

“An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative”

- Benjamin Graham and David Dodd, Security Analysis, 1934

This quote from the seminal book on investing recently came to mind as we observed what was going on in US markets. Bond yields were at thirty year lows. So low, that the government was able to borrow money for thirty years at rates barely above 3%. Everyone has their own opinion on the quality of the US government, but personally, I would not lend them money at such ridiculously low rates! Neither would Graham and Dodd, as 3% most definitely does not imply a satisfactory return.

In the US equity market, those old culprits, the internet stocks, are leading the pack again. The following table illustrates their performance and current valuation:

	<b>Historic P/E</b>	<b>2004 earnings P/E</b>	<b>Price change ytd</b>
eBay Inc	114	54	67%
InterActive Corp	N/A	41	82%
Yahoo! Inc	111	65	97%
Amazon.com Inc	N/A	58	105%
Expedia Inc	157	51	141%
E*TRADE Group Inc	33	17	114%
WebMD Corp	N/A	19	42%
<b>Total Index</b>	<b>4878</b>	<b>47</b>	<b>89%</b>

(N/A does not mean the information is not available – it means the company has no earnings on which to calculate the P/E ratio)

These nosebleed valuations are not the sort of stuff that promise safety of principal – we learnt that in 2000. Yet the US market continues to throw money at them. Graham and Dodd would have called this “a speculative operation”. As an aside, if this is a new bull market in US equities, then it would be the first time that the leaders of the previous bull market (internet stocks in the “new economy” bull market) lead out the market in the next one. Even in SA this does not happen – the small companies leadership in the “new SA” bull market, gave way to leadership by the resource stocks post the market crash of 1998.

So, it looks like the US market is caught up in a speculative environment, according to Graham and Dodd. With this background, we remain cautious on

the short term outlook for SA assets, as our market exhibits a very high short term correlation with the US market.

Longer term, the market is not expensive, although one needs to exercise some restraint after the run-up in equity prices during the past couple of months. To see how valuations have changed, the following table is quite illustrative:

<b>P/E ratios</b>	<b>January 2002</b>	<b>March 2003</b>	<b>July 2003</b>
Anglo American	20	8	10
Billiton	22	13	17
Richemont	19	7	12
SA Breweries	19	9	10
Standard Bank	10	7	9
Tiger brands	10	7	9
Edgars	10	9	13
Pick 'n Pay	16	13	15
Sappi	15	8	11
<b>Market</b>	<b>14</b>	<b>8</b>	<b>10</b>

Overall, a market P/E of 10 cannot be considered outrageously expensive, but neither can it be considered crushingly cheap. In March, valuations were much more attractive, but prices have run up by 20%, on average, since then.

Just as cyclical tech stocks are leading the way in the US, it seems as if the cyclical resource shares in SA want to lead the market up. As mentioned before, we are not sure if resource shares, which are basically yesterday's heroes, will lead out a new bull market.

This belief stems from our fundamental bottom up work, which shows that most resource stocks are still discounting a somewhat weaker rand. Two things can happen: either the Rand does weaken as everyone expects, and resource stocks are correctly priced, or the Rand stays at current levels (or even strengthens further!), and resource stocks decline sharply. These are not odds that favour the investor: a speculator might want to take on such risk, but not an investor. He would rather wait until he is being paid for the risk of something going wrong, and only then commit to buying such assets.

Our funds remain very much exposed to industrial counters, with limited exposure to resource stocks. We are not investing with the speculators.