RE:CM

_REGARDING CAPITAL MANAGEMENT

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2005: INVESTMENT OUTLOOK

"The task of man is not to see what lies dimly in the future, but to do what lies clearly at hand"
- Thomas Carlyle

"I never think of the future, it comes soon enough"
- Albert Einstein

At this time of year, analysts are always asked about their "outlook for the market". Very much like the moth that cannot resist the allure of the candle – and invariably with not dissimilar end results – analysts fire up their crystal balls and proclaim to all who will listen, and even to those who won't, what their opinion is on the "outlook for the market".

Needless to say, at RE:CM we take a somewhat different approach. We prefer to evaluate the existing pricing of assets, and try to figure out if this allows for inflation beating returns going forward. In addition, we take into account conditions in the market, some of which give strong clues as to expected returns. Such "market conditions" would include demand and supply considerations, consensus positioning as well as irrational actions by company management and/or our colleagues in the fund management industry.

Starting with **equities**, we expect the broad equity market to deliver no more than pedestrian returns from current pricing levels. In fact, we think an investor in an equity index fund would be lucky to get 2% real returns over the next 10 years. This is <u>not</u> a forecast, it is an expectation based on three very simple (and easily observable) facts of life – no crystal balls needed. These are:

1. The current P/E of the market is 15.5 – against a long term (40 year) average of 11.4

2. The current dividend yield of the market is a paltry 2.6%. Historically, dividends have made up by far the bulk of real returns from the equity market. If you start with a yield of 2.6%, you aren't exactly staring high real returns in the face! And by complete mathematical coincidence, the PE reversion back to normalised levels almost exactly negates the gains you would make from dividends over the next 10 years.

3. The remaining contributor to long term returns is earnings growth. Over the long term earnings growth (and, by implication, dividend growth) from the market has been around 2% above inflation. As an aside, this has huge relevance for all those company managers who think they are entitled to option allocations, which pay out huge sums because of arbitrary share price movements over short periods. In the aggregate, management's contribution to growing the earnings base of corporate SA has mattered far less than whatever the inflation rate happened to be. It is very clear that most remuneration committees have not grasped this very basic fact.

Without boring you with the math, the return from the market over the long term consists of the starting dividend yield, plus annual earnings growth, plus (or minus) the effects of a change in the P/E ratio over

the measurement period. Assuming the P/E ratio declines to its long term average over the next 10 years, it can very easily be shown that returns over that period will be quite low – in the region of 2% real.

With **bonds**, it is much easier to determine what prospective returns are – it tells you on the label. If you buy a bond at a yield of 7,5% your return expectations should be centered on that number! Bonds do not grow their coupon, nor does their par value increase over time. What you see is what you get, and if you have substantially different expectations (allowing for some luck in terms of potentially trading in and out of the market), well, there's a bridge in London for sale at a good price!

So, in both the equity and bond markets, we can very simply observe that prospective returns will be on the low side. No forecasts needed. Of course, the above analysis only obtains over the long run – in the short run anything can happen. Often enough, shorter term returns are determined by market conditions. One of the things we look at is the demand for, and supply of, equity assets. It's all in Economics 101 – increase the supply and the price drops (and vice versa), increase the demand, and the price increases (and vice versa). The equity market works like any other market – despite the best efforts of the corporate banking and fund management communities to convince investors otherwise.

The corporate market is the driver on the supply side – when prices for equity assets (as evidenced in share prices) are high, the corporate sector becomes willing to sell. Most often, this takes the form of new listings. This increases the supply of stocks in general, which over time drives down the price of these assets. When equity prices are low, corporates tend to buy these companies – and delist them. These actions tend to reduce the supply of stock. Over time, this works to increase the price of these assets.

The demand side for equity assets normally comes from institutional investors, as well as private and foreign investors. Currently, local institutions are reasonably fully invested, but both private investors as well as international investors are very, very underweight.

Another clue about the "condition of the market" can be gleaned from irrational actions by either the corporate sector or fund managers. When corporates buy other companies at prices which make no sense at all, using their own equity as currency, it can be seen as a sign of an overvalued market. Normally these transactions are rationalised on the basis of vague "synergies" or "competitive pressures" Most of them destroy value, and should encourage investors to minimise their exposure to the market. Another class of irrational action is when fund management companies launch new funds, based on some sort of theme or sector. Generally, this only happens when the sector or asset in question has enjoyed a tremendous run, and has already become massively overvalued. Most fund management companies like nothing more than taking their clients money and sticking it in the latest fad. When it doesn't work, they easily absolve themselves of all blame by saying that everyone else was doing it, so it must have been the right thing! Just think back to small companies' funds, financial sector funds, technology funds and offshore funds.

The only new funds that have been launched over the past few years have been so-called absolute return funds. No surprises for guessing that these funds were all launched roughly at the bottom of the equity market. As usual, the only beneficiaries were the fund management companies that charged high fees for investments that promised bond-like returns. As usual, their clients came off second best.

Based on this evidence, we think the equity market still has some upside, as investors who were mis-sold these funds, as well as over cautious investors still hiding in money market funds try to get back into an asset class that offers (offered?) some upside. In the meantime, we are sad to report that the fund management industry has not yet latched onto a new fad. This would help us immeasurably in deciding what to avoid with our clients' money going forward. We look forward to the next spate of fund launches, and warn our clients to steer well clear of whatever new fad is on offer.

This combination of a lack of supply of stock from the corporate sector, a private and foreign sector that still have a very low exposure to SA equities, as well as a fund management industry that has not yet started marketing the next big rip-off, describes a market condition that is very sanguine. Here at RE:CM this gives us some comfort that equity prices are not yet high enough to warrant an excessive amount of caution. Of course, there are a number of risk factors that can be identified as presenting some form of clear and present danger for the market. Then again, this has been true at any particular point in time in history. We tend to disregard these (unless they are very obvious, and very obviously not priced into the market) and focus on the long term outcome.

There is one course of action that is always worth considering – and that is increasing the amount of quality assets in your portfolio. The market is currently pricing low-quality (or risky) assets at very generous prices. This can be seen in the spread of South African bonds (a risky asset – lest we ever forget 1998!) over US treasuries (a much less risky asset). This spread is at all time lows, as can be seen in chart 1.

In addition, the PE ratio (or the price of earnings) of the South African market has reverted back to it's mean level relative to the US market, as represented by the S+P500 index. After a wonderful buying period for SA equities in the 1999 to 2003 period, these opportunities no longer exist. (see chart 2)

If two assets are priced at similar levels, but one is of much higher quality than the other, it is always a useful rule of thumb to buy the higher quality asset. In this regard, we are "doing what lies clearly at hand" for our clients – increasing the quality in the portfolio, and steadily moving some money offshore.

Chart 1: The difference between local bond yields and US bond yields (yield spread):

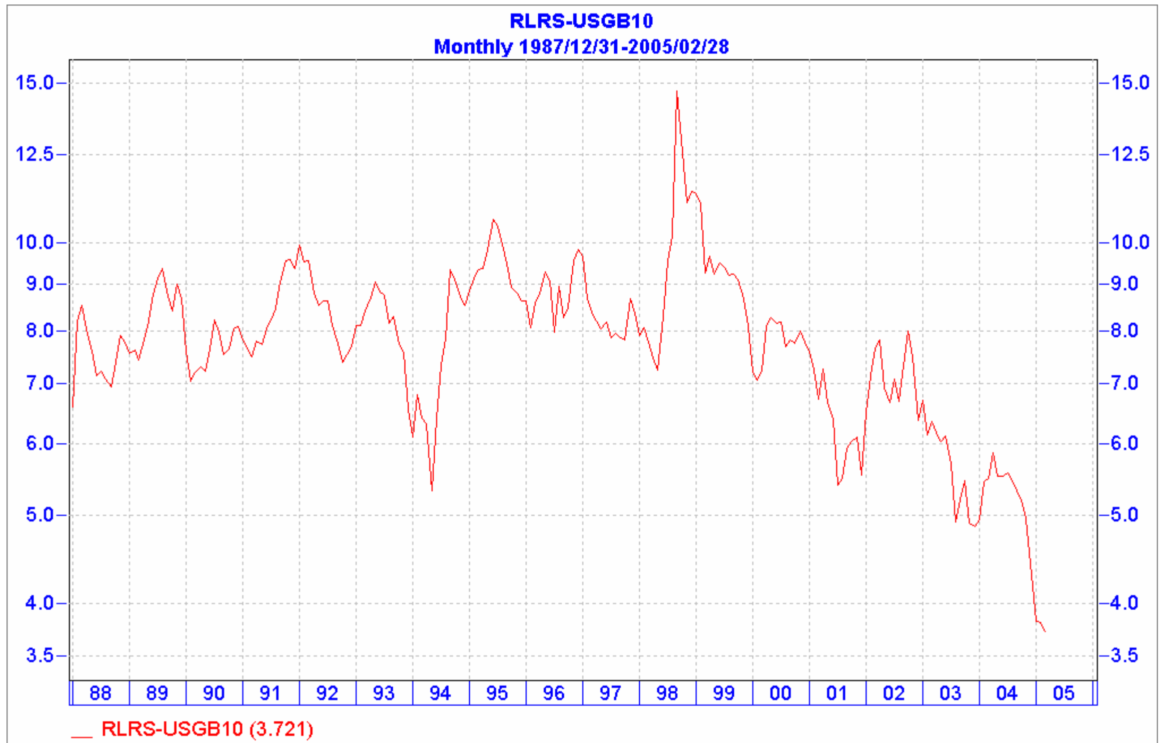
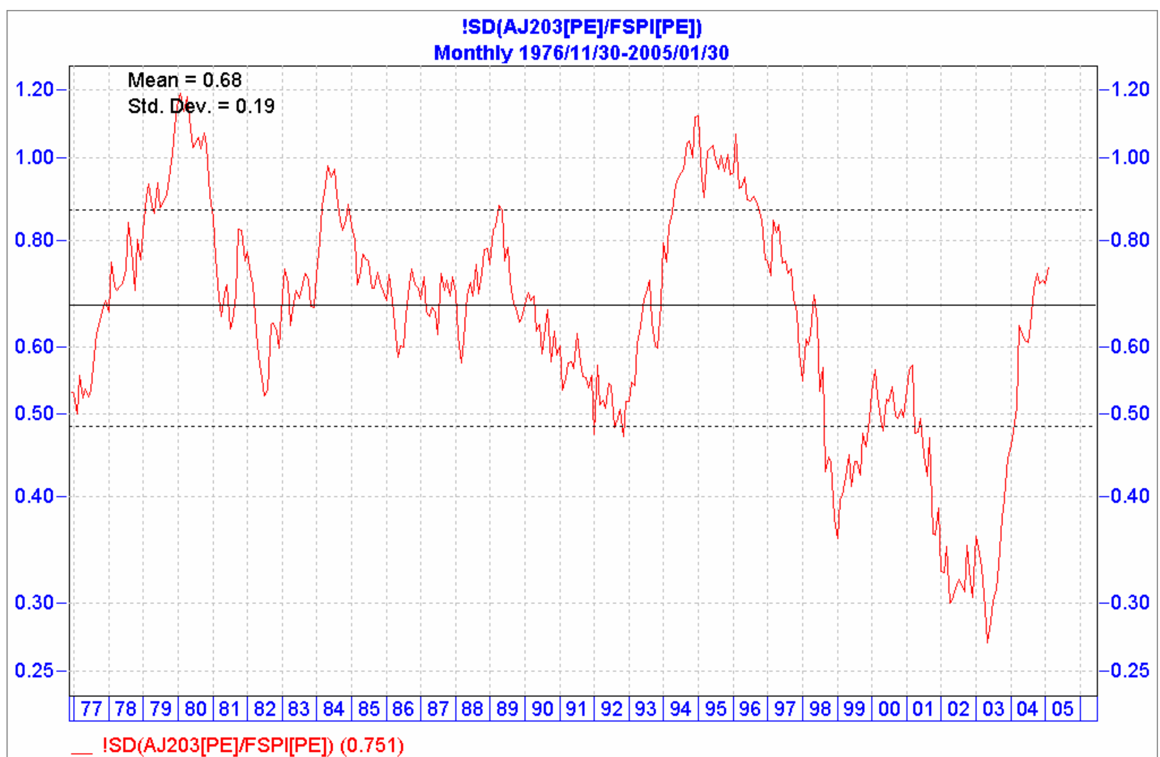


Chart 2: JSE P/E ratio relative to S+P500 P/E ratio



In summary, we are of the opinion that 2005 holds in store a lot of surprises – both negative and positive. We just don't know what they will be, or how they will affect market prices. In fact it will not be unlike most other years in this regard! Long term investors should ignore these periodic bouts of volatility, and focus on the long term: valuations are fair, not extreme, market conditions are fairly benign and there are still some good investment opportunities – albeit a lot fewer than 18 months ago.

For our part, we will continue to manage your money with an eye on doing what is obvious in the present time, with very little regard for what the market experts are forecasting for the "distant future". This is something we have been doing consistently now for a long time, and we see no reason to change how we do things. We continuously prepare for the worst, and hope for the best. This is our response to a world with limited outstanding investment opportunities. In addition, distortions caused by the index trackers, cloud the picture even further. One can only live in the hope that these lazy and irrational investors will have to answer for their actions one day!

In the meantime, we will continue to expend all out effort on searching out the good, low risk opportunities for our clients.

From all of us here at RE:CM, we hope you have a great year both financially and otherwise!

Piet Viljoen **February 2005**