

Volume 20  
Investment Insights  
April 2012

# RE·VIEW



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# Introduction

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The first quarter of 2012 got the year off to a bang, as most equity markets were up by double digits. The one exception was Europe, and even this 'laggard' was up just less than 10%. Given these strong short-term returns, it should come as no surprise that most of our funds have underperformed their benchmarks over the quarter. However, longer term, both the MSCI World and the JSE All Share Index languish with very low returns – despite this most recent bounce – and over this period our investors have earned good real returns, in excess of their benchmark indices.

It is probably appropriate to contrast our current investment view with what the broad consensus is in the market. Our view is that the excessive leverage in markets that was the source of economic problems in 2008 has not disappeared; it has merely moved from private to public hands. The fact that governments are now the indebted ones does not reduce risk; it simply changes the nature of the risk. Instead of banks defaulting and heading for bankruptcy, we now have countries on the verge of default and bankruptcy. The can has been kicked down the road.

The markets' view is that yes; these problems are still there, but they are confined to the economies of developed markets. Emerging market economies are healthy, and relatively debt-free. With this background, the right corporate strategy is to expand into emerging markets and the right investment strategy is to 'overweight' these markets at the expense of debt-constrained developed markets.

Of course, both these strategies (as stated) ignore two significant items. One is the price one needs to pay for such assets, whether you are a corporate seeking to expand your business into promising geographies, or whether you are an investor seeking to escape the low-return developed world. If one overpays for such assets, your returns will be low, despite the sound economic rationale behind them. The second item is the effect of increased competition on prospective returns. If everyone recognises that emerging markets are 'high growth' and invests to capture this growth, then returns will be lowered through increased

competition, even if economic growth persists at historically high levels.

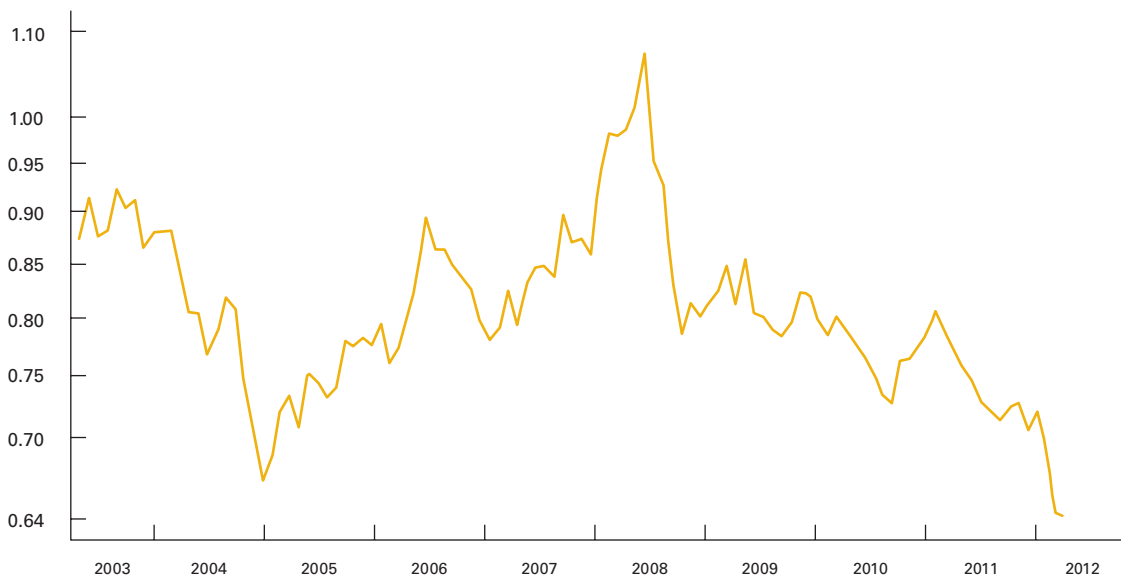
The reason that investment returns from emerging markets have been so high over the past 10 years is very simply that 10 years ago, no-one wanted to invest in them. This was the period immediately after the emerging market crash of 1998, and a time when technology was top of mind. Everyone wanted to own 'high growth' technology, and shunned 'low growth' emerging markets. As a result prices in emerging markets were low, and there was very little competition. Incumbents had a free ride. Today, we face the converse. A recent article in the Financial Times (April 3, 2012) described how more companies in the USA were 'on shoring' due to the fact that it was becoming cheaper to manufacture in the USA than in China or other emerging markets. We find it interesting that investor sentiment does not yet seem to reflect this changing reality on the ground

Our investment strategy is based on what has worked through many cycles: buying assets that are attractively priced, which in turn reflect low expectations; and where competition is low. As such, in our local South African mandates we have an increasing weighting towards cyclical stocks such as mining companies; as well as a continued high exposure to companies that operate in the tourism and hospitality sector. This sector is very much out of favour after the excitement and capacity expansion before the 2010 World Cup. As a corollary to this, we have very little exposure to the stocks which have the best current 'story', such as retail and bank stocks. These are the companies expanding into Africa at the fastest rate. They also have high prices relative to their intrinsic value, and face the most competition over the next 10 years.

In our global mandates, we have a continued high exposure to companies in the USA, Japan and increasingly Europe. We view the US dollar as one of the most undervalued currencies worldwide (possibly the best of a bad lot). We have a high exposure to technology companies.

In all our multi-asset class mandates, we have negligible exposure to bonds. We continue to view

## South African Resource sector relative to the All Share Index, since inception of RE:CM



Source: I-net

them as potential 'certificates of confiscation' – if not in nominal terms, then very definitely in real terms. At current low rates one is not being paid for any risk in these instruments.

As usual, we view discretion as the better part of valour. And as usual, in the short term, we are not being rewarded for this discretion. But, as has happened invariably in the past, careful investors have their funds intact when the next genuine buying opportunity comes around. Value investing is easy in principle; it consists of equal parts hard work - the valuation part; and patience - the waiting part. What makes it difficult in practice is not the valuation part, but the patience part. But it is exactly this patience that makes it so rewarding in the long term.

In this regard, and very appropriately, Danie Malan, our Investment Director has written the first article of this edition - "The Discomfort Trade-Off of Investing and Life in General". In this article, Danie shows us how to deal with the discomfort inherent in good investment ideas, and also gives us some practical examples.

In "The Goose that Laid the Platinum Egg", by Paul Whitburn, we explain our current optimism around the valuation of platinum companies. Over the years, RE:CM has acquired the reputation of not particularly favouring investments in

resource-based companies. Although we have historically avoided the sector, we did so purely on valuation grounds. Now that the resource sector has underperformed the JSE All Share index for almost 10 years (see chart above), it is starting to show some value. Unsurprisingly, we are getting interested. If things carry on this way, and prices continue to decline for resource assets, we might yet still earn the reputation of being resource 'perma-bulls'. It just goes to show how things can change over time.

In the third article, Thompson Ganyeka talks about our Money Market Fund. Although we are generally seen as equity-centric investors, we do believe that preserving one's capital has an important role to play in any investment strategy. A money market fund is an ideal vehicle to do so. As such, the RE:CM Money Market Fund is managed extremely conservatively, only allocating funds to the highest quality money market instruments. Of course, this means that we willingly accept lower yields. We compensate for this by charging the lowest fees in the industry. As a result, our Fund has the highest net yield to retail investors in the industry. Truly a case of having your cake and eating it.

Finally in the last article, "Emerging Markets versus Developed Markets: Where We See Value" by Wilhelm Hertzog, deals with a burning

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issue - one I tried to summarise earlier in this introduction. The dilemma facing investors today is that which seems sound from an economic point of view, might not be as sound when one takes the price of the 'opportunity' into account. Very much like the South African corporates who acquired developed market assets in London and New York 10 to 15 years ago, what was in principle a sound economic decision was disastrous for shareholders. Wilhelm gives us a bit of a 'deeper dive' into why this may be so today for investors moving into emerging markets.

As always, we hope you enjoy this edition of the RE:VIEW.

Good Investing

Piet Viljoen  
Executive Chairman

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# The Discomfort Trade-Off of Investing and Life in General

'You need to grab a hold of that line between speed and chaos, and you need to wrestle it to the ground like a demon cobra. And then, **when the fear rises up in your belly, you use it.** And you know that fear is powerful, because it has been there for billions of years. And it is good. And you use it. And you ride it; **you ride it like a skeleton horse through the gates of hell.'**

Lines from the movie 'Talladega Nights' (emphasis added)

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'Why does the thrill of soaring begin with the fear of falling?'

David McNally

When we do something for the very first time, we usually experience fear. Although it's normal, we need to overcome this fear to learn the relevant lesson and to grow. This principle also holds true in a career context: we need to continually step out of our comfort zone, challenge assumptions and push the boundaries to avoid becoming stagnant in our career development. This 'stagnancy' is often referred to as 'expert decay', where someone with years of experience reaches the status of 'expert' in their career and then becomes complacent, not fostering further growth and development.

This is just as true in a team setup, which is why we regard the different levels of experience of the RE:CM team members as an asset. 'New' experts or team members with less experience guard us against becoming complacent. In this article we illustrate our willingness to take on discomfort and step through fear when making investment decisions, to the benefit of our clients. We specifically discuss two practical examples:

- how we invested in Old Mutual shares at a time when it was highly unpopular to do so; and
- how we are currently taking on discomfort by refusing to invest in what we see as an overvalued South African equity market.

**To grow, we need to overcome the fear associated with doing something new**

Can you remember the excitement and adrenaline of being a 'beginner' at something? Sit back for a minute, close your eyes and think back to the very first time you rode your bike without training wheels, flew a kite, went to school, swam without drowning, got up on a surfboard, strummed a guitar chord just right, your first kiss, accepted your first job, went travelling and got lost in

a foreign city, did your first presentation, got married, bought your first car or house, or became a parent. The list is endless.

Reflecting on all of these experiences, I recall my core emotions of fear and excitement; sometimes only one of them and sometimes both. But fear was the one emotion that was almost always present. With the benefit of hindsight, I can now add that it was usually a fear of the unknown. As the unknown became the known, my level of fear declined meaningfully, eventually disappearing altogether. For me, excitement tended to closely follow the fear, not the other way around. Each time I had to step through my fear to access my excitement and ultimately my personal growth.

The same principle applies to how we manage our career development. In this article we discuss this in the light of investing, focusing on two investment analysts in particular – an internationally renowned investment guru and one of our own highly talented team members.

**As we get older, we become conditioned and act according to our assumptions**

We sometimes forget how to step through fear. We get comfortable and conditioned from years of 'stick and carrot' reward systems that promote 'groupthink' and destroys individualism. 'Step in line or you'll get in trouble' begins to dominate our social behaviour. The pressures of providing for a family lowers your tolerance for career risk (the risk of getting fired). We become 'experienced' and we start to make assumptions and apply rule of thumb decisions instead of thinking for ourselves and questioning the current status quo with an open and ready mind.

### **Varying levels of experience in our investment team removes complacent thinking**

The RE:CM investment team consists of a group of very experienced people and a group of relatively less experienced people. This is good. In fact, it's great. We continually challenge the older generation to stay mentally fit by challenging their assumptions with data, and to set an example for the younger crew.

At RE:CM we are all 'beginners', regardless of how many years of experience we have. And we all hope to stay 'beginners', to avoid the trap of becoming a stagnating 'expert'...

### **Achieving 'expert' status has its downfalls and can lead to complacency**

For decades global company management philosophy has developed along the lines of 'experts' being people with 10,000 hours (which is approximately 10 years according to Malcolm Gladwell) of deliberate practice under their belt. This certainly holds some truth, but we have observed that something really stupid often kicks in after that: being pattern-entrained. This means people act, make decisions and deal with problems according to certain tried and tested patterns that they've learned through their years of experience. In an extreme version, this becomes complacency.

It works as follows: After someone achieves expert status, your inner mirror, or ego, is always ready and willing to take over. Suddenly a lot of their time is being demanded by non-productive tasks and it becomes easy to mislead others with short-sentence assumptions borrowed liberally from the first 10,000 banked hours of their career. As a result, an expert may not get much better at what they do between years 11 and 45 of their career!

We've all heard of writer's block. Similarly, we can call this 'experience block'. If an analyst is widely considered an 'expert' by colleagues, clients, media, family and friends, it can severely obstruct their personal long-term growth and development. The key word is of course 'can', as fortunately there's a lot that can be done to stop this from happening.

### **Deliberate practical exercise reduces your comfort zone and helps avoid trouble**

The length of time you can get away without exercising your craft depends on what kind of 'expert' you are. If for example your 'expertise'

relies on regular practice to stay sharp, like competing in a high performance sport or flying an aeroplane, you will be found wanting pretty quickly. On the other end of the scale, if you are an investment analyst, you may be able to get away with little deliberate practice for some time without anyone really noticing.

The modern work environment is filled with perfectly excusable distractions such as email, the internet, social networking and group meetings. This leads to one of the most painful things to witness in companies: experts firmly nestled in their comfort zones, appearing very busy and spending their days in endless meetings, but doing very little productive work. Eventually they get booted because they are not in the same trenches growing with the rest of the troops and are not respected anymore. As soon as the next hungry, growing individual has achieved expert status, the cycle begins again and the new expert may begin to decay.

This phenomenon intensified in Japan and much of the UK because of the 'salary man' concept where employees were only promoted when their boss died. Fortunately, this is slowly changing.

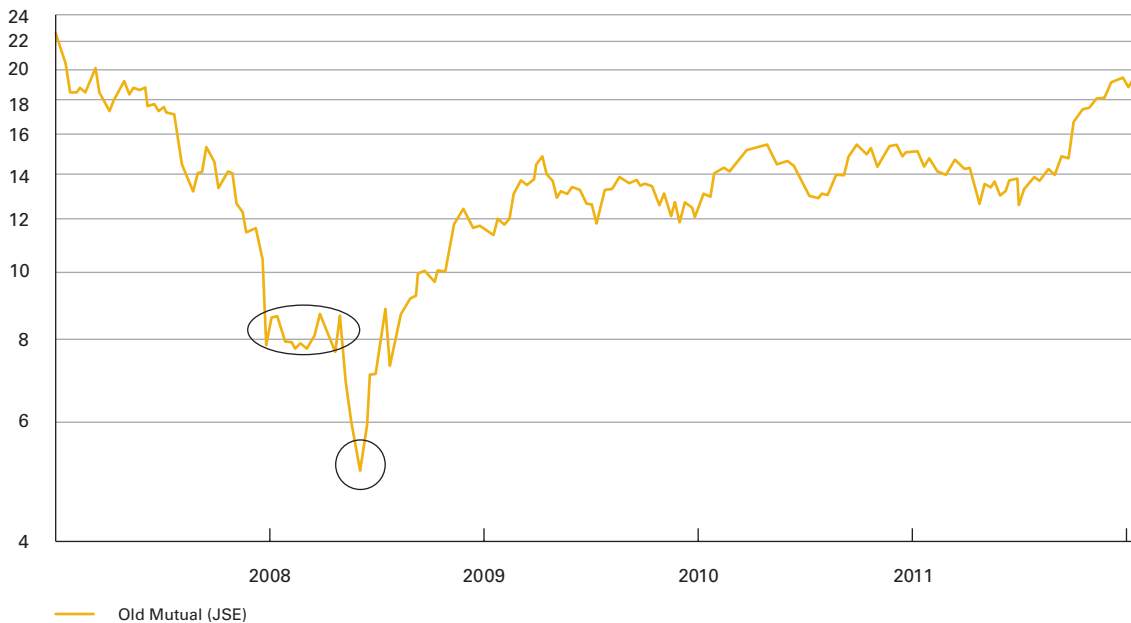
In the US, many leading businesses appear to be the undisputed world leaders in the art and science of firing large numbers of people. But what is remarkable is the ability of these same people to reinvent themselves after they get sacked. When they are forced to step through their fear and leave their comfort zones, sheer necessity and the need to pay the bills ignites creativity and reinvention.

### **Warren Buffett shows that continuous practice prevents the 'expert decay cycle'**

I'm no Buffettologist, but he built and runs one of the world's largest and most successful businesses from a small office with a telephone and a desk – in Omaha, Nebraska of all places. I've been in Omaha and all I can tell you is that it's very far from everything.

Mr Buffett's public investment research process appears to consist mainly of reading annual reports. The more he reads the more he thinks. The more he thinks, the more he learns and the better he gets at what he does. Once a year, he sends one letter, which is definitely worth a read, to his shareholders. If you read these chronologically you can get a good sense of his continued improvement over time. He also writes the occasional one-page letter to the New York Times every decade or so

Chart 1: Old Mutual Share Price from January 2008 to date



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Source: Thomson Reuters Datastream

when he feels he has something very interesting to share with the general public. Many books have been written about him, but he has never written a book himself (or rather, not one that's been published yet – maybe there's a post-mortem autobiography waiting somewhere in the wings?). I think it's because he's simply way too busy still trying to get better at what he does. He has done this consistently for over 60 years and I bet he probably still considers himself a 'beginner'. Yet, he's widely acclaimed as the world's most successful investor. This can't be a coincidence.

**You can stop or significantly slow down the 'expert decay cycle' with awareness**

When my colleague, Johannes Visser, started his research on Old Mutual in December 2008, it was one of the most disliked businesses in the South African and UK investor communities. Its management was heavily criticised for making consistently poor capital allocation decisions for over a decade. There was also a gaping black hole in their US life business. Old Mutual was generally considered impossible to analyse.

**Thorough research and facts can beat scepticism, as shown in Old Mutual's case**

Johannes ignored the noise, knuckled down and focused on the facts and doing the work. His colleagues routinely sent him back to the drawing

board to redo components of his analysis. Let's just say the level of internal disbelief was high, almost to the point of ridicule. He came back three times, each time strengthening his arguments with factual evidence and he eventually convinced his colleagues that Old Mutual is an investable business.

**After our portfolio managers bought Old Mutual shares, the share price halved**

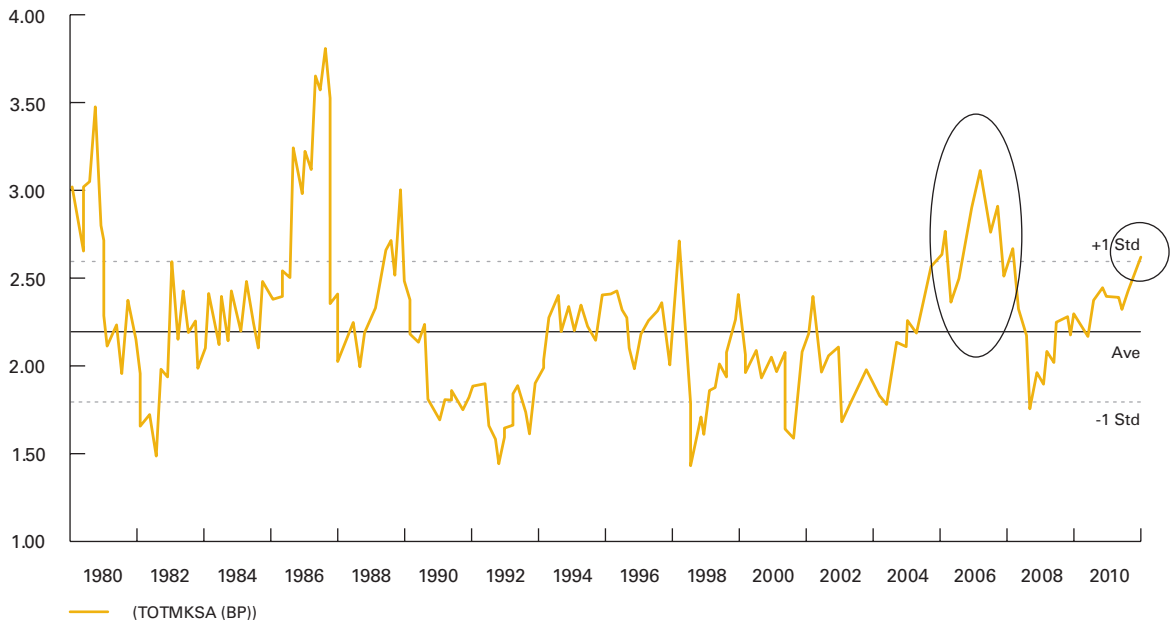
The portfolio managers first bought Old Mutual shares at around R8, only to be rewarded with a nearly 50% decline in the share price to nearly R4 as shown in Chart 1.

At this point some of our clients were rightfully asking the portfolio managers tough questions. As you can imagine the portfolio managers were, in turn, asking the analyst tough questions.

**Consistent focus and turning a deaf ear to the noise and distress paid off**

Johannes focused on his work, reviewed the facts and defended his views with enough conviction that the portfolio managers allocated more of our clients' capital to the idea. The mistake we made (with the obvious benefit of hindsight) was that there was so much distress in the air that we didn't buy nearly enough of the Old Mutual shares!

**Chart 2: Long-term Price-to-Book Multiple of the South African Market**



Source: Thomson Reuters Datastream

Johannes went even further and recommended an investment in euro-denominated Old Mutual senior credit securities yielding 26%, annualised to an 11-month maturity. This is one of the best, virtually risk-free return ideas I have seen in my career.

**Old Mutual's share price recovered and it has since been one of the top contributors to returns**

With the Old Mutual share price currently just below R20, it has been one of the top contributors to our clients' recent returns in domestic and global accounts. The Old Mutual management team is back in the headlines – this time for all the right reasons. Our portfolio managers have been reducing our Old Mutual exposure because the stock is no longer cheap or very unpopular. It may not be back in the 'loved' category yet, but we don't aim to dance this leg of the tango. The euro-denominated credit security matured and our clients got all their capital back, intact, for what we consider a virtually risk-free 26% per year return in a hard currency.

**This example of Old Mutual shows we're willing to take on discomfort and step through the fear**

My key point is that our clients pay us to take on discomfort in the form of internal and external ridicule. The levels of discomfort can be so high at times, that most people and businesses could not

stomach it. Chart 2 places a very tangible reality check on this.

**Our analysis shows that the South African market is overvalued**

Our numbers show that the South African equity market is overvalued, as we've been telling our clients for the past 18 months. We know from the experience of 2007 that a market that is overvalued by two standard deviations (the circle on the left in Chart 2) produces significant discomfort for all our stakeholders – our clients, our people and our business. When markets behave in this fashion, our funds will underperform. A word of caution: our clients would have good reason to be concerned about the safety of their capital if they ever see us outperforming in such an overvalued market environment.

**Similar to our experience in 2007, we underperform when the market is expensive**

Only four years later in March 2012 (the circle on the right in Chart 2), exactly as expected, we are in an already overvalued market that is getting more and more expensive. And as you might have guessed, we are underperforming this rising market. We will probably continue to underperform if the market continues to go up, and it may get much worse; just like it did in 2007. But underperforming

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an expensive market shows that we are staying true to our value investing philosophy.

**We don't know when markets will be fairly priced again, but our clients' savings are already positioned for this outcome**

What we do know from studying over 100 years of market history is that it's simply a matter of time before markets are fairly priced again. And this is very likely to be well before we are all drawing our last breaths. We also know that our clients' savings are already well-positioned for when markets begin to approach real world business values again. Knowing that we are consistently doing the right thing for our clients gives us a good night's sleep, despite the discomforts of underperforming in the short term and being ridiculed.

**Always be willing to learn, and be aware of the danger of assumptions**

All of us at RE:CM know that the true path to learning lies in stepping through fear and focusing on deliberate practice. The cycle of learning will never end. We are acutely aware of the risks of assumptions and biases, particularly those made by experts.

Here's to being a 'beginner' for the rest of our lives and in all walks of life; riding our fears like a skeleton horse going through the gates of hell.

*P.S: Johannes didn't pay me to write this piece, but he might buy me a cup of coffee or two in the future...*

Daniel Malan

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# The Goose that Laid the Platinum Egg

‘A mine is a hole in the ground owned by a liar.’

Mark Twain

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‘With prices the way they are everyone is drilling frantically. It's no El Dorado, but certainly there will be projects that will be viable.’

Tony Reilly, Corporate Affairs Director at Lonmin, 27 November 2002

Global demand for platinum has increased since the 1960s and 1970s mainly because of its uses in the industrial sector. South Africa is a major platinum supplier and the reserve base is controlled by three major local platinum mining companies, with limited new entrants. Although long-term historic returns have been good for these companies, returns remain cyclical because the demand for platinum is quite price sensitive. In addition, there are currently many negative sentiments attached to the local mining sector.

In this article we give an overview of the platinum mining industry, focusing on the significant role of South Africa's platinum sector as a major global supplier and the challenges our industry faces. We specifically investigate:

- historic patterns of platinum demand and supply and how these interact;
- the nature of the local platinum mining industry and the impact of this on pricing and output;
- the underperformance of the local industry relative to the market; and
- the current valuations of the South African industry and what this means for investors.

## The modern history of platinum only began in the 18th century

Platinum is generally mined with six other precious metals that occur in the same ore body and share similar physical and chemical qualities. These include palladium (Pd), rhodium (Rh) and other relatively insignificant metals.

During the 16th century, it was believed that platina (a diminutive of plata or silver) had no value except as a means of counterfeiting silver coins.

In 1924, the geologist Hans Merensky discovered two platinum deposits of around 100km in length. Together these deposits became known as the

Bushveld Igneous Complex of South Africa and produce three quarters of the world's platinum supply. Separately, the two reefs were known as the Merensky reef and the UG2 reef. The Merensky reef was first mined in 1926 and today has more than 12 operating mines. The UG2 ores were first mined in the 1980's. Platinum recovery remains difficult in the UG2 reef compared to the high payload of the Merensky reef.

## 1. Demand

### In the 1970s the automotive, jewellery and industrial sectors made platinum useful

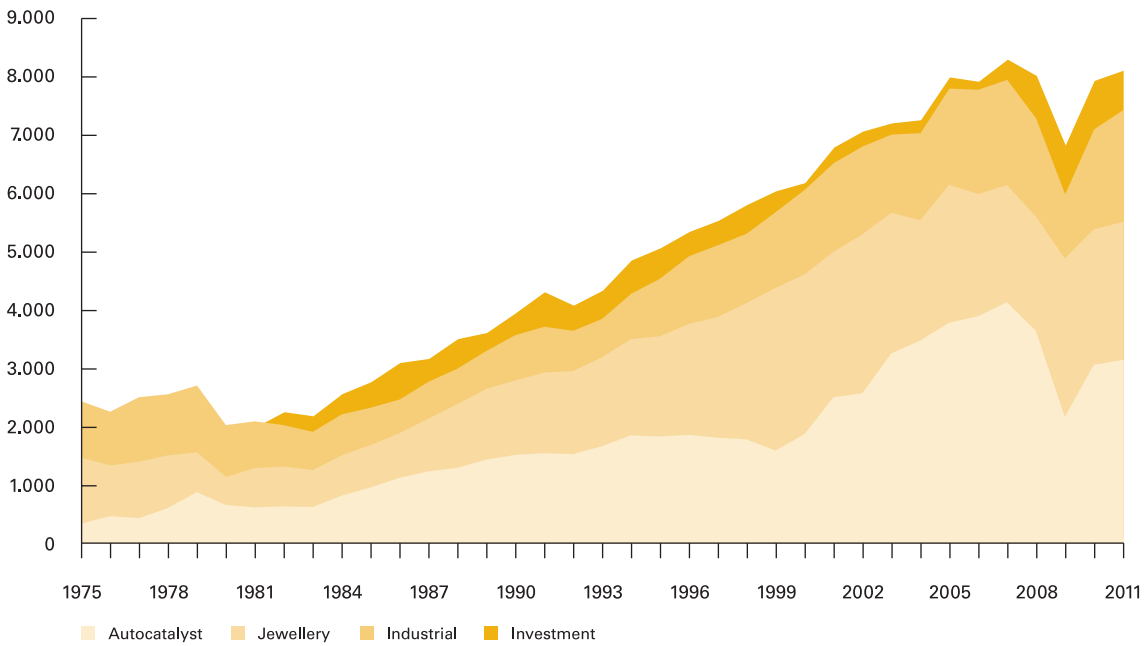
Demand for platinum started increasing in the 1960s and 1970s when it was used predominately for jewellery in Japan, Europe and China. In 1974 new regulations for air quality led to the invention of the autocatalyst, which requires platinum, palladium or rhodium. The autocatalyst market has grown substantially over the past 40 years. The majority of the demand for platinum still stems from the automotive sector (40%) followed by jewellery (30%) and other industrial uses (25%).

### The demand for platinum has slowed due to declining vehicle production

Chart 1 plots platinum demand by use since 1975. Platinum demand has grown at a compound annual growth rate (CAGR) of 3.2% per year, mainly driven by the global demand for autocatalysts (6.2% CAGR). The CAGR of the industrial and jewellery segments of the market has been approximately 2% since 1975. The amount of platinum used for investment purposes is still very small compared to other precious metals such as gold.

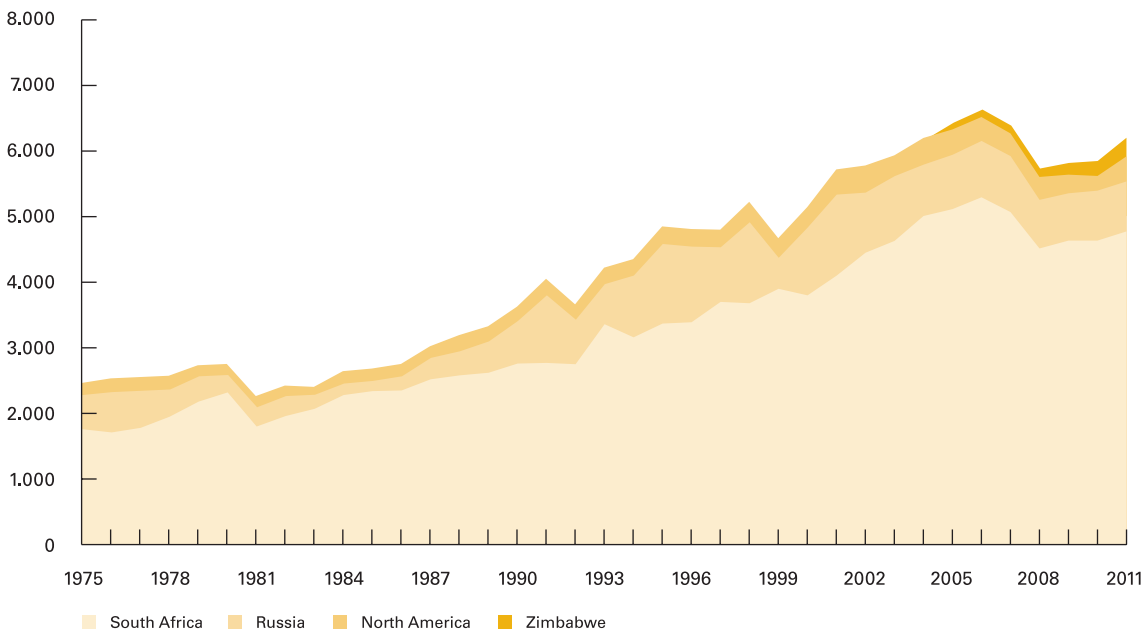
During the past five years, the demand for platinum slowed to a CAGR of 0.5%. The main cause is declining vehicle production in the developed world. However, emerging markets are

**Chart 1: Historic Platinum Demand by Use**



Sources: Johnson Matthey, RE:CM analyst

**Chart 2: Historic Platinum Supply by Geographical Region**



Sources: Johnson Matthey, RE:CM analyst

slowly consuming more platinum and the demand for autocatalysts in these markets has grown. But emerging market demand is still relatively insignificant compared to the demand from markets such as Europe, the US and Japan.

Demand for jewellery is very price sensitive as consumers substitute gold and platinum. China – and its powerful consumers – is a prominent role player in this segment and is expected to continue growing. In volume terms, Europe consumes 28%

of global platinum production followed by China (26%), the US (15%) and Japan (12%).

## 2. Supply

### South Africa is a major player in global platinum production, but supply has been declining

Chart 2 plots platinum production since 1975. The South African platinum mining industry's output grew consistently until 2006 when supply was reduced because of safety stoppages, strikes and the steady decline of older shafts. This resulted in local platinum supply reducing at a CAGR of 2% since 2006, while the demand for platinum has grown at 0.5% per year over the same period.

### Zimbabwe and Russia, the other significant suppliers, will struggle to meet demand

Russia's platinum supply reached a peak in 1998. With the fall of communism, Russia was able to sell off platinum stockpiles that had come about as a 'byproduct' from mining palladium. These reserves have slowly diminished and Russia's share of global platinum supply has declined since the late 1990s.

Zimbabwe is a relatively new supplier and has about 5% market share. Their production is

expected to grow but the investment landscape remains extremely uncertain.

North America's platinum supply continues to grow, but with a share of only 5.6% of global supply, they are unable to meet the market's needs.

### The recycling industry is the fastest growing platinum supplier

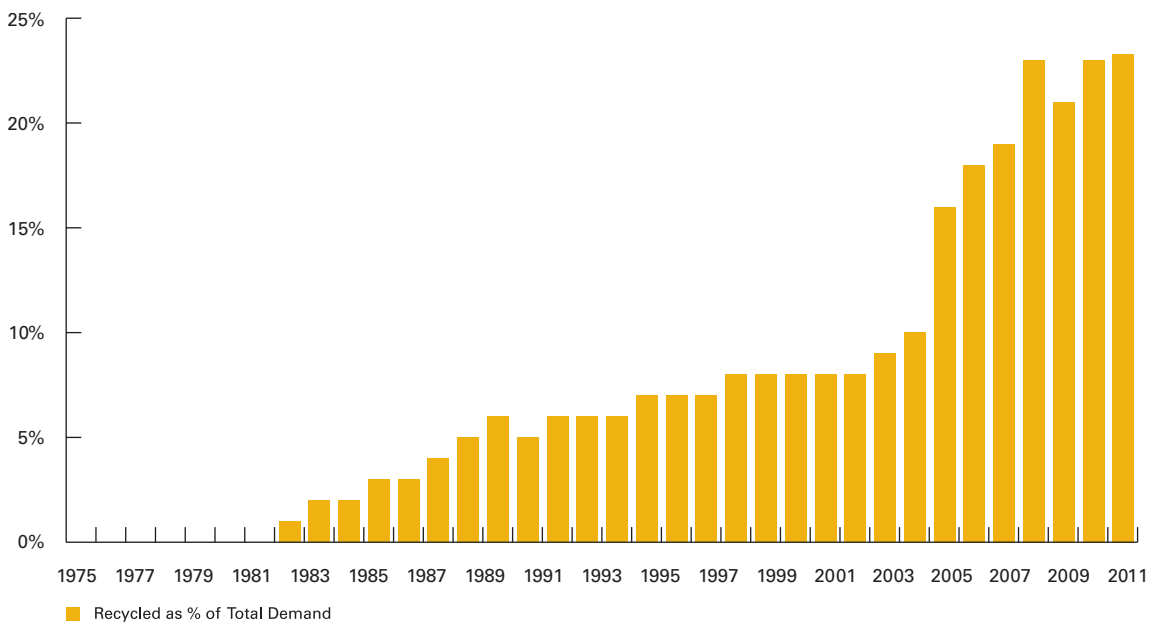
When it comes to supply by industry, the platinum supplier that has grown the fastest over the past 35 years is – interestingly enough – the recycling industry. It continues to gain market share against the primary producers. Currently 23% of all platinum is recycled, mainly from the collection and smelting of autocatalysts and industrial equipment. These recycling companies have become more efficient in tracking products containing platinum, and with stricter environmental recycling laws in developed countries we expect these companies to gain further market share.

### The growth in the recycling industry supply is likely to continue, bringing prices down

In the current low growth environment, the high recycling rate of platinum is negative for the platinum price as any new demand is fulfilled

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**Chart 3: Platinum Recycling as a Percentage of Total Demand**



Sources: Johnson Matthey, RE:CM analyst

by recycled material. Chart 3 plots the growth in platinum recycling since 1975.

**The nature of platinum demand and supply affects the price over the long term**

Platinum is an industrial metal with many uses and demand and supply will significantly impact prices over the long term. This is different to gold, where pricing is mainly driven by investment sentiment (fear).

**3. Platinum mining in South Africa**

**South Africa produces 80% of the world's platinum (excluding recycling)**

South Africa's market share of global platinum production has remained consistent since 1975 at between 70% and 80% (excluding recycling). The relative market share of the three largest producers has also remained stable over the last decade with over 90% share of South African production.

**The oligopoly of the South African platinum industry has limited new entrants**

The South African Platinum Group Metals (PGM) industry is dominated by three companies, namely:

- Anglo Platinum,
- Impala Platinum, and
- Lonmin.

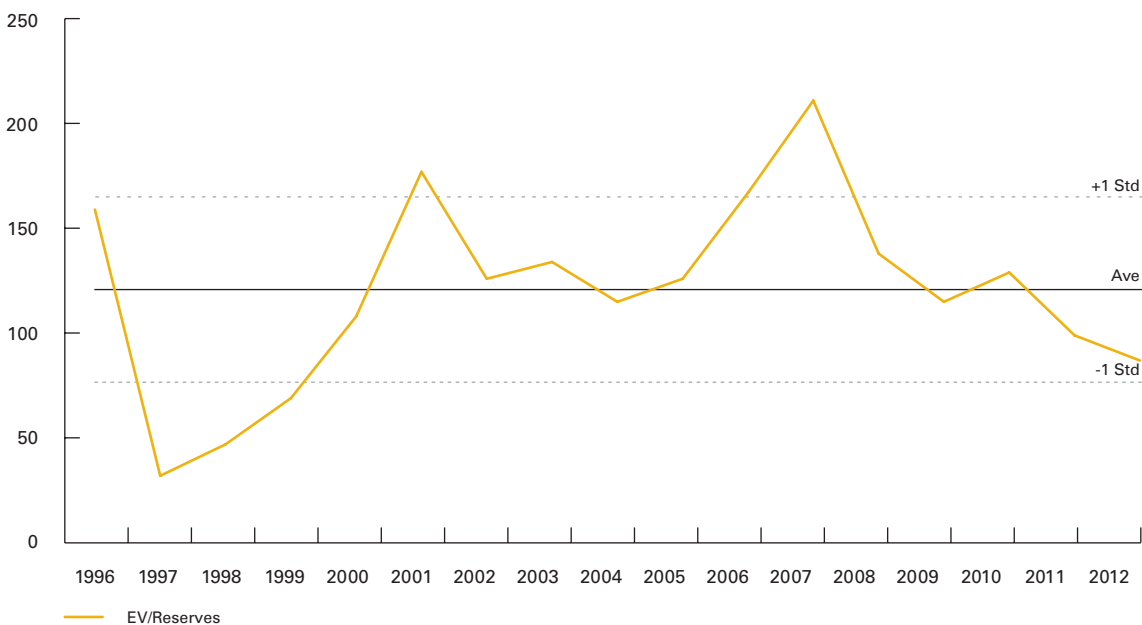
Anglo Platinum has 50% market share and is the largest local producer, followed by Impala with 29% and Lonmin with 16%. These three companies are the only fully integrated platinum producers in Southern Africa. They control the entire process from mining, processing and refining, to sales and marketing.

Overall, there are only 22 operating platinum suppliers in Southern Africa. No new significant player has entered the market in the last 30 years. Over the past few years however, mining legislation has changed to encourage the creation of BEE miners. This resulted in new companies such as Royal Bafokeng Platinum (RB Plats) and other smaller players entering the market on the Eastern Limb of the Bushveld Complex.

**Mining costs are fairly consistent across the different mining companies**

The breakdown of PGM extraction costs has remained fairly consistent over time with mining at 65%-75% of total costs followed by processing (9%-12%), refining (11%-12%), and smelting (6%). The cost breakdown is very similar across the

**Chart 4: Historic Enterprise Value/Reserve ounce for Anglo Platinum**



Sources: Anglo Platinum, RE:CM analyst

industry and cost increases are a problem for the entire industry. There doesn't seem to be a sustainable cost advantage as market shares have remained so consistent over the past few decades. There will however be specific mines that generate better economic returns over time due to better ore bodies and leaner cost structures. It is debatable whether these advantages will remain due to different strategic mining plans undertaken by the three dominant players.

**Major mining companies have focused on increasing output, which is detrimental to better returns**

As an investor you would think that this oligopoly would focus on maximising economic profits. This is not necessarily the case. These large players have not actively reduced output to meet slowing demand – in fact, most have plans to increase output! As shareholders become more critical of returns, this situation may however change in the near future.

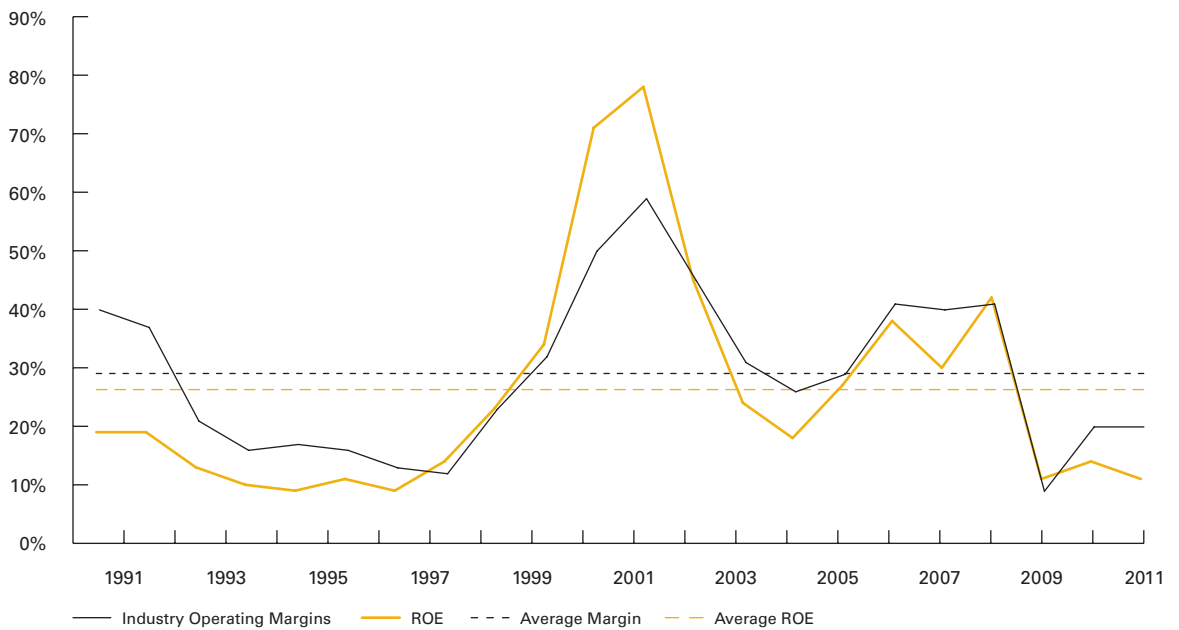
Local platinum producers have a long history of dealing with considerable issues relating to safety stoppages and industrial action. Due to the concentration of platinum supply, platinum miners should have more pricing power and generate better economic returns than miners of other commodities. However, this is currently not the

case as each company tries to increase output in a weak market. In addition, there are more junior miners in the industry due to the 'use it or lose it' recommendation of the Department of Resources when it comes to new order mining rights.

**The three largest producers control more than 80% of known Southern African platinum reserves**

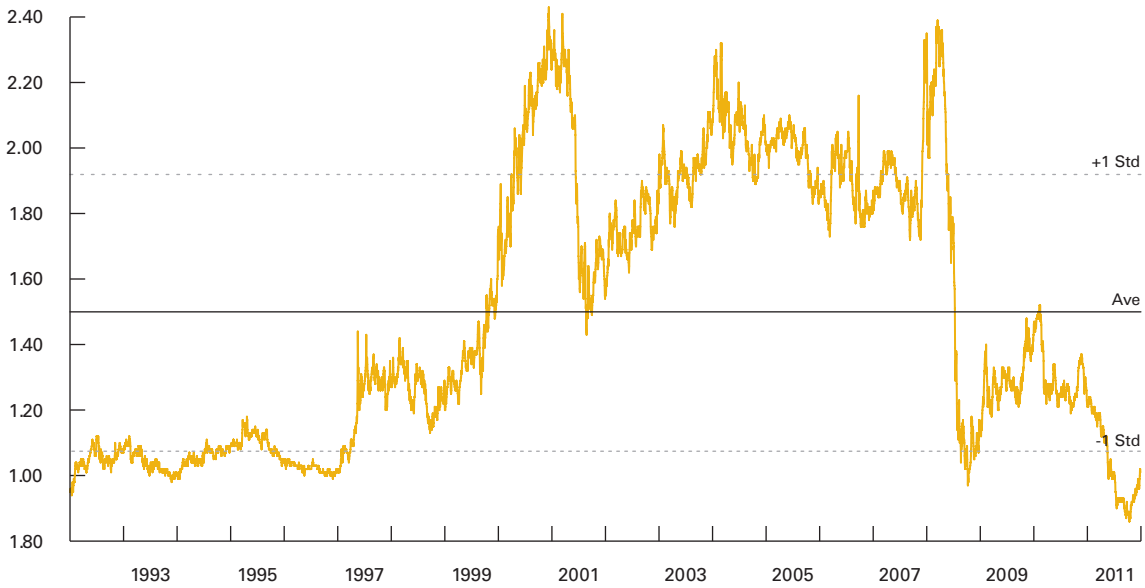
Anglo Platinum has the most extensive reserve base followed by Impala and Lonmin. This entrenches their dominant position well into the future. The best way to illustrate what has happened to the reserve base and the valuation of the platinum companies is to follow Enterprise Value per Reserve (EV/Reserve) ounce over time. Chart 4 plots Anglo Platinum's EV/Reserve ounce and shows how it has de-rated over the past four years, while the reserve base has remained stable. Negative sentiment about demand has caused the decline in EV/Reserve ounce, compared to 2006/2007 when the market was overly optimistic. While we do not know if or when platinum demand will recover to historic levels, we do believe it is likely to happen over the long run, as global auto sales will grow as emerging markets continue to grow and environmental restrictions are enhanced.

**Chart 5: Historic Returns of the South African Platinum Industry**



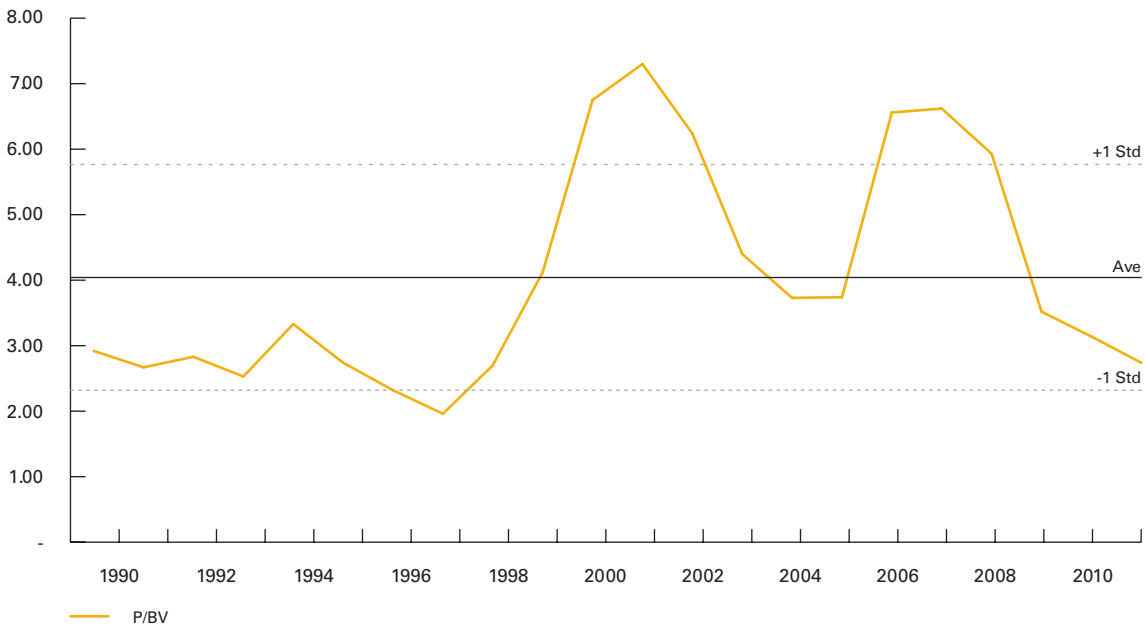
Source: RE:CM analyst

**Chart 6: Platinum Price (US\$) per Ounce Versus Gold Price (US\$) per Ounce**



Source: Datastream

**Chart 7: Historic P/B Value of the South African Platinum Industry**

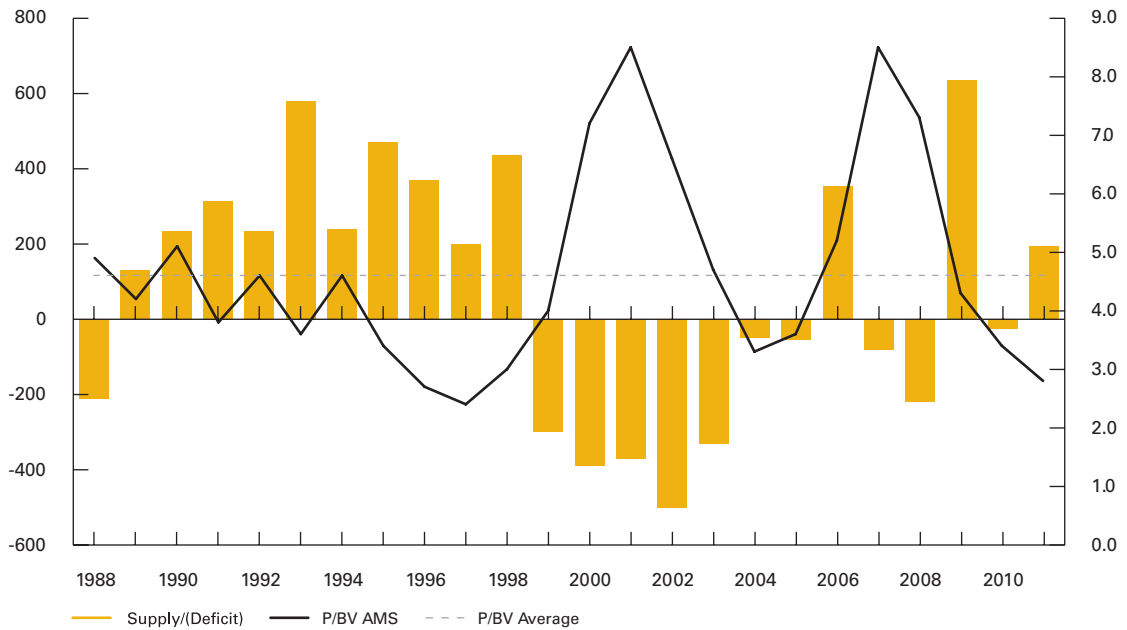


Source: RE:CM analyst

**4. Performance of the local platinum mining industry**

**Although platinum industry returns have been cyclical, they have been significantly above the cost of capital**

South African platinum industry returns over the past 15 years have been cyclical as the market moves between oversupplied and deficit positions. Chart 5 plots the historic return on equity (ROE) and operating margins for the industry, using Anglo Platinum, Impala and Lonmin as representative of the industry at large. Average ROE for the industry

**Chart 8: Historic Platinum Demand/Supply and Anglo Platinum's P/B Value**

Sources: Johnson Matthey, RE:CM analyst

since 1990 is 29%, well above the long-term cost of equity of 14%. Average long-term operating margins are 30%, as opposed to the current margins of 20% that are well below normal.

#### **Exchange rates and the prices of other platinum group metals are the main drivers of high returns**

The rand/US dollar exchange rate is an important driver of returns since the majority of platinum refined in South Africa is exported. The other important driver of profitability is the price reached for the other platinum group metals extracted from the process, namely palladium and rhodium. These metals are used in similar industries and the price volatility over the years has been extreme. Rhodium moved from \$1,000/oz to \$10,000/oz and back again in just nine years. The higher the prices for palladium and rhodium the better the returns for the industry as these metals are refined from the platinum refining process at an insignificant cost.

It's impossible to forecast metal prices and exchange rates, but in order to understand the normal earnings power of platinum mines we have made two assumptions. Firstly, we assumed a slightly weaker currency in line with our fundamental view that the rand is overvalued. Secondly, we assumed platinum prices equal to the marginal cost of production for an ounce of platinum. Using these assumptions and further

assuming mean reversion of the industry's margins, we believe that the local platinum producers are undervalued.

#### **Over the past five years the platinum sector has underperformed the market**

The platinum sector has underperformed the FTSE/JSE All Share Index notably over the past five years. During this time the press often reported on a bull market in metal prices, particularly precious metals. This is clearly not the case for platinum. Platinum has in fact underperformed the CRB Metals Index and is now at a 20-year low versus gold. It is therefore reasonable to assume that platinum is not part of any commodity boom but rather trading close to the marginal cost of production for the South African industry.

#### **5. Valuation of the local platinum industry**

##### **The three largest platinum producers are trading at their cheapest levels since 1997**

Chart 7 plots the average long-term price-to-book (P/B) value of the three largest platinum producers. The P/B value for the industry is currently at 2.2 times, compared to the long-term average of 4 times. This is almost one standard deviation below the 21-year average. If you invested in the sector during 1997 – the last time the P/B value was 2, your annualised return over the next five years would

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have been 38%. In 1997 the market was concerned about the emerging market meltdown and for this reason sentiment and demand forecasts became overly pessimistic. Currently the market has similar negative sentiment towards the developed world.

**The current oversupply of platinum should lead to industry consolidation, reduced production and higher prices**

Chart 8 plots Anglo Platinum's P/B value and the global supply and/or deficit of platinum since 1988. The periods of outperformance by Anglo Platinum are correlated to global platinum deficits in 1999-2005 and again in 2007-2008. Currently the market is oversupplied, resulting in a lower platinum price and below normal profitability for the industry.

At these current low prices platinum producers should not increase output due to payback periods of several years on new mines. This should result in constrained supply in the years to come and demand growth should slowly reduce the oversupplied position. There is currently very little incentive for new entrants to the platinum industry

due to the extended payback periods, which is positive for the current producers. There hasn't been closures or consolidation in the industry yet, and this may be the next step before the industry recovers. Time will tell.

**South African platinum producers provide a compelling investment opportunity at current valuations**

The largest risks the industry faces is that platinum is substituted by other commodities and that autocatalysts are not used in vehicles. The current economic climate and mining issues such as the recent strikes have also resulted in negative market sentiment and reduced profitability. As often happens, bad news creates opportunities for the patient investor, and at current valuations we believe the South African platinum producers provide a compelling investment opportunity.

Paul Whitburn

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# The Risks Associated with Money Market Investing

‘To make money, you will have to take risks, even if it’s just your time on the line. The key to risk-taking is knowledge.’

**Stuart Wilde**

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‘I learned to embrace risk, as long as it was well thought out and, in a worst-case scenario, I’d still land on my feet.’

**Eli Broad**

‘When everyone feels that risks are at their minimum, over-confidence can take over and elementary precautions start to get watered down.’

**Ian Macfarlane**

Money market investments are considered to be a low-risk investment asset class compared to equities, bonds and property. This is because its main constituents – cash, bank deposits and short-term debt instruments – are perceived to be relatively low risk in nature. However, this does not mean these investments are risk free.

In this article we discuss the nature of the risks associated with money market investing and how we deal with these. We specifically:

- define the different types of money market investments risks, namely reinvestment risk, counterparty risk, instrument risk, and liquidity risk;
- explain how we at RE:CM manage these risks; and
- explain how we focus on preserving our clients’ capital while offering them liquidity and ensuring they earn a low-risk income.

## 1. Reinvestment risk

**Reinvestment risk is the risk of investing maturing funds at a lower interest rate and getting a lower yield than on the maturing investment**

Conversely, money market funds tend to benefit from an ‘interest rate opportunity’ when interest rates increase. The South African Reserve Bank through the Monetary Policy Committee (MPC) has the sole responsibility of managing monetary policy by raising or lowering short-term interest rates. The MPC periodically decides on the level of short-term interest rates based mainly on inflation. If inflation is rising, the MPC will raise short-term

rates and vice versa. Although inflation has been rising in the past year the MPC has kept interest rates unchanged. This has affected interest rate expectations, resulting in uncertainty and volatility in short-term interest rates. To money market fund managers, the task of managing reinvestment risk can be cumbersome if short-term interest rates are highly volatile.

**We do our own economic and yield curve analysis to manage interest rate risk**

To manage reinvestment risk, we do our own economic analysis combined with interest rate or yield-curve analysis. We aim to take advantage of low reinvestment risk opportunities presented by the yield curve, even in times of uncertainty. We do this by investing in short-dated instruments when the yield curve is flat, or lengthening our duration when the yield-curve is steep. A steep yield curve means longer-dated deposits offer higher yields than short-dated deposits. Our discipline is focused on allocating capital where money market instruments offer value relative to our base-case interest rate scenario. We are not yield seekers but value seekers. Focusing on value enables us to manage reinvestment risk even when there is volatility in the market.

## 2. Counterparty risk

**Counterparty risk is the risk of the borrower not making payments as promised**

Counterparty risk (credit risk) is the risk that the counterparty or issuer of the debt will fail to fulfil its obligations to pay the borrowed amount or the promised interest amount. The banks and

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corporates that issue deposits and commercial paper are examples of money market fund counterparties. Counterparties with poor or weak balance sheets pose a high risk to money market assets when they default on their borrowed funds.

During the global financial crisis in 2008, foreign money market funds lost capital because of counterparty defaults. The reason for this was that there was a lack of liquidity in the global money market space. Banks and corporates that depended on short-term funding were exposed to a funding or liquidity crisis, resulting in multiple counterparty defaults. This funding crisis led to a systemic risk in the global financial market. The lesson from this is that understanding and managing counterparty risk is vital to avoid capital losses.

**We manage counterparty risk by investing only in counterparties with strong balance sheets**

Our money market fund only invests in counterparties with strong balance sheets, such as the big four banks (Absa, Nedbank, First National Bank and Standard Bank), National Treasury and the South African Reserve Bank. We don't simply take comfort in allocating capital to the big banks or only rely on the 'too big to fail' belief. Instead, we analyse their prudential liquidity requirements as required by the Reserve Bank. We do this to identify banks that are facing potential liquidity pressure before it becomes a liquidity or credit event in the market.

Even though poor quality counterparties generally pay higher yields, we generally avoid them. Our goal is to generate steady interest income at low risk rather than the highest possible income. Managing counterparty risk exposure will remain a cornerstone of our capital allocation on a continuous basis.

**3. Instrument risk**

**Instrument risk is the risk that is specific to a particular debt instrument**

Instrument risk arises when a particular money market instrument does not perform as promised due to adverse events in the market. These events could include the counterparty defaulting on its commitments or the underlying credit risk of the instrument (or counterparty) increasing dramatically.

Deposit or short-term debt instruments is the source of income yield for money market funds. Money market instruments comprise a variety of instruments, including plain fixed deposits, tradable certificates of deposit, treasury bills, asset-backed securities and commercial paper. These instruments have different risk characteristics, depending on the issuer and term.

Treasury bills and bank deposits have the least risk due to security in the capital structure and the quality of the issuer. On the other hand commercial paper borrowers and asset-backed issuers have been known to fail.

Although money market instruments are typically a source of income yield in an investor's portfolio, it is important to balance yield and risk and to know the nature of the underlying instruments. Managers that seek higher yields could be lured into investing in high-yielding unsecured instruments where the yield does not compensate for the risk.

**We manage instrument risk by investing in high quality money market instruments like bank deposits**

RE:CM's mantra is 'Your capital first' and this is core to our investment process. The RE:CM Money Market Fund only invests in high quality money market instruments like bank deposits, which offer capital safety, albeit at slightly lower yields. We focus on investing in deposits that we understand and avoid instruments that offer limited security such as poor quality commercial paper or asset-backed securities.

**4. Liquidity risk**

**Liquidity risk is the risk of being unable to sell an asset at the desired time or at fair value**

Liquidity risk arises when a money market fund experiences unexpected large cash outflows and is forced to sell because it has insufficient liquid assets to fund the outflows.

During the global financial crisis investors in asset-backed securities and commercial paper lost capital because these instruments were sold at a discount to their face value as investors in funds sought immediate liquidity. Generally money market instruments such as fixed deposits or asset-backed securities are not easily tradable in the secondary market. Selling illiquid instruments before their maturity usually results in an

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additional cost to the fund, which reduces the fund's income. The poor tradability means that a fund should have limited exposure to instruments that are unsecured so as to avoid becoming a forced seller.

**We manage liquidity risk by maintaining 5% exposure in overnight deposits**

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One of our key objectives in setting up the Fund was to offer liquidity to our clients. Liquidity determines our duration exposure across the money market yield curve. We maintain a minimum liquidity level of 5% exposure in overnight deposits. Additionally the step-up deposits (in which the fund is significantly invested) offer us the opportunity to liquidate every one or three months at no cost when we need the cash.

**Our priority is to preserve your capital and offer you liquidity while earning you an income at low risk**

Although the money market asset class generally preserves capital when compared to equities and

bonds, it is important that investors are familiar with the risks of investing in this asset class. At RE:CM our priority is to preserve capital, offer liquidity and then generate incremental income at the lowest risk possible. It is not our objective to generate high yields by investing in risky counterparties and dubious instruments. With every decision we make when we allocate clients' assets, we carefully consider our ability to manage reinvestment risk, counterparty risk, instrument risk and liquidity risks. Ultimately, we believe that to be better at managing these risks we should be consistent and disciplined when we invest in low-risk income opportunities.

Thompson Ganyeka

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# Emerging Markets versus Developed Markets: Where We See Value

'For equity investors, this growth looks cheap. Emerging market price/earnings multiples are 9.8 times forecast 2012 earnings, a 30% discount to the average and a discount to developed-world equities, on 11.5 times.

Moreover, with developed world central banks still pumping liquidity to stimulate economies, there is plenty of cash. Despite recent inflows into emerging market funds, volumes have been modest compared with 2011 outflows. The MSCI Emerging Market Index is still about 15% short of last year's spring peak. The bulls see plenty of headroom in the market.'

**Excerpt from the article 'Slide fails to derail emerging market bulls', published on the Financial Times website, 7 March 2012.**

At RE:CM we have been fairly vocal about our preference for developed over emerging market stocks. This might not seem like the obvious choice: Emerging markets have outperformed developed markets for more than a decade. This outperformance has been driven by significant re-ratings and growth in earnings power.

- the inflow of capital into emerging markets will eventually erode the superior returns on capital currently being achieved in emerging markets;
- in calculating a high level fair value for emerging markets compared to developed markets, it is not clear that a P/B premium is justified.

We believe that book and price-to-book (P/B) values give a better indication of long-term value and prices than earnings-based measures. With this belief as background, in this article we explain why the fairly high P/B ratios in emerging markets are not justified by arguing that:

(Please note that we will focus on macro arguments in this article. As bottom-up stock pickers, macro issues do not typically determine how we construct portfolios. But in this instance a macro perspective best allows us to illustrate our point.)

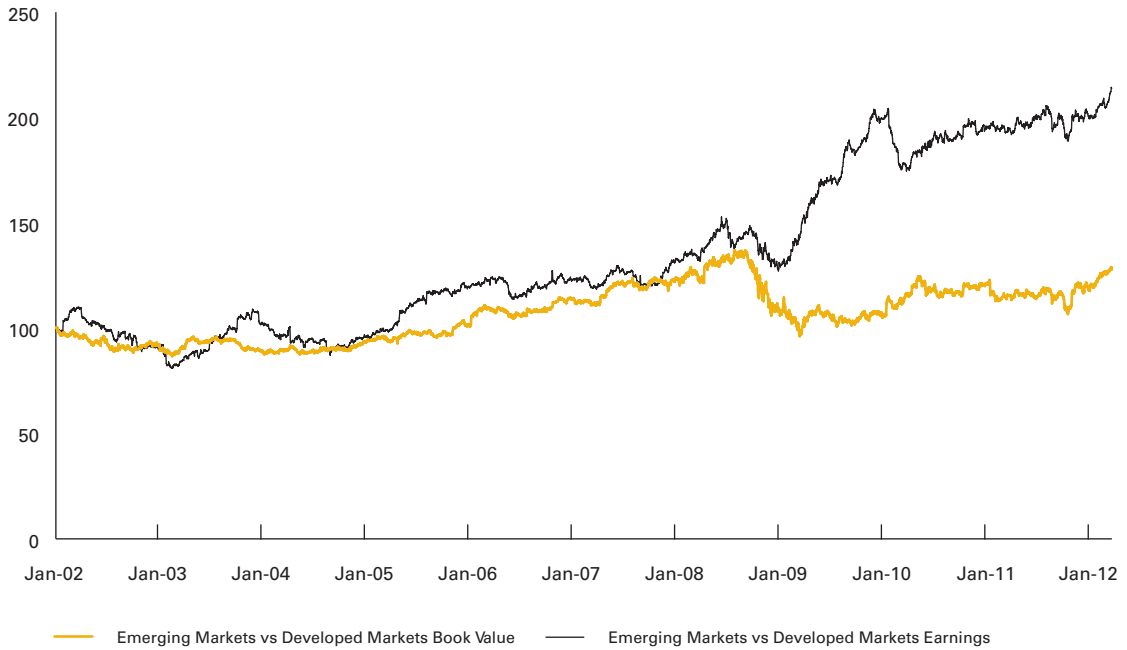
**Chart 1: MSCI Emerging Markets Index vs MSCI World Index. (1987 - 2011)\***



\*January 2002 = 100

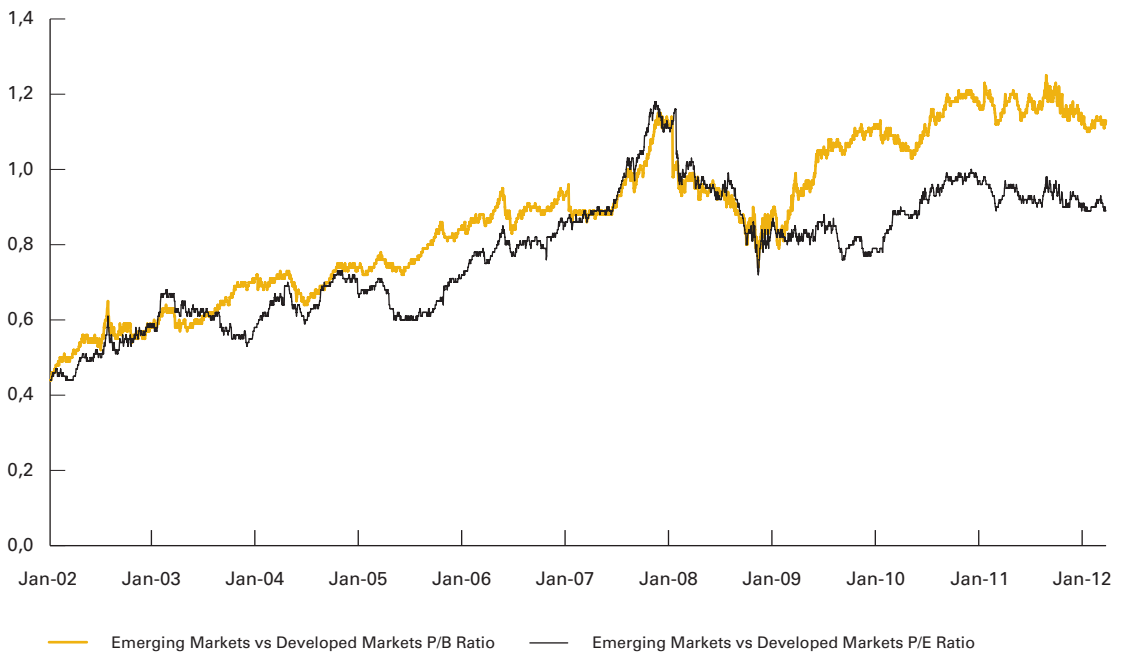
Sources: Thomson Reuters Datastream, RE:CM analyst

**Chart 2: Book Value and Earnings – Emerging Markets vs Developed Markets (2002 - 2012)**



Sources: Thomson Reuters Datastream, RE:CM analyst

**Chart 3: P/B and P/E ratios – Emerging Markets vs Developed Markets (2002 - 2012)**

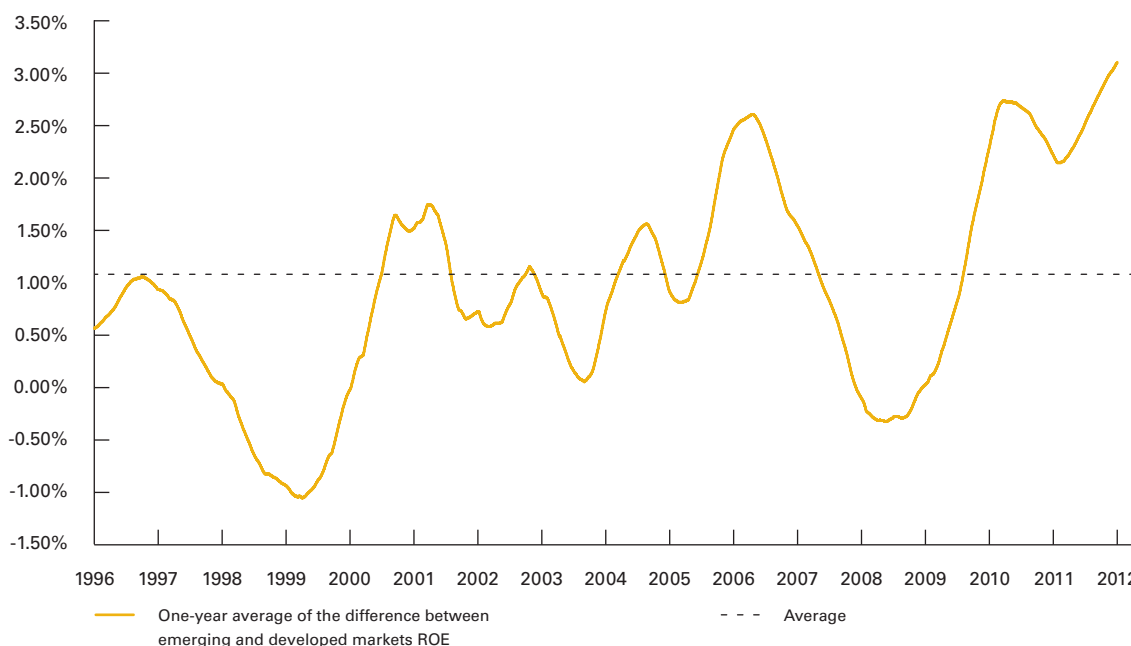


Sources: Thomson Reuters Datastream, RE:CM analyst

**Emerging market outperformance has been a function of a material re-rating and superior book value and earnings growth**

Emerging market equity indices have outperformed developed market indices by a wide margin since the turn of the century. Chart 1 shows the price performance of the MSCI Emerging Markets Index

Chart 4: ROE – Emerging Markets vs Developed Markets (1996 - 2012)



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Sources: Thomson Reuters Datastream, RE:CM analyst

compared to the MSCI World Index since inception of the Emerging Markets Index. The dramatic outperformance since the late 1990s and early 2000s is clear.

This outperformance has been driven by superior growth in earnings power (whether measured by book value or earnings), and by a major re-rating of emerging market stock indices relative to developed market indices. Chart 2 shows the superior growth achieved by emerging markets. The superior earnings growth since the 2008/2009 global recession is particularly notable.

Chart 3 shows the effect of emerging markets' re-ratings relative to developed markets, on both a price-to-book value (P/B) and price-to-earnings (P/E) ratio basis.

**Returns on equity have only been slightly higher in emerging markets than in developed markets**

Charts 2 and 3 illustrate how re-rating has been as important as earnings growth when assessing emerging markets' superior returns from an earnings and P/E point of view. When it comes to book value and P/B value, the P/B re-rating has actually had a bigger impact than the superior book value growth.

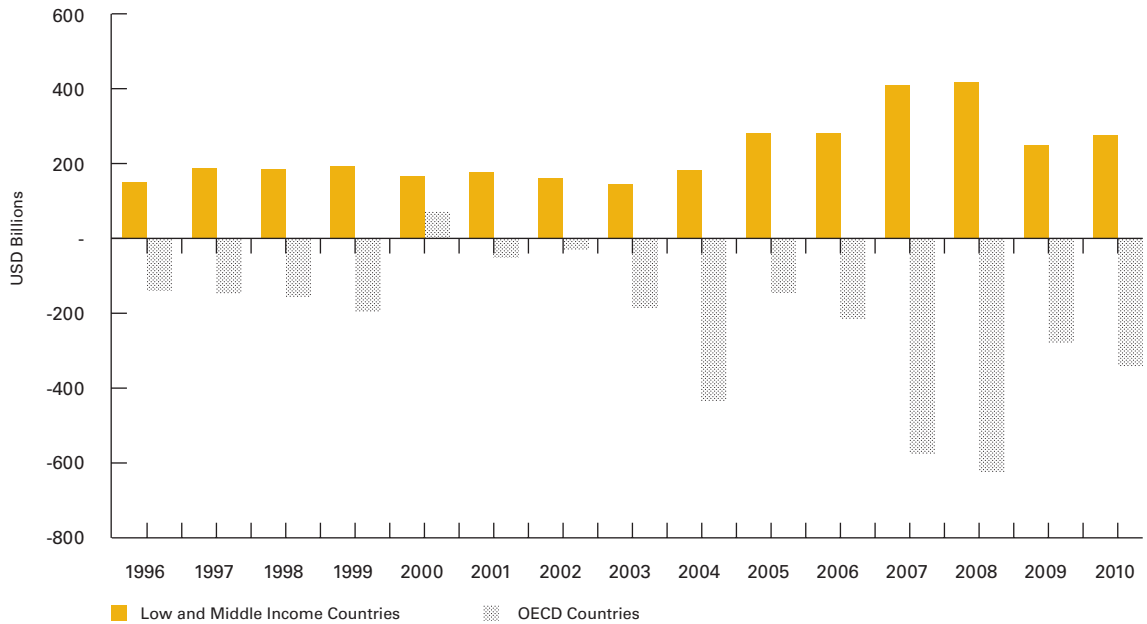
This discrepancy is interesting because it highlights the substantial increase in returns on equity (ROE) in emerging markets since 2002. Earnings have grown relatively faster than book values in emerging markets compared to developed markets. Chart 4 shows the difference in ROE between emerging and developed markets.

Note that the ROE for emerging stock markets has on average only been about 1.0% higher than the ROE for developed markets since 1996 (where our available data starts). Since 2002, the difference has been about 1.4%, and since the onset of the 2008 recession, the gap has opened up significantly to more than 3.0%.

**In theory, there shouldn't be a vast difference in P/B values between markets**

When we try to draw conclusions about markets, we prefer to look at matters from a book value perspective. In our experience, book values and P/B values give a better indication of long-term value and price levels for markets as a whole than earnings-based measures. Chart 3 clearly showed that since the early part of 2009, emerging markets have traded at a P/B ratio premium compared to developed markets. We believe these high ratios are not justified, for the following reasons.

**Chart 5: Inflation-adjusted Net FDI – Low and Middle Income Countries vs OECD Countries (1996 - 2010)**



Sources: Thomson Reuters Datastream, RE:CM analyst

**1. Over the long term, risk-adjusted returns on capital between markets should not diverge widely**

Theoretically there is no reason why a dollar invested in a developed market should be worth more or less than a dollar invested in an emerging market. Please note that the emerging market indices we have used for the charts in this article are all calculated in US dollars. Investors will be indifferent about where to invest if the risk-adjusted returns are the same from investments in emerging and developed markets respectively. If the risk-adjusted returns are different, capital will tend to flow to the superior destination, which will erode the superior returns over time. A clear discrepancy in prospective risk-adjusted returns should therefore not last for a very long time.

The statistics show that capital has been flowing into emerging markets at a rapid rate. This should drive down the superior returns on capital (and equity) enjoyed in emerging markets over the past decade (as was shown in Chart 4). Chart 5 shows inflation-adjusted net foreign direct investment (FDI) into Low and Middle Income Countries (as per the World Bank classifications) on the one hand, and Organisation for Economic Co-operation and Development (OECD) countries on the other hand, both since 1996.

Note the dramatic increase in FDI in low and middle income countries since 2005, which is more or less when emerging markets’ ROE started increasing meaningfully above that of developed markets.

**2. P/B value should be viewed in a fair value context to determine whether a premium is justified**

The mathematics also does not necessarily favour emerging markets when one does a high level fair value calculation for emerging and developed markets. The following equation can be used to calculate the fair value of an asset (or index in this case) from its book value:

$$\text{Fair value} = \text{Book value} \times \frac{\text{Return on equity} - \text{Growth}}{\text{Cost of equity} - \text{Growth}}$$

Given a constant cost of equity, it is clear that a market generating a higher return on equity and faster growth is worth a higher multiple of book value. Besides the 1.0% - 1.5% higher return on equity achieved by emerging markets over time, trend earnings growth since 1996 in emerging markets has been about 2.5% faster than in developed markets (Thomson Reuters Datastream, RE:CM analyst). But note that growth only adds value if the ROE is higher than the cost of equity. We are sceptical of the sustainability of the current historically large spread between ROE in emerging

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markets compared to developed markets. The capital flows shown in Chart 5 should drive that spread down.

If we consider the longer-term 1.0%-1.5% spread to be more reflective of a sustainable level, and assume that emerging markets will continue to grow earnings about 2.5% faster than developed markets, the question that will determine empirically whether emerging markets should trade at a P/B premium to developed markets is simply whether cost of equity differences between emerging and developed markets offset the better growth and returns achieved in emerging markets. The dynamics of the fair value equation above is such that a cost of equity difference of about 2% will fully offset the growth and return advantages enjoyed by emerging markets.

There is unfortunately no definitive answer to the question of what the cost of equity differential is between developed and emerging markets. But our assessment is that a 2% equity risk premium for emerging markets above that of developed markets is easily justifiable. While political risk and matters like the security of property rights have certainly vastly improved in most emerging markets over the last decade, expropriation of assets, super-taxes and capital controls still occur more often in emerging markets than developed markets. These all increase investment risk, and hence warrant an increased required rate of ROE.

We must however mention that with the uncertain state of most developed market government finances, matters like capital controls and interference in property rights (as in the most recent alteration to the terms of Greek government debt) may well become more common in developed markets in future.

**We believe the most stable, long-term value still lies in developed markets**

We don't believe the P/B premium that emerging markets currently enjoy over developed markets is justifiable. We are finding attractive value in high quality businesses in developed markets, and will not be lured into emerging markets just because (or especially because) they are currently top of mind for most investors and capital allocators globally.

Wilhelm Hertzog

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