality businesses in Italy, Spain and Greece. Detailed valuation work suggested that many of these could be cheap enough to successfully compete for fund capital.

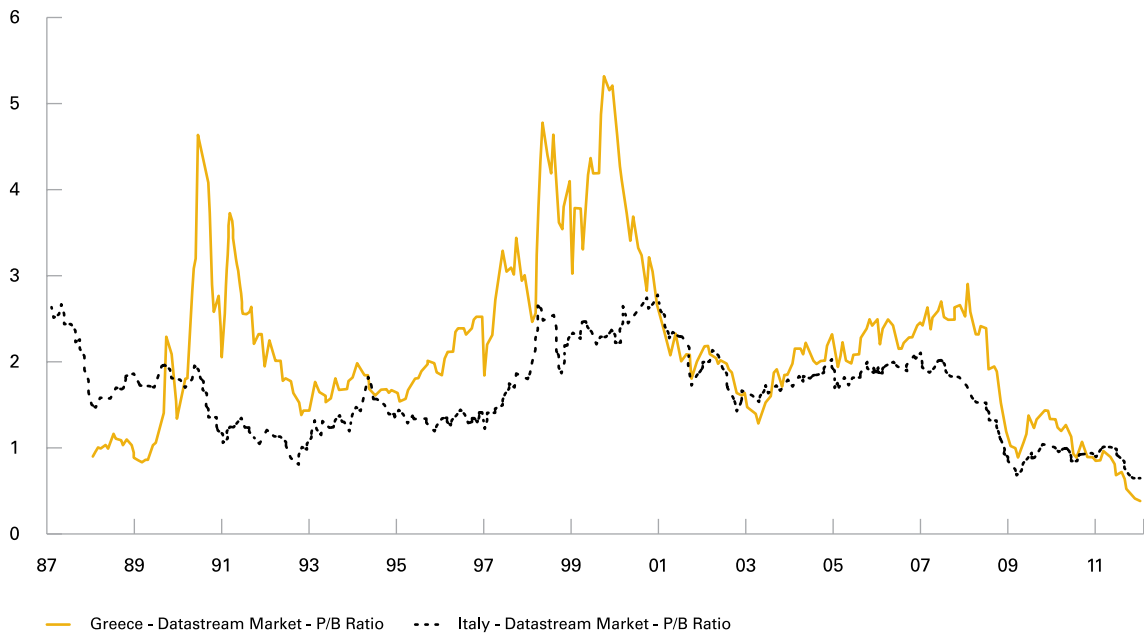
With these prospects in mind, we arranged a trip for three of our analysts to travel to seven European cities in early November. This was our chance to experience for ourselves what is happening on the ground in these countries. We do most of our work far from the noise and dust that often obscures

the perceptions of close observers, which is an advantage that we exploit. We therefore used the opportunity to get up close and personal before stepping away again and applying a forced cool-down period to wash the noise and dust away before we formed our views.

## **The investment landscape differs substantially between Greece, Italy and Spain**

Greek retail investor equity participation is down from 60% to 10%. In addition, few foreign investors are still interested in these markets, especially in the smaller capitalisation stocks outside the main indices, which is a good contrarian indicator. Because of investors selling out of the Greek market at all costs, Coca-Cola Hellenic Bottling is now the largest company in Greece by market capitalisation, and forms 25% of the index. We have completed our detailed follow-up analysis and it appears to be a decent business.

The Italian and Greek economies are fairly closed with limited competition. The competition commission entities are weak and the legal system is difficult to navigate, which lowers one's ability to enforce contracts through the courts. This led to a decline in foreign direct investment (FDI) in these two countries, strengthening the positions of domestic oligopolies (when a few companies dominate a market or industry). On the other hand,

**Chart 1: Long-Term Price-to-Book (P/B) Ratio History for Greece and Italy**

Source: Thomson Reuters Datastream

Spain received a lot of FDI as their economy is open to competition and competition law is well enforced. As a result, there are a disproportionately large number of family-owned and controlled businesses in Italy and Greece, while Spain has a low proportion of such businesses by European standards.

#### **The European banking sector remains under intense pressure**

Greece, Italy and Spain all have a strong culture of home ownership, with over 80% home ownership rates. In Spain 110% mortgage financing was common until recently, and developers and residential investors showed a predictable supply response. We understand that there are now approximately one million newly built homes standing empty in Spain. The mortgage situation gave us a keen sense of the continuing disaster unfolding for the European banking sector. It appears that many of the mortgage-associated bad debts have not yet been fully accounted for in their books. In addition, retail bank deposit bases are shrinking as people use their savings to survive, banks' exposure to regional sovereign credits remains significant and regulatory capital requirements are tightening. These factors all put increasing pressure on the banks' funding positions.

Many immigrants entered Spain and Greece in the boom years and these people are generally now the first to lose their jobs. This has resulted in an increase in crime and a reducing population as the unemployed immigrants relocate to countries with better job prospects. The Greek government also employed up to 25% of the population on inflated compensation packages. These government employees are now being forced to accept salary cuts of over 50%, causing understandable economic and social disruption in Greece.

#### **We've uncovered new investment ideas but are mindful of currency devaluation risks**

Although the information we collected in Europe paints a gloomy picture, we returned reasonably satisfied as we found eight new investment ideas. We also affirmed our investment thesis on three current fund holdings in the countries discussed above.

Paul Whitburn's piece titled 'Listed stock exchanges – bubbles & busts' in RE:VIEW Volume 18 touched on the inherent risks of companies that operate in countries that face significant currency devaluation. We follow a strategic process when it comes to allocating fund capital to investment opportunities in such countries. Allow us to refresh the memories

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of existing RE:CM investors and to enlighten future clients about how we perceive risk.

### **We define risk as losing money**

In fact, we hate losing money so much that we built our RE:CM investment philosophy on this principle. We start our analysis by considering a worst-case outcome and its impact on the intrinsic value of an investee company. We define intrinsic value as the net present value of all the future cash flows, which are unknown, even and perhaps especially to company management. Taking this as the starting point forces our analysts and portfolio managers to think outside of the traditional optimism of risk-hungry equity investors who stand last in the payment queue when bad things happen. Bad things do happen, which is why we believe it's ignorant to perform an analysis without considering a worst-case outcome.

Based on this approach, our ideal investment is one that has:

1. the smallest possible chance of suffering a permanent loss of capital if things turn out badly, and
2. a good chance of delivering superior results if circumstances and events are average or turn out better than expected.

In assessing risk, it is vital to consider the worst-case scenario.

Using our investment framework, our analysts work on a worst-case scenario when they consider investing in businesses listed in Greece, Spain and Italy. In this context, the worst case is the assumption that the European Union is disbanded.

Three of our analysts have attended a 'Practical history of financial markets' course in Edinburgh over the past five years. This course features the duo of Andrew Smithers, author of several academic publications and Gordon Pepper, former advisor to Margeret Thatcher. It includes a case study of the record 209 billion percent hyperinflation rate achieved in Weimar Germany in 1922-1923 – a black swan if there ever was one.

From these workshops and our own research, we know that currency devaluations and hyperinflation events typically have one of two outcomes.

The best outcome is when the ownership of a 'hard' asset (such as land, commodities or a business that generates its revenues and profits outside that

country) is combined with debts denominated in the local currency. The assets and cash flows maintain their intrinsic value while the liabilities decline. The best thing a business can do to prepare for devaluation is to increase its offshore activities and to borrow from a local bank (while it can).

The worst outcome is when a business generates all or most of its cash flows from domestic activities and its debts are denominated in another currency. During massive devaluations, such a business would suffer a permanent impairment of its intrinsic value. In most cases, equity holders are wiped out. This does not conform to our approach of safety first. We do not wish to participate in these odds irrespective of the potential upside.

As an aside, businesses that maintain high levels of financial leverage through the business cycle can find themselves in situations that call for 'breaking open the baby's bank' at a time when even the baby's bank has nothing in it, which equates to reaching the end of the road – if not for the business then certainly for its current equity owners.

It follows that the types of companies we are looking for in regions like Europe are ones with:

- net cash on the balance sheet or low levels of gearing with true long-term domestic debts; and
- assets and cash flows that can maintain their intrinsic value in global terms.

Sir Winston Churchill's quip is aspirational and can be applied to most walks of life. But it is an extremely dangerous approach to follow when it comes to investment analysis. In the words of Warren Buffett: 'You only find out who's swimming naked when the tide goes out'.

### **The businesses in our Global Fund meet our investment criteria**

We will now take a look at three businesses we hold in the RE:CM Global Fund to see how they square up to the factors discussed above.

#### **1. Titan Cement (listed in Greece)**

Titan Cement has net debt but 80% of its operating cash flows are produced outside of the troubled Eurozone economies. On depressed profitability, it still covers its interest payments by a tight margin, which is a valid concern. On the positive side, cement businesses have high variable costs. This implies that they can manage reduced unit volumes better than most in the event of an ongoing recession. For

example, currently their Greek cement business is operating at 35% capacity utilisation but they are close to breakeven. Under normal operating conditions their cement businesses will tend to operate at 80% capacity utilisation.

We ascribe intrinsic value to Titan Cement of €27 and a worst case intrinsic value of €16 (explicitly assuming their Greek assets are worthless), against the current share price of €11.

## 2. Hellenic Exchanges (listed in Greece)

Hellenic Exchanges has substantial net cash on the balance sheet equating to €1.80 per share. This is a real downside risk to our estimate of intrinsic value as the cash is held entirely with Greek banks.

Hellenic Exchanges is a natural domestic monopoly that has pricing power. Their revenue streams are more diverse today than they were seven years ago and have a meaningful annuity component. The current market capitalisation of the entire stock exchange is made up of companies with significant operations outside Greece. Even though all of Hellenic Exchanges' cash flows are produced in Greece we believe they have the ability to pass inflation along and survive a lengthy trough in the business cycle by virtue of their strong balance sheet.

We ascribe intrinsic value to Hellenic Exchanges of €8 and a worst-case intrinsic value of €4.20 (explicitly assuming all of the cash is worthless), against the current share price of €2.80.

## 3. Coca-Cola Hellenic Bottlers (listed in Greece)

Coca-Cola Hellenic Bottlers (CCH) has €1.71bn in net debt consisting of medium term bonds that are A-rated and therefore considered investment grade by a number of rating agencies. Approximately 69% of the groups revenue is generated outside the Euro region and Greece contributes only 4% of current operating profit. In fact, the majority of CCH revenue is from emerging markets such as Russia, Nigeria,

Romania and Poland. CCH would be able to pass on price increases across the majority of its markets due to the dominant market share of Coca-Cola globally and the companies dominant share in its regional markets. Profitability is under pressure across all regions due to declining volumes in regions such as Greece and Italy. Margins are thus below long term averages as is the Company's current valuation.

When considering the downside risk we assumed that the Euro denominated regions contribute nothing to revenue and profit while assuming that full amount of €1.71 billion outstanding Euro debt remains. The downside valuation would be €11.1 versus an intrinsic value of €19.25, currently trading at €13.

## We face the same risks and rewards as our investors

We conclude this article with an overview of the exposure of our Global Funds to put our arguments into perspective. The cumulative exposure to assets in Greece is currently 6.5% for investors in the RE:CM Global Fund, 2.4% for investors in the RE:CM Global Flexible Fund and 1.3% for investors in our Regulation 28 balanced funds with offshore (non-South African) exposure. In addition, we continue to work hard to ensure that every existing investment and every new investment idea meets the criteria outlined above.

We invest meaningfully alongside our investors, accepting the same risks and rewards and paying the same fees. Investors can therefore rest assured that we place a very high value on the safety of our personal savings, as well as their own.

Daniel Malan and Razeen Dinath

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