

# RE·VIEW

Portfolio and Investment Insights - Volume 15  
January 2011

RE·CM



## **TABLE OF CONTENTS**

INTRODUCTION	2
TABLE OF RETURNS	4
PERFORMANCE AND PORTFOLIO REVIEW	
RE·CM GLOBAL FUND	5
RE·CM GLOBAL FLEXIBLE FUND	8
RE·CM FLEXIBLE EQUITY FUND	11
RE·CM AUSTRALIA EQUITY FUND	14
INVESTMENT INSIGHTS	
SOUTH AFRICA JOINS THE BRIC'S – A BUY SIGNAL?	16
IS THIS A DIVIDEND WHICH I SEE BEFORE ME?	21
PRICE ABERRATIONS IN GLOBAL CEMENT	24
THE ADVANTAGE OF PERMANENT CAPITAL: LOOKING WHERE OTHERS ARE NOT	32

## INTRODUCTION

Dear Fellow Investor

Charlie Munger once said “the key to living a happy life is to keep your expectations low. In this way, you will receive many positive surprises.” At RE·CM, we adhere to this philosophy. Our expectations of the returns that can be earned by buying common stocks and other financial assets are always tempered by a good dose of reality. Between a company’s earnings power and the dividends an investor receive stand a good many agents, all of which are jockeying for a bigger slice of the pie. It starts with the labour force, which is continuously negotiating for better employment conditions, suppliers and customers who want a better deal, company management, which often dilute shareholders – sometimes excessively – with remuneration schemes that have arbitrary outcomes, the government, which continuously come up with new taxes (overtly or covertly) to fund their expenses. And last, but not least, the various fiduciary agents, from brokers through investment bankers to fund managers, are also in the queue.

It should come as no surprise then that long-term returns for markets as a whole are much lower than one would guess. Over the past 110 years, stocks have returned about 6% p.a. in real terms in the USA, while in South Africa returns have been slightly higher at 7% p.a.. This translates to roughly 8% to 12% in nominal terms. Unsurprisingly, the bulk of these returns have come from dividends and their reinvestment. So with dividend yields testing all-time lows in most markets globally – sub 2% in most cases - we think one’s expectations should be set accordingly. And this is exactly how our funds are now positioned – conservatively, with low expectations of future returns, positioned to take advantage of the inevitability of more attractive pricing in the not too distant future.

Last quarter we pointed out how our positioning was different from the consensus, and that has continued through this quarter. As share prices have moved ever higher, our funds are becoming even more conservatively positioned. Relative returns (see table overleaf) over the most recent six month period bear this out. While we have made money for you, we have made less than the indices against which we are measured. Which brings us back to the touchstone of successful fund management: The winner is not the one that makes the most when markets are going up, it is the one who loses the least when markets go down. Our investment process is based on this, and the results we have achieved over the past eight years bear this out. Returns since inception for all the funds we manage are very good, despite the market’s volatility over that period.

With markets’ expectations being ratcheted up to new highs during the period under review, leaving us with few attractive investment ideas, we have continued to do two things: Invest in the talent available to our clients in the form of investment professionals, and uncover promising new investment ideas – most of which will only bear fruit when prices are more reasonable. Over the past six months, our investment team has added six new analysts, and we have added three people to our operations team. RE·CM now employs 32 people, all of them working very hard on your behalf.

We have also added a few new ideas to our funds. You can read about the actions we have taken in the different funds we manage on your behalf in the next section of this RE·VIEW. I would particularly like to point out the addition of a new fund, the RE·CM Australia Equity Fund, managed out of Sydney by my colleague Christopher Boehmke with some input from both Daniel Malan (our Investments Director) and myself. Although the fund has only been going for nine months, the returns to date have been gratifying, both on an absolute and a relative basis. The fund is suitable for any client wishing to invest in the Australian market. It uses the same philosophy and process as all our other funds (in fact, Chris worked with us here in Cape Town for three years before moving to Sydney).

In the next section, we include four articles by our team of analysts. As an aside, the internal competition to get published in the RE·VIEW has been getting quite intense, with the addition of so many bright new minds to our investment team. It was not an easy job to settle on these four. You will also note that, for the first time, we have started to attribute the articles to specific analysts. (Many clients had been laboring under the impression that I was the sole author of all articles in previous RE·VIEW’s! Of course, nothing could be further from the truth).

In the first article, “South Africa joined the BRIC’s – a Buy Signal” I write (yes, I do actually write some of the articles!) about emerging markets and the investment implications of South Africa joining the BRIC grouping of eminent emerging markets. This is very positive for sentiment; less so for prospective investment returns. Not because joining the BRIC grouping is per se a bad thing for investors, but because of the high expectations that are built into current equity prices. In the second article “Is This a Dividend I See Before Me?” Chris Boehmke explains some of the false logic behind the payment of dividends in Australia. Sometimes cash in your hand is not really worth its face value!

Johannes Visser expands on the quality and valuation of cement companies globally in the third article, entitled “Price Aberrations in Global Cement”. He also talks about one of our newest investment ideas in the RE·CM Global Fund.

In the last article, one of our newer analysts, Faure Heymans, expands on the advantages of having permanent capital to manage – an advantage which the company that listed last year, RECM & Calibre, enjoys. This is essentially a follow up article to the one we published in the April 2010 edition of RE·VIEW, which was titled “The Value of Permanence”. Of course, RE·CM manages the listed investments on behalf of this company, and Faure gives a good example of the type of opportunity to which RE·CM & Calibre is in the process of allocating capital.

We hope all of our clients have a very good 2011, and, as always, good investing!

Piet Viljoen  
Chairman, RE·CM

**TABLE OF RETURNS**

For the period ended 31 December 2010

**TOTAL RETURNS OF RE·CM FUNDS** (annualised after fees %)\*

Fund	Inception	6 Months**	1 Year	3 Years	Since Inception
RE·CM Global Flexible Fund (ZAR)	Apr-03	8.0%	9.9%	7.2%	16.5%
CPI + 8% p.a (ZAR)		5.1%	11.6%	14.8%	13.7%
RE·CM Flexible Equity Fund (ZAR)	Mar-05	13.8%	17.6%	8.5%	19.4%
ALSI (ZAR)		24.0%	19.0%	6.5%	19.8%
RE·CM Global Fund (USD)	Mar-06	12.7%	8.7%	3.6%	4.9%
MSCI World (USD)		23.9%	12.0%	-4.4%	1.7%
RE·CM Global Feeder Fund (ZAR)	Mar-07	-5.0%	-3.3%	0.3%	-0.9%
MSCI World (ZAR)		6.9%	0.2%	-5.3%	-4.6%
RE·CM Australia Equity Fund (AUD)	Mar-10	7.9%	n/a	n/a	3.4%
ASX 300 (AUD)		13.3%	n/a	n/a	0.5%

**MAJOR MARKET RETURNS** (annualised, in US Dollars %)

Index	6 Months**	1 Year	3 Years	5 Years
S&P 500	22.0%	12.8%	-5.0%	0.1%
FTSE 100	25.0%	5.2%	-10.4%	-1.0%
Nikkei 225	18.1%	9.6%	-2.7%	-1.7%
MSCI World	24.2%	12.3%	-4.3%	3.0%
MSCI Emerging	25.4%	16.4%	-2.6%	10.3%
FTSE/JSE ALSI	42.1%	30.1%	4.9%	11.3%

**MAJOR CURRENCY RETURNS** (annualised, against the US Dollar in %)

Currency	6 Months**	1 Year	3 Years	5 Years
South African Rand	15.7%	11.6%	1.2%	-0.9%
Euro	9.4%	-6.5%	-2.8%	2.5%
UK Sterling	4.5%	-3.5%	-7.7%	-2.0%
Yen	9%	15%	11%	8%
Swiss Franc	15%	11%	7%	7%
Australian Dollar	22%	14%	5%	7%

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

\*With effect from 21 April 2009 the RE·CM Core Managed Fund has been renamed the RE·CM Global Flexible Fund and the RE·CM Core Equity Fund has been renamed the RE·CM Flexible Equity Fund. The investment policy for these funds has been amended to give RE·CM more flexibility in the choice of asset classes. There has been no change in the benchmarks of these funds and RE·CM continues to manage these funds on a consistent basis. The performance therefore reflected in the table above takes history into account as this continues to be of value to our investors.

\*\*Not Annualised

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.

**Fund Details**

Fund Size	US \$200m
Benchmark	MSCI World
Performance Fee	20% above/below MSCI World +2.5%
Annual Fee	0.5% annual fee

**Portfolio Diagnostics**

	Fund	MSCI World
Volatility	13.1%	19.8%
% Maximum Drawdown*	-33.3%	-53.7%
% Positive Months*	57.9%	56.1%
% Turnover Rate**	30.3%	n/a
Number of Holdings	78	n/a
Concentration of Top 10 Holdings	34.9%	9.1%

\*Life of Fund

\*\*Trailing 12 months

**RE·CM GLOBAL FUND**

**Investment Results**

The RE·CM Global Fund has outperformed the MSCI World by 3.5% p.a. since inception almost five years ago. Over this period, the fund has grown by 4.9% p.a. in US\$, while the MSCI World has grown by 1.4%p.a., also in US\$. Despite volatile and difficult markets, the fund has grown the value of your investment in real terms over this period. It has been able to do so mainly by avoiding large drawdowns in times of market turmoil. At the same time, when markets are rising the fund tends to underperform. The past six months has proven to be no exception, as the fund has increased its NAV by 12.7%, while the MSCI World has advanced by 23.9%. While this is not entirely satisfactory, it is in line with our historical pattern of returns, and is a direct result of our long standing investment philosophy and process, which we see no reason to change.

It might be worthwhile to point out that the type of stocks that have shown the largest increases over the period under review are exactly the type of stocks to which your fund generally has low exposure – risky, cyclical, poorly financed companies. Emerging markets have strongly outperformed developed markets, to the extent that valuations of emerging markets are trading at all-time highs relative to developed markets. Needless to say, your fund eliminated almost all emerging market exposure over the past six months. We feel investors are once again paying too much for risk, as cheap money floods the world. We think we are paid firstly to protect your capital when prospective risks are high, and secondly to grow it when prospective risks are low. In 2009, when valuations (and thus prospective risk) were low, the fund was fully invested – we grew your capital. Now, valuations are high (prospective risks are high) and we are back into protection mode again.

**Management Actions**

Overall, the fund's equity weighting stayed at around 65% of total fund value. The funds price to value relationship now stands at around 75%, meaning the margin of safety has increased to 25% from 20% when we wrote to you last July. This has been achieved by almost completely selling out of any residual emerging market exposure that was in the fund, and adding to holdings of good quality companies (with global franchises) which are predominantly listed in developed market bourses. Such companies have underperformed significantly, leading to the improved price/value relationship in the fund. If the current situation continues going forward, it is not impossible that the fund will be fully invested at a price/value ratio of better than 30% over the next six months. And the exposure will be attained via large, good quality companies. This is a very exciting prospect.

The fund's currency exposure is still predominantly in US\$ - it probably being the best of a bad lot. Although the US monetary regime is trying to devalue their currency to boost growth, so are most other monetary regimes around the world. At present, according to purchasing power parity calculations, the US\$ is still significantly undervalued. In any case, we are not specialists in currency movements; we accept what falls out from our bottom up company holdings. For example, Johnson & Johnson is listed in New York, so the fund's exposure to this company counts as 100% US\$. But J&J operates globally, and generates over 30% of its revenue from emerging markets. In the aggregate, the companies owned by the fund generate over 20% of their revenues from emerging markets despite almost none of them being listed in those geographies! And our holdings are trading at an average P/E of

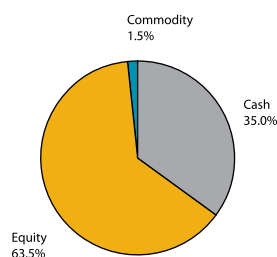
**Top 10 Positions (%)**

Johnson & Johnson	5.3
Wellpoint	4.9
Vodafone Group PLC	4.0
Dell	4.0
Harmony ADR	3.3
Wal-Mart Stores Inc	3.2
Astellas Pharma	2.8
Dish Network Corporation	2.6
Titan Cement	2.5
FamilyMart Co Ltd	2.3

14, relative to an emerging markets average P/E of 17. So, in a nutshell, we are buying companies with reasonably strong barriers to entry domiciled in an environment where there is relatively good corporate governance, rule of law, secure property rights and, at a valuation discount to companies operating in environments which are not always as benign and where barriers to entry might be lower.

The fund has attracted strong inflows over the past six months, which has resulted in it continuing to add to its existing holdings. The biggest purchases were in Johnson & Johnson, Wellpoint, Astellas and FamilyMart, which were all bought to maintain their weight in the fund. The fund increased its weighting in Dell, while it added new holdings in Titan Cement (a Greece based cement company), Aristocrat Leisure (an Australian based global leader in gaming technology), BP (a global oil producer, which suffered some operational difficulties) and H+R Block (a US based financial services firm).

**Asset Allocation**



The fund has completely exited from its last emerging market exposure, in the form of its holdings in Thailand (Minor International and Kiatnakin bank), as well as the last remaining Hong Kong based property developer (Hysan holdings) which were bought at the height of the financial crisis in 2008/9.

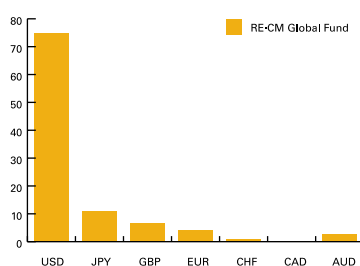
**Good ideas that worked**

- Zimplats
- Kiatnakin bank
- Hysan
- BP

It should come as no surprise that the fund's emerging market holdings were amongst the best performers. They have also been sold at these high levels. BP was a new holding, and has done spectacularly well. The market was very negative in our opinion about its prospects following the disaster in the Gulf of Mexico, which allowed the fund to pick up a global leader at a

hugely discounted price. Other holdings whose share prices did really well were the funds technology holdings Oracle and Ebay – the fund lightened its holding in both of these stocks during the period under review.

**Currency Exposure**



**Good ideas at the time**

- Aristocrat Leisure
- H+R Block
- Berkshire Hathaway

Both Aristocrat and H+R Block are new positions, and our experience is generally that such positions tend to decline after purchase – purely because we generally buy companies when the news flow is poor, with no visibility as to any improvement. It is under such conditions that good businesses trade cheaply.

And just because they are cheap, doesn't mean they can't get cheaper. Of course, we usually welcome such price declines as it offers the fund the opportunity to buy more!

Berkshire has been a long standing holding of the fund, which has done very well – to the extent that the margin of safety has reduced, as a result of which fund management trimmed the funds position during the period under review. Simultaneously, the price of Berkshire has also not participated in the most recent upswing in global equity prices. We think this is a temporary phenomenon and continue to hold some exposure to this fantastic business.

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)

TER is 1.00%. 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.

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	R1,150bn
Benchmark	CPI + 8%
Performance Fee	20% above/ below CPI + 8%
Annual Fee	1% annual fee excl. VAT

**Portfolio Diagnostics**

	Fund	ALSI
P/E Ratio	16.1	17.2
Dividend Yield	2.5	2.2
Volatility	8.5%	19.0%
% Maximum Drawdown*	-11.5%	-40.4%
% Positive Months*	73.9%	66.3%
% Turnover Rate**	20.2%	n/a
Concentration of Top 10 Holdings	44.7%	52.1%

\*Life of Fund

\*\* Trailing 12 months

TER is 3.28%. Inclusive of the TER's herewith, a performance fee of 2.03% was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

**RE·CM GLOBAL FLEXIBLE FUND**

**Investment Results**

The RE·CM Global Flexible Fund has compounded your capital at 16.5% p.a., after fees, since inception (April 2003). This compares favourably with the targeted return of inflation plus 8% which equates to 13.7% p.a. In the six months June to December 2010 the fund increased by 8% compared to the targeted return of 5.1%.

**Owner's Manual**

In the portfolio diagnostics table on the left you will find the following:

**P/E Ratio:** The 'as you see it' price to trailing 12 months' earnings ratio of all the investments in the fund, combined at a fund level. The current figure of 16 times earnings looks decidedly unattractive considering the long-term averages of 11 (SA) and 15 (global). However, our analysts use normalised (adjusted) numbers in our internal valuation models and our funds are often populated with businesses that are experiencing depressed revenues and profit margins – resulting in depressed after-tax profits and conversely in high P/E ratios. A good case in point being our current largest holding, Sun International, with an 'as you see it' P/E ratio of 19.5 times being far above our estimates of its long run earnings power. Because it's the largest holding in the fund it serves to skew the calculation. We advocate that you ascribe more meaning to the fund's price to value ratio, disclosed under the investment return expectations section.

**Dividend Yield:** The 'as you see it' dividend yield of all the investments in the fund, combined at a fund level. The current figure of 2.5% is an accurate reflection of the cash dividends you are receiving on your capital today, but equally, based on the same argument as made for the interpretation of the P/E ratio above, is likely understated and we reach the same conclusion.

**Volatility:** A statistical measure of the average swings and roundabouts in the price (after fees) of the fund, since inception. The figure of 8.5% is less than half that of the SA market index. A lower number than the index should be expected of any flexible fund with the ability to own asset classes other than equity, but as you know our philosophy and process compels us to populate our funds with high quality businesses. These types of companies typically experience a more stable rate of change in revenues and profit margins that is reflected in the rate of change in their share prices and ultimately in the rate of change in the price of your fund.

**% Maximum Drawdown:** The largest fund price (after fees) decline over any time period, since inception. The figure of minus 11.5% represents the largest possible loss any investor in the fund could have experienced if they bought high (at a peak in the fund price) and sold low (at a trough in the fund price). It compares very favourably with the substantial minus 40% figure of the SA market index.

**% Positive Months:** The percentage of the time since inception that the fund delivered positive investment returns (after fees), before inflation. The figure of 74% means the fund delivered seven to eight positive months out of every ten. It compares favourably with the 66% figure of the SA market index.

**% Turnover Rate:** The lower of total fund sales or purchases during the trailing 12 month period, divided by the average value of the fund. Basically it's a calculation

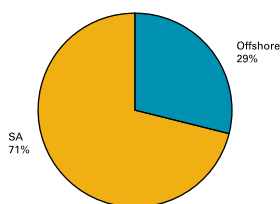
**Top 10 Positions (%)**

Sun International	5.5
Discovery Hldgs	4.0
Telkom SA Ltd	3.4
Tiger Brands Ltd	2.8
FirstRand	2.5
Omnia Holdings	2.5
Old Mutual Plc	2.5
Harmony Gold Mng	2.5
Brait SA	2.4
Remgro Ltd	2.2

**Asset Allocation**

Equity	SA	49.1%
	Offshore	17.0%
		<b>66.1%</b>
Cash	SA	16.0%
	Offshore	11.2%
		<b>27.2%</b>
Bonds	SA	4.6%
Prefs	SA	1.8%
Commodity		0.3%

**Currency Exposure**



of our transactional activity levels. Because we proclaim to be long-term investors we use this number to check if we are staying true to our principles. The figure of 20% can be interpreted as follows; it means we will transact the value of the whole fund once every five years. Conversely it means we own the shares of any individual asset in the fund for five years. There is an additional and significant benefit in such low transactional activity; it results in lower transaction costs paid by fund investors. Various detailed consultant studies suggest that the industry average turnover rate runs over 100% a year, which means the average fund manager owns any individual business in their funds for less than one year. Importantly, sticking to a 20% target is not a rule we apply; you can expect us to go well above or below 20% if market conditions warranted such actions. Through a full market cycle we expect to average 20%, and in the completed market cycle from 2003 through 2008 we were marginally above that number.

**Concentration of Top 10 Holdings:** The sum of fund exposure to the ten largest individual investments, divided by the size of the whole fund. The figure of 30.4% means the fund is significantly less concentrated than the 52% of the SA market index. In dealing with significant uncertainty as OPMI's (outside passive minority investors), achieving a reasonable level of diversification for a fund is a very important aspect of a sensible investment process.

**Fund Composition**

Please refer to the table and the pie-chart on the left. Key changes since June 2010 are:

1. SA Equity exposure has declined from 53% to 49%.
2. Global Equity exposure has increased from 14% to 17%.
3. Exposure to assets denominated in currencies outside SA has increased from 19.5% to 28.6%.

These changes reflect fund management's increasing conviction that quality cheap assets are currently scarce in SA. We don't have a strong conviction on the Rand either way but can state emphatically that our team are continuing to find exciting investment ideas outside SA borders. For more on some of these please refer to the RE-CM Global Fund comment.

**Management Actions**

This table summarises the five largest purchases and sales for your fund in the second half of 2010.

Largest purchases	Value (Rmn)	Largest sales	Value (Rmn)
Vividend Income Fund	22.5	Imperial	29.9
RE-CM & Calibre Pref	13.2	Vodacom	18.7
Eqstra	11.5	Old Mutual	11.0
Old Mutual	7.9	JD Group	9.4
Nedbank	7.9	Remgro	9.1

Fund management participated in the primary capital raising of the South African listed Vividend Income Fund, a property investment vehicle that aims to take advantage of the sales of so-called non-core property assets at attractive yields by banks and large listed property funds. We do not typically entertain the notion of supplying capital to unproven ventures, but in this instance a strong track record of the key people, a sensible investment philosophy and a market opportunity only

available to an investor with a reasonably small pool of capital made sense to us. Despite being our largest capital allocation by value in this period, it is a small exposure in the context of your fund.

An exciting development for our clients and our business was the recent successful listing of RE·CM & Calibre Preference shares on the JSE. The broad mandate and a new universe of investment opportunities with a lack of capital competitors that can be pursued within this instrument, we think is more than enough reason to own it. We did not participate in the primary capital raising for your fund due to the inherent conflicts of interest, but we were provided with an opportunity to purchase a sizeable holding after it listed.

Old Mutual is represented on both sides of the ledger and demands explanation. Our average sale price was R15.25 and our average purchase price was R13.86. The sale was done around mid-year against a significant overweight exposure relative to what our process justifies, whilst the purchase was done against cash inflows from new investors into the fund late in the year.

We remained net sellers of SA equities and in the case of Imperial, Vodacom, JD Group and Remgro margins of safety have all but disappeared. We sold sizeable portions of your holdings in these, but not everything. Our investment process drives our capital allocation decisions, and as you know position sizing is largely determined by popularity and the business cycle.

You unashamedly own many of the equity and debt instruments of the same businesses in your fund as the ones in the RE·CM Flexible Equity Fund and the RE·CM Global Fund. Please refer to the relevant sections elsewhere in this RE·VIEW for our more detailed commentary on the management actions and some of the stock ideas that worked and didn't work during the course of the past six months.

### **Investment Return Expectations**

We know that fair value can be a confusing term. We find that it helps to think of fair value in terms of a range of outcomes, including what we call a 'margin of error' of about 10% either side of a single point of fair value. That said, we measure the fund's prevailing price to value relationship at approximately 80%. So far the fourth scenario (described in the previous fund comment as one whereby equity prices continued going up) is playing out and we have already taken most of the necessary actions to reposition the fund accordingly and avoid risk of permanent capital loss.

We remain confident that you co-own (with us and our families) a fund with the flexibility to both protect your capital and take advantage of investment opportunities, depending on Mrs Market's mood swings. Truly a fund for all market seasons that affords us a very good night's sleep as managers and significant co-investors.

### **A (final!) Word on Fees**

Fund management has decided to investigate means of increasing the period of time used in the calculation of the performance fee from the current rolling 12 months to a rolling five year period. The motivation for this decision is to better align the periods over which performance is earned and for which it is paid. If we are successful in implementing this change it will only affect future performance fees charged to fund investors. We will communicate with you in this regard in due course.

Daniel Malan  
Portfolio Manager

The RE·CM Flexible Equity Fund's aim is to out perform 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	R955m
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	16.2	17.2
Dividend Yield	2.6	2.2
Volatility	14.8%	19.0%
% Maximum Drawdown*	-27.1%	-40.4%
% Positive Months*	68.1%	66.3%
% Turnover Rate**	23.9%	n/a
Number of Holdings	39	164
Concentration of Top 10 Holdings	44.7%	52.1%

\*Life of Fund

\*\* Trailing 12 months

TER is 0.56%. 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.

**RE·CM FLEXIBLE EQUITY FUND**

**Investment Results**

Your investment result (after fees) for the six months to the end of June 2010 was 13.8%. This compares to the performance hurdle (ALSI + 2.5%) of 25.3%. Needless to say, this investment result is particularly poor in relative terms, and accordingly we thought some comments about this might be apposite.

As we have noted before, we are struggling to find value amongst South African equities. When the All Share Index was last in the kind of territory it finds itself in now (early 2008), a clear divergence had developed between valuations in the mining sector and valuations in the financial and industrial sectors. At the time, we were able to find value in these sectors (more so as the roller coaster of a year that was 2008 progressed, of course!). Currently, we are seeing less extreme divergences in valuations, and a more uniformly fully priced market. We are having to dig deep to unearth cheap stocks, and those stocks are often the shares of lower quality businesses. After the strong increase of the last six months, the South African market as a whole is again trading well clear of one standard deviation above its 30 year average price to book ratio. Here be dragons.

This type of market environment, in which expensive assets keep getting more expensive, is one in which we expect to deliver fairly poor relative performance (refer to our article in this regard, "Conquering Our Biggest Investment Problem: Ourselves", in RE·VIEW Volume 14). Given a fairly expensive market, it probably comes as no surprise that your fund has contained substantial cash holdings over the past six months – this obviously holds back returns when share prices rise. Probing a bit deeper though, over the last six months, financials (which feature prominently in the Flexible Equity Fund) underperformed the market substantially, whereas consumer services – and then specifically the media sector (i.e. Naspers) outperformed strongly.

RE·CM clients own no Naspers shares. The portfolio of businesses which constitute the Naspers group is a fine collection – some of the best anywhere. Unfortunately the valuations assigned to some of these businesses are also some of the highest anywhere. These valuations may be entirely justified: a business with the growth prospects and network effects of a Tencent is a rare find. But in an environment where the darling of one year becomes the dog of the next (MySpace), and where investors assign valuations of tens of billions of dollars to companies of which they cannot obtain published financial statements (Facebook), we are happy to sit on the side lines and throw Naspers on the "too hard" pile.

**Management Actions**

There has been some change to the top holdings in the fund over the last six months. Most notable is probably Pick n Pay's absence from the top ten holdings for the first time in a number of years. Pick n Pay has been a relative laggard in the retail sector for the past number of years, but as valuations in the sector have risen substantially over the last two years, even Pick n Pay has reached a price level too close for our comfort compared to its intrinsic value, and as such it has featured as one of the stocks which we have sold down substantially over the last few months.

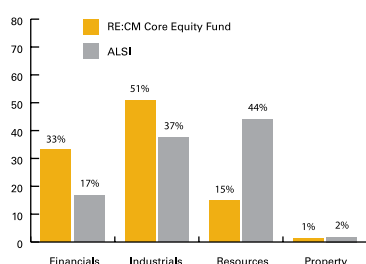
Other notable changes are the substantially reduced exposure of the fund to Imperial and Adcock Ingram (both of which were top ten holdings six months ago, but are

**Top 10 Positions (%)**

Sun International	7.9
Discovery Hldgs	6.4
Telkom SA Ltd	5.1
Tiger Brands Ltd	4.2
Harmony Gold Mng	4.1
Old Mutual Plc	3.6
MMI Holdings Ltd	3.5
Brait SA	3.4
FirstRand	3.3
Omnia Holdings	3.2

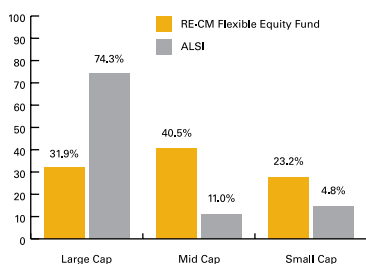
now fairly small holdings). Same story here: margins of safety declining to negligible levels, which compels us to sell the shares. As an aside, we did not have any particular prior insight into Adcock’s recent product withdrawal and anti-retroviral tender woes, which impacted the share price materially: we were fortunate that we sold the bulk of our holdings prior to these events occurring. But this illustrates the point of valuation-based investing: at the share price levels Adcock was trading at shortly prior to these events occurring, there was very little, if any, margin of safety in the share price for an investor. Any impairment in intrinsic value of a business due to unforeseen events (such as product withdrawals or losing a material contract) results in a permanent loss of capital if one owns a stock where there is no margin of safety. If such events occur in a business where the share price does embody a decent margin of safety, such impairments in value will also detract from future investment returns, but those returns should, ceteris paribus (which it never is, of course!) still meet one’s hurdle rates.

**Sector Split**



On the purchases front, things have been more subdued. Eqstra (a small holding in the fund) features as the top allocation of capital. RE·CM clients underwrote Eqstra’s rights issue earlier in 2010, and subsequently we bought shares in the market. One of Eqstra’s lines of business is in a sector (contract mining) which has been under considerable pressure for the last year or two, and valuations of the businesses in the sector reflect that. Unfortunately, the businesses in this sector are not necessarily of the highest quality (or of sufficient size), so our capital allocation to the sector will always be limited.

**Equity Allocation**



Another stock worth mentioning amongst the top purchases is Old Mutual. RE·CM clients have owned this share since late 2008, but the holding has varied as a percentage of fund capital since then, depending on the margin of safety that the share price offered. Following the announcement that HSBC’s proposed bid for subsidiary Nedbank has been withdrawn, Old Mutual’s share price suffered a marked decline, which once again increased the margin of safety and therefore the investment appeal of the share. We have bought shares accordingly.

**Good ideas that worked**

- Sun International
- Imperial

We wrote about Sun International as a “Good Idea At The Time” in our last Flexible Equity Fund commentary six months ago (RE·VIEW Volume 13). At the time, sentiment towards the hospitality industry was particularly negative. We managed to

take advantage of this by deploying more capital into Sun International, and this time around Sun International makes it into the “Good Ideas That Worked” category. To the best of our knowledge, nothing much has changed about the long-term prospects and intrinsic value (still well above the share price) of Sun International: market sentiment has simply swung around from dour pessimism to something a shade or two more rosy.

When we first started buying Imperial about three years ago, it was in the process of getting shoved ever deeper into the dog box by the market. Sell side analysts were downgrading the stock, and few people seemed interested in a business with such clearly negative short-term prospects – never mind the fact that the share price was in the region of R50 and way below a reasonable longer term estimate of intrinsic value. Now, at more than R120 a share (and at or above our estimate of intrinsic value), analysts are upgrading the stock and Imperial is again back in vogue. We have (surprise, surprise!) used the increasing optimism towards the business to sell down the fund’s holding of Imperial shares to much lower levels than it has typically represented over the last three years.

Good ideas at the time

Cash

Trans Hex

Your fund's cash holding has on average been well above 20% for the last year, and is currently at about 27%. Cash is an obvious performance drag in an environment of rising share prices. We are perfectly happy to forego the risky returns associated with owning expensive assets that keep getting more expensive in favour of the safety that cash offers.

In the current low interest rate environment, a pervasive theme one hears is that investors are looking to move out of cash into higher yielding assets (equities, bonds). This is relative return thinking at its most dangerous. Buying overvalued assets simply because they offer a higher yield than cash is very risky in the long run. The fruit may taste sweet in the short run, but the consequence of giving in to temptation is still expulsion from Eden. We shall not succumb.

Trans Hex is a small holding in your fund, but RE·CM clients are one of the two largest shareholders in the company. The business has gone through a tough time for a number of years now, and the share is priced cheaply for understandable reasons. We consider the management team to be very sensible, and we trust them to realise the value in the company's assets. At the current share price, we are comfortable that the remaining value of the company's South African operations (which are nearing the end of their lives) more than covers the share price, and there is potential value in the company's Angolan operation which one is getting for free. This is the kind of risk-return relationship that we like.

Wilhelm Hertzog  
Portfolio Manager

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.

**Fund Details**

Benchmark	ASX 300
Performance Fee	20% above ASX 300 + 2%
Annual Fee	0.8% annual fee excl GST

**Portfolio Diagnostics**

	Fund	ASX 300
P/E Ratio	14.7	19.1
Dividend Yield	5.8	3.5
Volatility	6.3%	13.9%
% Maximum Drawdown*	-4.3%	-11.4%
% Positive Months*	55.6%	44.4%
Number of Holdings	22	295
Concentration of Top 10 Holdings	47.7%	51.5%

\*Life of Fund

**RE·CM AUSTRALIA EQUITY FUND**

**Investment Results**

After nine months we are pleased to report the fund has delivered a satisfactory return. The benchmark is just above even, while the fund is over 3% better.

We initiated the fund in late March after a few months of initial research. While this initial period turned up enough ideas to invest 25% of our capital in nine holdings, valuations kept many of the stocks we had assessed out of reach. Shortly after the fund's inception, and prompted by the government's intention to implement an extra tax on resources companies, the market reached what would be its peak for 2010. As it tracked lower we were able to add more ideas to the fund, both from our initial work and subsequent research efforts.

We must stress that our reaction to market conditions (valuations) in Australia is as it would be in any new market we might tackle. This is what we frequently refer to as the repeatability of our investment process. We established a list of companies we understood well enough to value with a reasonable level of conviction, and thereafter committed capital to the best and cheapest ideas only if or when the market offered a satisfactory margin of safety. This is the same sensible approach RE·CM has followed for the past eight years.

**Management Actions**

This table summarizes the five largest capital commitments and realizations to date.

Purchases	Sales
Tabcorp	Perpetual
National Australia Bank	Australia Securities Exchange (ASX)
Aristocrat Leisure	Sims Metal Management
Cabcharge	Aristocat Leisure
Sonic Healthcare	

Our initial commitments to Tabcorp, National Australia Bank, and Aristocrat Leisure were among the first in the fund. We identified them as cheap and out of favour, always a healthy combination in our opinion. The large Australian banks have a comparable oligopoly to those in South Africa, yet due to a far more politicized environment are frequently the subject of pessimism around government interference. This is not enough to undermine the deep moats these businesses have dug over the past twenty years.

Tabcorp too has seen its popularity wane thanks in part to actions taken to strip it of certain gaming licenses, although the effects of this seem to be more than discounted in the share price. The company is entering a phase of capital expansion, which is wise given that the gaming cycle is relatively low. Included in our commitment in the table above is a recent rights issue in which we chose to take part. Aristocrat is presently subject to a double whammy of unpopularity. Not only is the gaming cycle low in its largest markets (US and Australia), but casino operators are delaying replacement of electronic gaming machines – Aristocrat's core product.

Two relatively recent additions to the fund are Cabcharge and Sonic Healthcare. Both are high quality companies with enduring moats. As its name implies, Cabcharge is a payments network which provides EFTPOS machines to taxi operators. Its machines

**Top 10 Positions (%)**

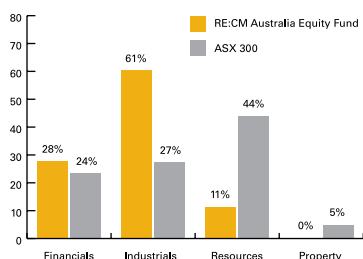
Tabcorp Holdings	7.0%
Caltex Australia	6.2%
National Australia Bank	5.9%
Cabcharge Australia	5.9%
Sonic Healthcare	5.8%
Aristocrat Leisure	4.5%
QBE Insurance Group	4.2%
Telstra	3.0%
Sunland Group	2.9%
Brambles	2.2%

are present in nearly every cab in Australia. While not immune to competition, its greater scale has allowed it to remain ahead by offering superior, more secure technology. Cabcharge operates as a derivative of a highly regulated industry, where the supply of cabs and the prices they charge are controlled. In this instance it is assured of pricing power.

Sonic is the world’s third largest provider of pathology services, and an example of one of several Australian listed companies that are global leaders in their fields. A complex and poorly understood regulatory change caused a severe derating in the stock midyear. This allowed us a welcome opportunity to establish a meaningful position.

It should come as a surprise to see sales of any magnitude given the short period with which the fund has been active. In the case of Sims, a global metals recycler, an improvement in our understanding of the business’s normalized earnings caused a downward revision in our estimate of its worth – to the point where its discount to fair value was insufficient to warrant continued exposure.

**Sector Split**

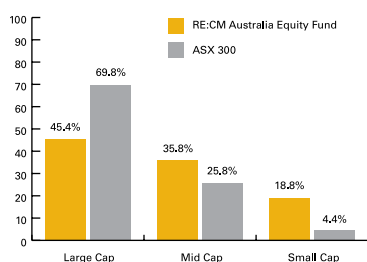


The fund manager Perpetual and Australian Stock Exchange were both subject to potential corporate activity during the year. In both cases the share price responded to levels where the margin of safety was no longer attractive and we reduced these positions to zero. We were pleased to see the talks around Perpetual fail to materialize and we have subsequently been able to re-establish a position therein.

**Investment Return Expectations**

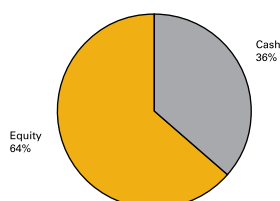
At year end the fund as a whole was priced at 85c in the dollar. Equities account for 64% of the fund, and on a weighted basis the 22 stocks we now hold are priced at 76c in the dollar, representing a 24% discount to our assessment of fair value. This is quite reasonable and bodes well for future returns in the fund. We are committed to maintaining a dominant exposure to quality businesses, and the fund ended the year with well over our self imposed minimum of 70% of equities in companies we consider high quality. By definition these are companies whose intrinsic values are likely to grow in real terms with time.

**Equity Allocation**



Our research efforts continue unabated and we look forward to further expanding our universe of Australian stocks in the course of the next six months.

**Asset Allocation**



Christopher Boehmke, Piet Viljoen, Daniel Malan  
Portfolio Managers

## **SOUTH AFRICA JOINS THE BRIC'S – A BUY SIGNAL?**

I don't care to belong to a club that accepts people like me as members.

**Groucho Marx**

But what I don't do, which makes me different than most other managers, is I don't say, "I love Brazil 'cause the macro is good, therefore, I'm going to get some Brazilian exposure." I might say I love Brazil, and then I'll send a team of my guys down to Brazil for a couple of weeks, and if they can find something that's especially interesting and cheap on an absolute basis, and cheap on a relative basis, then we'll buy it. But we start out with a macro view and then we work our way down to find things that are compelling on a micro basis. And if any of you have careers or are considering careers in the investment world, I strongly advise against getting exposure to things. Getting exposure is a sure way to not make money. One needs to be an investor, and the way you invest in things is by looking for things that are mispriced, and generally the way to find things that are mispriced is look at quantitative measures of their mispricing, which generally comes down to valuation. And if you look out, back into history, and you look at what techniques make money, value investing trumps everything.

**Bill Browder, from the transcript of a discussion with Bruce Greenwald**

**The Perils and Rewards of Emerging Markets**

Can I leave them with one thought that you should never forget about investing? Every time you buy something, thinking it's a good idea to buy 'cause it's going to perform really well, somebody else is selling you that same thing thinking it's going to do badly. And one of you is always wrong. And who do you think is wrong if you're flying in and they're local? Keep that in mind with emerging markets and keep it in mind with Russia.

**Bruce Greenwald, from the same interview.**

The tidal wave of cash flooding into emerging markets has pushed valuations sharply higher and is in danger of creating a bubble, according to a growing minority of market commentators. Net inflows into the emerging worlds equity and bond markets have totalled \$1,787bn in the last decade, according to data from the Institute of International Finance. As a result the MSCI Emerging Markets equity index has jumped 236 per cent in the last ten years, while the S&P 500, FTSE 100 and FTSE Eurofirst 300 have all fallen, rapidly eroding the attractive valuation of developing world stocks. With vast swathes of the investment industry still encouraging their clients to invest even larger sums in emerging markets, concerns are rising that valuations could be pushed unsustainably higher.

**Financial Times, 20 December 2010**

2010 was a good year for South Africa. We successfully hosted the World Cup, interest rates declined to a generational low and the economy started recovering from the US induced global financial crisis. The Rand ended the year incredibly strong. And to cap it all off, we were invited to join that elite group of emerging markets – the BRIC's. For those readers who might have missed it, BRIC is an acronym for Brazil, Russia India and China – first coined by the Goldman Sachs economist Jim O'Neil in 2001– to function as a catch-all for the biggest and fastest growing emerging markets.

Returns from the SA equity market over the past year have rivaled and exceeded those of the existing members of the BRIC club. The table below shows the last year's numbers, as well as longer term figures. In fact, our readers might be surprised to see how well their SA market has done over even longer periods of time! Given that most of our clients are South African and that most of their assets are domiciled right here in South Africa, it might please many to see how they have prospered relative to the rest of the world over the past ten years. Indeed, it has been good to be South African with the bulk of ones assets denominated in the good old Rand!

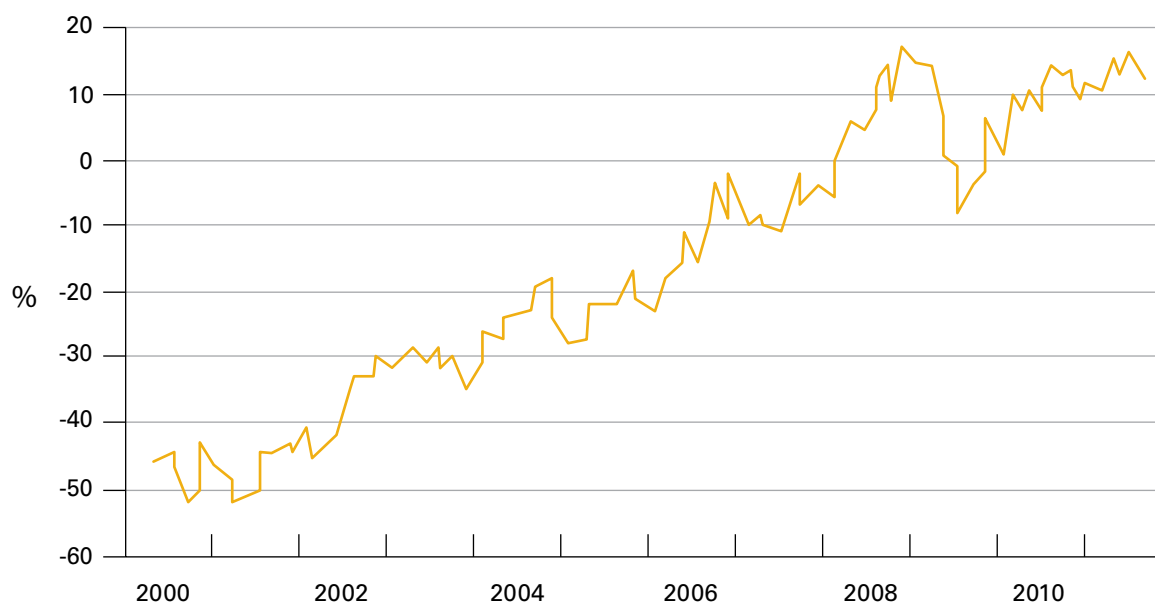
**Table 1:**

<b>% p.a., US\$</b>	<b>12 Months</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
South Africa	31.4	7.3	13.2	18.2
Brazil	2.5	5.6	23.9	18.0
Russia	22.6	-10.0	8.9	28.0
India	24.0	-2.5	18.7	20.5
China	8.3	-2.9	12.5	8.1
Emerging Markets	19.0	-0.2	12.9	15.6
Developed markets	12.4	-4.2	3.0	2.9

Many market commentators ascribe this good performance to astute fiscal and monetary management, favorable geographic positioning as the gateway into Africa or even high quality corporate management. But, as Occam's razor demands, we think the truth is much simpler: SA is an emerging market with a twist. Emerging markets have done well, ergo SA has done well. But it has done better because of the twist.

This probably demands an explanation. Being an emerging market has meant that global investors have upped their allocation to us, as emerging markets have become increasingly popular, due to their historically good performance. (See table above) This historical performance came about due to very low valuations ten years ago – just after the emerging markets crash of 1998, and during the tech boom of 1999, no one wanted to know anything about emerging markets, their stock markets were neglected, unloved and cheap. See Chart 1 below. From a discount of 50% to developed market stocks ten years ago, emerging stocks have re-rated to a premium of 10% just recently. It is no surprise that they are coming up on everyone's radar screen just now.

**Chart 1: Emerging Markets Premium to Global Equity Price/Book Value**



Source: FinancialTimes, Deutsche Bank

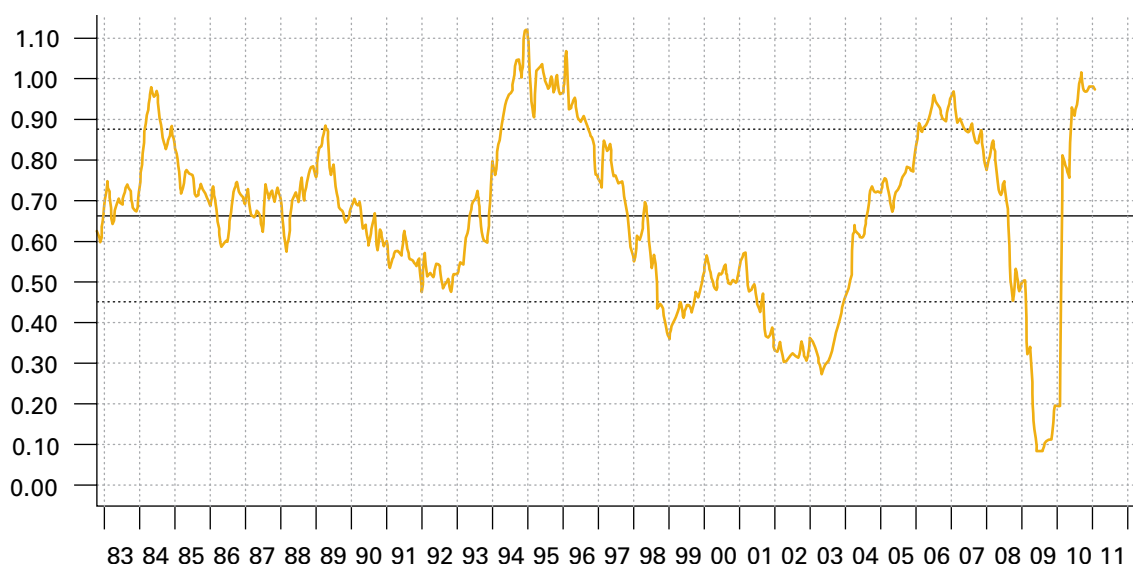
As most of the big money globally is indexed (or quasi indexed) the better a particular stock or market does, the greater its weighting in the index becomes, the more popular it becomes and the more widely accepted it becomes in institutional and private portfolios. This, of course, has nothing to do with value for money, but all to do with higher prices begetting higher prices. Our astute readers will recognize this as simple momentum driven investing, and would not expect us at RE·CM to partake of such a "poisoned fruit". Be that as it may, the fact that SA is an emerging market has attracted a lot of

money, something we expect will accelerate with our joining of the BRIC club. Unfortunately, more and more money is being attracted at ever higher valuations, which will ultimately end, as always, with disappointed investors.

The second part of the statement above: “emerging market with a twist” needs some explaining too. By twist, we refer to the historical scarcity of capital in South Africa, due to firstly sanctions, and thereafter the – sometimes bordering on irrational – desire of locals to move their capital offshore, almost at any cost. Microeconomics tells us that when supply (of capital in this case) contracts, price increases. This is clearly what has accentuated the good performance of South African equities over the past decade. The scarcity of capital has meant less competition, and less competition means higher returns per unit of capital invested.

Thus, due to the combination of a favorable geographic environment as well as low levels of competition, SA equities have performed extremely well, and, in doing so, have moved from being very cheap to being very expensive. The following chart shows the P/E ratio of the South African market relative to that of the US market (as represented by the S&P 500 index). South Africa is now as expensive as it was in 1996 and 2007 – both times that ended up not being particularly good entry points.

**Chart 2: P/E Ratio of the JSE All Share Index Relative to the S&P Index**



Mean = 0.62  
Std. Dev. = 0.25

Source : Inet

This point is further illustrated by a comparison of the valuation of local retailers against US retailers. In the following table, we compare the valuation of Massmart with Wal-Mart.

	Massmart		Wal-Mart	
	Long term average	Current	Long term average	Current
EV : Sales	53	82	91	59
EV : EBIT	11%	16.3%	15.5%	9.9%
P/E	12.6	26.1	24.1	14
Trading margin	3.4%	3.9%	5.8%	5.9%
Free cash Flow Yield	9.5%	5.9%	2.6%	7%

Surprisingly, there has been an almost complete role reversal in terms of valuations. Massmart is trading at similar valuation levels as Wal-Mart was ten years ago when it was expected to continue growing rapidly. Ten years ago SA retail was very cheap (who remembers Foschini trading at a discount to its book value?) Of course, such low valuations were

(then) justified on the basis of SA based retailers being ex-growth and operating in a saturated market – sort of what one is hearing about US retailers right now. Unsurprisingly, the share price of Wal-Mart since then has done nothing, while the share prices of companies like Massmart have increased ten fold! The net result is that Massmart is trading at a huge premium to its historical rating, while Wal-Mart is trading at a significant discount.

So, what will returns look like over the next ten years, given current starting valuations? As usual, we don't know, but would guess that South African retailers (and those of emerging markets in general) will have less per share growth than the consensus believes, while the USA retailers will probably have more. This is reversion to the mean in practice. And the reason for this reversion is simple – competition. As we speak, competition in emerging markets is heating up, as more and more developed market corporates allocate their capital towards emerging markets to compete for a piece of a growing and lucrative market. This will inevitably have the effect of driving down returns for all concerned, even if emerging economies in the aggregate continue to grow at high rates. At the same time, retailers in the USA are struggling, with bankruptcies common. Competition is diminishing. We firmly believe that an investment in Wal-Mart will be far more profitable than an investment in Massmart or any other South African retailer over the next ten years.

To illustrate the scarcity of capital argument, the chart below shows the relative performance of the SA market to that of the USA, overlaid with significant corporate transactions. When the market valuation was low, and the Rand weak, there was an extraction of capital from the economy, as many corporates moved their primary listings offshore. In the period 2000 to 2003, Old Mutual, Investec, Dimension Data, SAB and Anglo American all moved to London, thereby reducing capital commitment to SA. Perversely, this enabled local firms to earn better returns! The following charts compare these London listed firms with similar locally listed companies. We compared PSG to Investec, Sanlam to Old Mutual and ARM to Anglo American. In all cases, the "locals" significantly outperformed the "globals" – by a factor of three to five times! (The title of a popular TV show on Reality TV springs to mind: "What Were They Thinking?") At the time, based on valuations, we thought that "local was lekker" and invested our client funds accordingly.

**Chart 3: JSE All Share Index Relative to S&P500, in US\$**

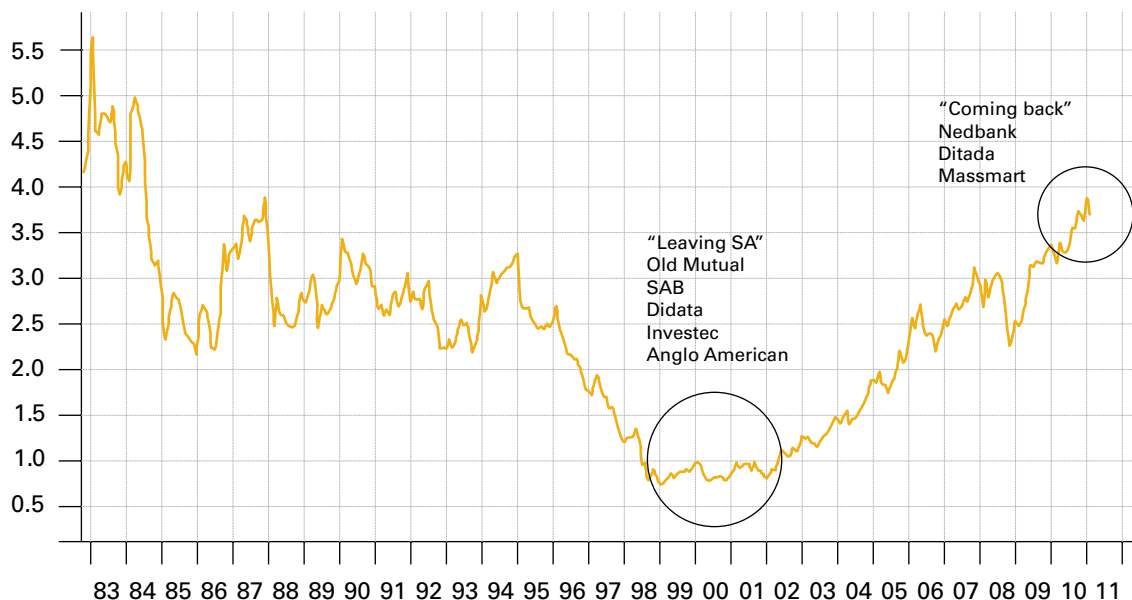
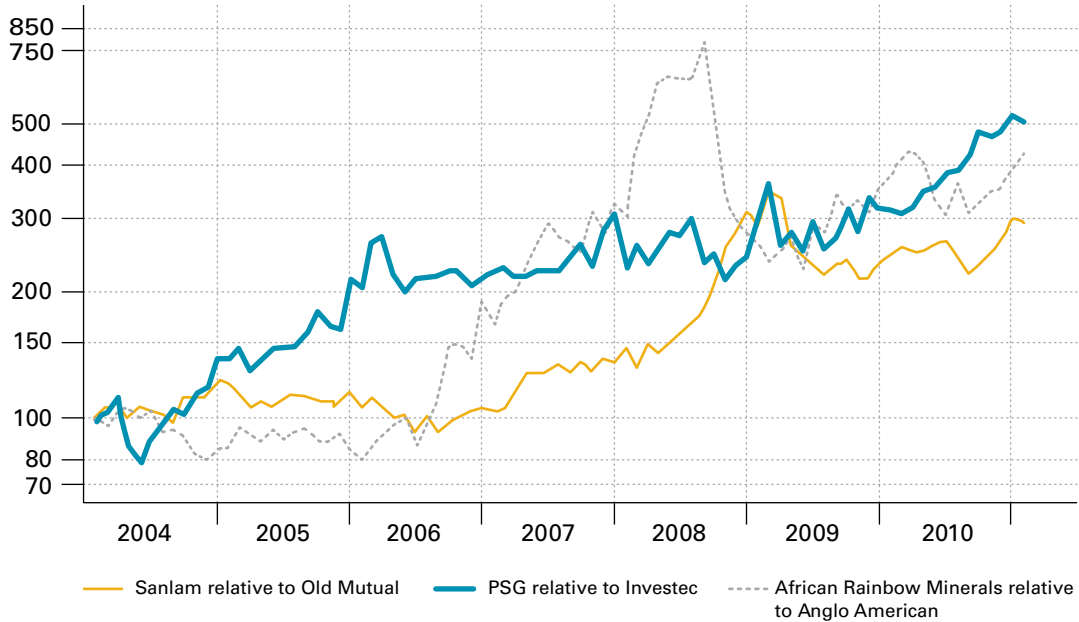


Chart 4: Relative Returns of “Locals” to “Globals”



The question that immediately springs to mind is how some corporates, which are generally characterized as the “smart money”, can get it so wrong. The answer, as always, lies in their incentives. As we have explained in previous RE-VIEWS, the institutionalisation of company ownership has devolved the power away from true owners to management. Management is generally incentivised by short term stock options, not long term wealth creation. This means they will do what the market wants, regardless of economic substance, leading to sub-optimal capital allocation as per the preceding paragraph.

Today, the markets want exposure to emerging economies, so multinationals are now buying into the local economy (or at least attempting to in the case of HSBC/Nedbank). They are doing so under the spin-doctors’ guise of buying into “faster growing emerging markets”, but the substance behind this is that they are increasing competition, and paying high prices to do so. The currency has moved from being undervalued to being overvalued and equity valuations have done the same. We think it is again time to start taking the other side of this trade.

Piet Viljoen

## IS THIS A DIVIDEND WHICH I SEE BEFORE ME?

Is this a dagger which I see before me,  
 The handle toward my hand? Come, let me clutch thee.  
 I have thee not, and yet I see thee still.  
 Art thou not, fatal vision, sensible  
 To feeling as to sight? Or art thou but  
 A dagger of the mind, a false creation,  
 Proceeding from the heat-oppressed brain?  
 I see thee yet, in form as palpable  
 As this which now I draw.

Act 2 Scene 1, Macbeth, Shakespeare

Replace the word 'dagger' in Macbeth's famous soliloquy with 'dividend' and the result resonates surprisingly well with what follows.

*"...all at Centro are extremely disappointed not to declare a distribution for the current period..."*

Brian Healey, Centro Chairman, Nov 17 2007

Becoming closely acquainted with a new market involves not only years of establishing history with companies and management teams, but also learning the ins and outs of the system. The 'system' includes whatever tricks and traps that regulators, management and investment bankers may lay across the path of the unwary. As always, the rule in markets is "caveat emptor", and it is our responsibility to know how the system works. We have previously touched on the notion of dividend imputation (the curious method of administering corporate tax on individuals in Australia), and in this article we highlight two pitfalls in taking dividend declarations at face value. When it comes firstly to dividend reinvestment plans and secondly to listed property structures, all may not be as it seems!

You may recall an article of ours titled Show Me the Money! (RE-VIEW Volume 10, October 2009), in which we bemoaned the decline in investor respect for dividends and the commensurate reliance on reported earnings as a proxy for value. We noted the attraction of dividends is in the certainty in the number, whereas earnings are by and large an accounting construct meant to portray the results of a business's operations, but easily manipulated through accounting convention.

We cited 'true' earnings as that which can be taken out of a business at the end of a period, without leaving it any poorer than it was at the start. Most firms that are beyond startup phase are unable to redeploy all their earnings at an economic profit. Firms that generate economic earnings beyond what is required for value adding growth – retained earnings which continue to earn returns above the cost of capital – can reasonably be expected to return the excess to shareholders. This is ultimately what is expected of an equity investment: to provide a stream of cash flows which increases in purchasing power over time. The very act of giving up cash is a discipline that management should be held to.

### **Dividend Reinvestment Plans: 'False Creations?'**

It is common knowledge that a large proportion of an investor's long-term returns are attributable to reinvested dividends. The procedure for implementing this has traditionally involved cashing one's dividend cheque and then purchasing shares in the market. The popularity (for good reason) of reinvestment has led many companies to make life easy for their owners by offering an automatic process administered by their share registrars. Shareholders electing to participate pool their dividends which the registrar uses to buy shares on the open market.

Sounds simple enough? A good example in the UK is Vodafone's Dividend Reinvestment Plan. In Australia, however, the same term is used to describe a process with a subtle yet very significant difference. Shareholders participating in an Australian company's "DRP" can generally expect their forfeited cash dividend to be replaced with newly issued shares, and not with shares bought in the market.

In effect, to the extent that shareholders participate in a DRP, that company does not part with cash at all, but rather increases its share count. Whether this is reinvestment or merely additional investment is a matter of semantics, but

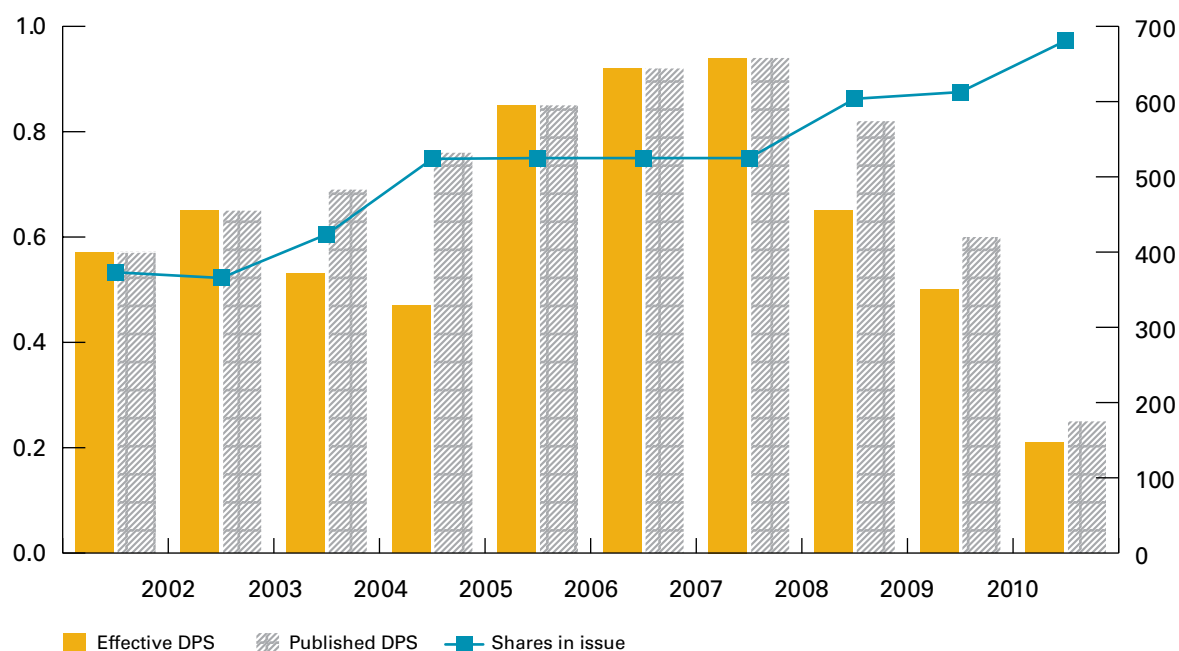
in our opinion this belies the intended purpose. DRPs are optional, but a common attraction pitched to shareholders to convince them to participate is that the new shares will be issued at a discount, say 2.5%, to an average of recently traded prices. This discount directly benefits participants at the expense of non-participating shareholders, who suffer from the resulting dilution.

In Australia, thanks to a prevalence of own-name or direct investment in listed companies, there is a healthy respect for dividends and DRPs are enjoyed by many as a way of putting their investments on autopilot. There is enough literature and commentary on how to consider these options as an investor, mostly involving tax return considerations. From our point of view, it would only make sense to participate if the stock in question is cheap. We have participated in Vodafone's plan in the Global Fund for some time. What we are interested in is whether a company installing a DRP where new shares are issued can be judged as acting in the best interests of long-term shareholders.

It strikes us that Australian DRPs are a fairly opaque tool of capital management. Most DRPs are governed by conditions which the issuer is allowed to change as suits it. Since the proportion of participating shareholders is known beforehand, by limiting the maximum number of shares one can subscribe for, suspending the plan entirely or even choosing to obtain existing shares in the market, firms can preempt and vary what we might coin as the net dividend (declared dividend less cash received) for newly issued shares. This makes it possible to smooth dividends!

By way of example, consider Tabcorp, one of Australia's largest gaming companies and the biggest position in our Australian fund. Tabcorp's DRP was first offered in 2004. From Chart 1, several points are worth noting.

**Chart 1: Tabcorp Published vs. Effective Dividend Per Share (DPS)**



Source: RECM analysis, company reports

In this chart, the grey bars represent the official declared dividend in the period it was paid for each year since 2002. 2011 shows only the final 2010 dividend. The yellow bars show the dividend figure adjusted to what is effectively the net dividend as described earlier. The number of shares in issue at year end is presented as a proxy for Tabcorp's capital requirements.

In 2002 and 2003, the company was actually conducting a share buyback, reducing their share count slightly. In 2004, coinciding with the installation of the DRP, Tabcorp merged with the Queensland casino business Jupiters Limited and

then in 2005 acquired the wagering business Tab Limited. Evidently, the purpose of the DRP was to claw back cash during this acquisitive period, and as you can see, the effective net dividends were lower than those declared. What followed was a change in the rules of the game: the DRP continued but Tabcorp sourced shares in the market, the result being that shares in issue remained flat until 2008, while effective net dividends equaled those declared. In 2009, Tabcorp announced a major upgrade at their flagship casino in Sydney, and with this switched to issuing new shares to DRP participants. Incidentally, the latest (2011) change to the share count is due to a rights issue ahead of spinning off the casino assets in a separate listing.

It should be clear from the picture that the volatility of reported dividends is lower than the effective dividends. The difference in variance is a factor of 6 – now that's smooth!

Consider the extreme case of the fully underwritten DRP: when an investment bank commits to take up shares to the entire value of the declared dividend, in return for an underwriting fee and a generous discount. A shareholder who insists on receiving cash is having the wool pulled over his eyes if he thinks this money is coming from the firm. Management, rather than admit that no dividend will be declared, forfeits fees and dilutes shareholders (through the discount) merely to maintain the façade of regular payments. Perhaps in their apprehension ahead of their initial 2004 DRP, Tabcorp had it partially (35%) underwritten.

Our whole theory of cash dividends being the last bastion of reliability now appears on decidedly shaky ground. Fifty-two companies in the ASX100 have had active DRPs in the last six months. The proportion is similar if one looks at RE·CM's investee companies. This criterion has, thus far, not impacted negatively on our stock selection. One of the things we look at in determining whether a business is of high quality is long-term dividend growth greater than the market's. The prospect of declared dividends being 'false creations', is fairly alarming. While we cannot avoid companies who engage in this practice, a more sensible approach is to factor this in to our assessment of managements' record of capital allocation.

#### **Distributions from Listed Property Trusts: 'Fatal Visions?'**

The second and more egregious pitfall worth mentioning is the prospect of hollow dividends, or in this case, distributions from listed property trusts (LPTs). The end of cheap debt cost the LPT sector so dearly they had to rename themselves A-REITs (Australian Real Estate Investment Trusts) to try and wash the stain off. This is the story of Centro Properties Group.

Centro is the second largest owner of retail property in Australia, with 120 shopping centres, and the fifth largest in the US with over 700 centres. To tell the story somewhat backwards, the mess that is Centro currently has A\$18.6bn worth of property assets, and A\$18.4bn in debt. The assets are co-owned through two complicated layers of ownership by Centro and various listed and unlisted property funds in a manner not too dissimilar to what Macquarie Group was perfecting around the same time. The debt is owned by banks and hedge funds.

Rewind three years to mid December 2007 to what was very nearly the top of the market. Prior to an announcement in which Centro admitted to being unable to service its debt, the company and management were lauded for being the best performing LPT, having delivered a total return of 25% p.a. over 10 years, and, importantly, distribution growth over the same period of 7.6%.

What eventually emerged was that the dividends, rather than being genuinely funded out of distributable profits, were the result of successive revaluations, which in turn allowed for successive gearing. Dividends were then funded out of the increased debt levels, instead of from the underlying earnings power of the owned buildings. Of course, when property values reverse, or even just stagnate, it should come as no surprise to investors in these subtle "Ponzi schemes" when their income disappears. The general lesson is to be ever wary, as even cash in your hand can be deceiving.

Christopher Boehmke

## PRICE ABERRATIONS IN GLOBAL CEMENT

*"When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean – neither more nor less."*

*"The question is," said Alice, "whether you can make words mean so many different things."*

Lewis Carroll - *Through the Looking Glass, and What Alice Found There (1871)*

*"Do not trust the horse, Trojans. Whatever it is, I fear the Greeks even when they bring gifts."*

Virgil

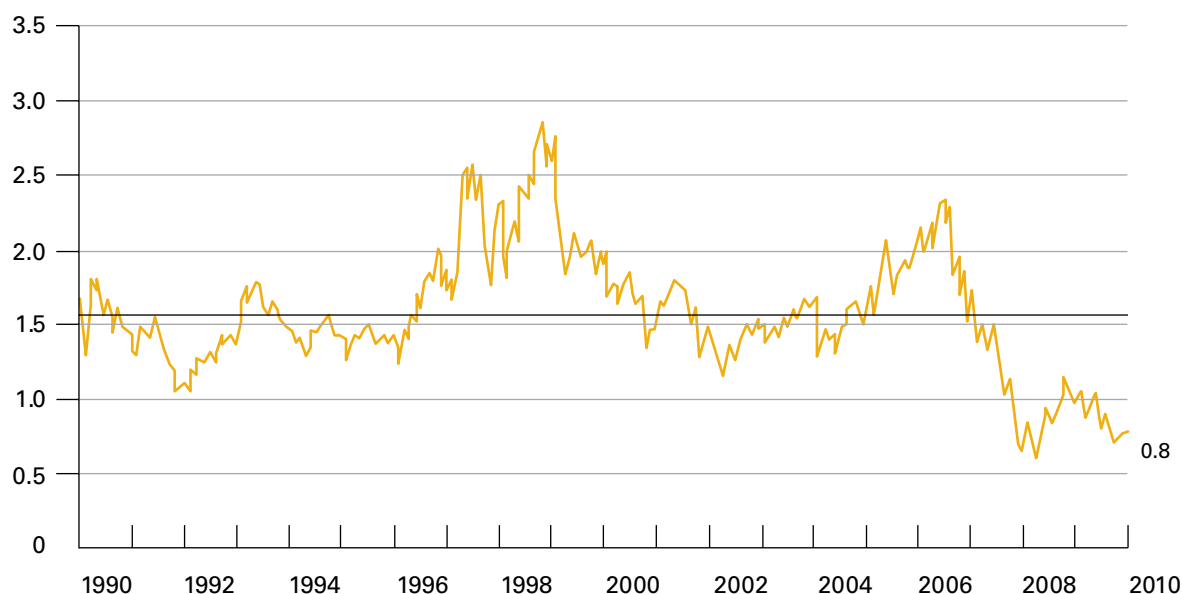
Globally, cement producers have fallen on tough times. After the peak in the global housing boom, total cement demand has declined three years in a row. As you might expect, the decline in demand coincided with the completion of expansion projects signed off during the boom years. The industry currently has considerable excess capacity, which will not vanish as it would in industries with a shorter capital replacement cycle.

Cement plants are capital-intensive investments, often with useful lives in excess of 50 years. Although plants are closed temporarily from time to time, they are rarely shut down permanently. This suggests that in the absence of a recovery in demand, surplus capacity is likely to persist.

To make matters worse, a sizeable portion of Global Cement Incorporated made acquisitions at peak market levels, the easiest way to destroy value permanently for shareholders.

Chart 1 shows the Price: Net Asset Value for a large group of multinational cement companies over time. From this, it appears that the market is considering these sentiments. However, with the benefit of hindsight and a general penchant for countercyclical capital allocation we believe that now is a favourable time to look at acquiring selected cement plants.

**Chart 1: Global Cement Index Price: Net Asset Value**



Source: Datastream, RE·CM analysis

**The downside appears limited**

It certainly seems that the absolute risk of losing money is low. Most cement multinationals remain securely profitable in perhaps the toughest environment the industry has ever faced and a further deterioration in operating conditions seems unlikely.

Sometimes mistaken as high fixed cost businesses, cement plants are high variable cost businesses, which mean that profits are quite resilient when volumes decline. Currently they earn enough cash flows to pay dividends, although admittedly smaller, and their balance sheets are not too highly geared. In addition, cement does not travel economically – it has a low value to weight ratio. Due to the high transport cost cement companies cannot dump cement around the world on a huge scale, thereby depressing regional prices, in times of excess global capacity. Overcapacity tends to be a regional problem rather than a global one.

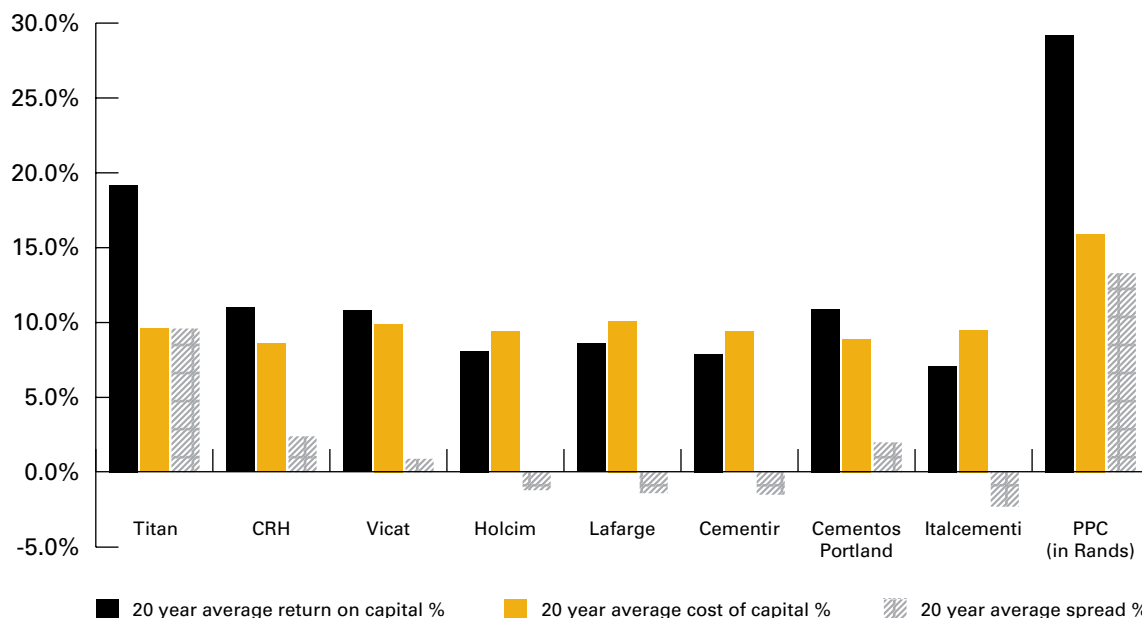
But most notably, these companies appear to be the cheapest they have been in the last 20 years and more, so the risk of a further decline in their market price appears limited.

**We assess quality by investigating the moat or barriers to entry that companies possess**

Searching for high quality companies can be defined as searching for companies that sustainably earn returns on capital higher than their cost of capital. The larger the spread between its return on capital and its cost of capital and the more sustainable the spread, the higher the quality and the more value a company is likely to create. By examining their histories, we can identify those companies that were better businesses historically. This is not to say that they will be better in the future. Rather, the idea is to identify those businesses that may possess a moat or barriers to entry that enables them to sustainably re-employ capital in the business at favourable rates of return.

Chart 2 compares the return on capital and cost of capital and the resulting spreads for various multinational cement businesses. It suggests that over the last 20 years companies like Titan Cement and PPC with a wide positive return on capital spread over their cost of capital were the most likely to have created value for shareholders. In fact, PPC is widely regarded as one of the most profitable cement companies in the world. In contrast, companies with negative spreads like Italcementi possibly destroyed value for shareholders over the last 20 years and are unlikely to have rewarded shareholders for the risk they assumed.

**Chart 2: Global Cement Returns on Capital and Costs of Capital (Euros)**



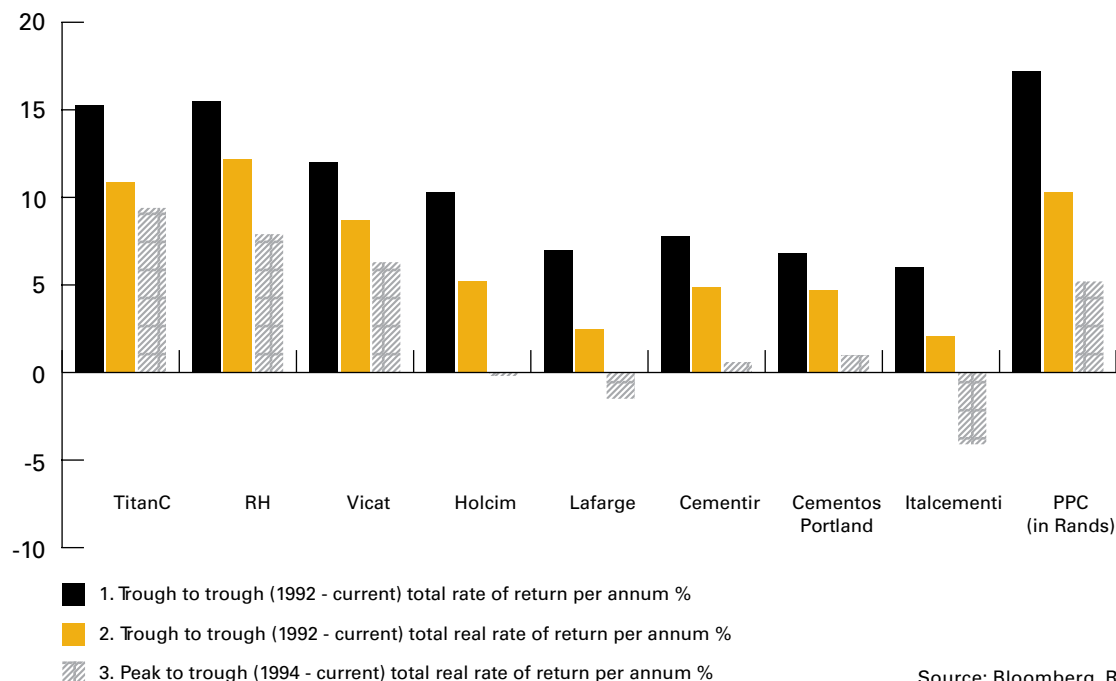
Source: Bloomberg, RE-CM analysis

It is important to remember that these are accounting returns on capital compared to estimates of company specific cost of capital. Imperfect measurement is possible for a variety of reasons - more on this later.

The true test lies in whether and by how much the accounting return spread estimates have translated into value for shareholders. This is captured in Chart 3 and Chart 4 where we measure the total rates of return to investors over three market cycles:

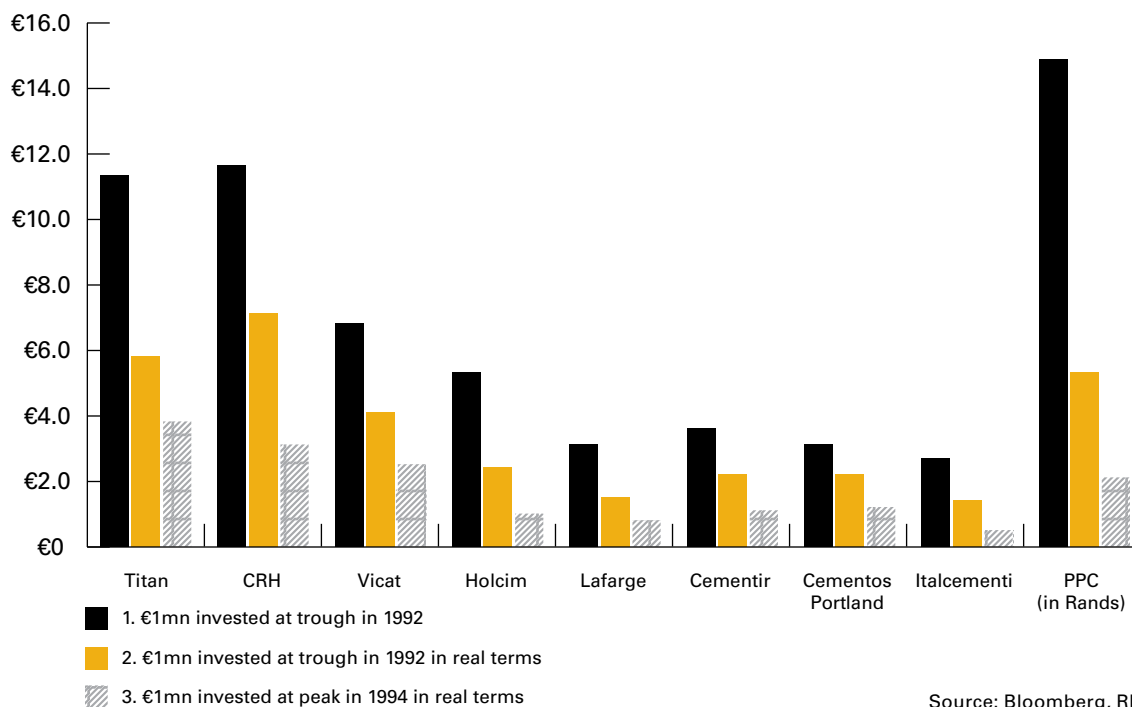
1. From a low point in the cycle in 1992 to the current low point to obtain a fair measurement of the nominal total return investors earned over a full market cycle. In this case, over three full market cycles.
2. Similar to the above, measuring trough to trough over three full market cycles but measuring the total real returns after subtracting inflation in order to assess the growth in real purchasing power.
3. From a high point in the cycle just two years later in 1994 to the current low point to assess the impact that the price paid had on the total real returns to investors.

**Chart 3: Global Cement Total Rates of Return to Investors (Euros)**



Source: Bloomberg, RE-CM analysis

**Chart 4: Global Cement Total Returns to Investors**



Source: Bloomberg, RE-CM analysis

**Return on capital is a good indicator of the total nominal rate of return**

The accounting return on capital and spreads over cost of capital in Chart 2 seem to be a good (or at least fairly consistent) predictor of the returns investors earn. Companies with higher return spreads tended to generate higher nominal returns for investors while those with poor spreads generated relatively inferior returns.

**Real returns are more important than nominal returns**

Real returns, in other words how investors did after considering the eroding effect of inflation, matter most. Although all of the companies created value in real terms, companies with higher return spreads created more value than those with poorer spreads. Note that PPC's real return is significantly lower than its nominal return and below the real returns of Titan and CRH. This is due to much higher inflation in South Africa over the last 20 years. It appears that the purchasing power of European investors' investments in Titan and CRH was better protected than that of South African investors in PPC. This also highlights the importance of considering the impact of inflation before getting excited about cited nominal returns. Real returns to PPC investors are unexpectedly weak for a company that is considered massively profitable.

**The price you pay matters**

If you invested in any of these cement companies two years later in 1994 and held the investment until today you would be substantially worse off than if you invested in 1992. In most cases, you would only have half the money. The price you pay for an investment has a major bearing on investor outcomes.

In some cases like Italcementi, investing in 1994 destroyed value for shareholders over the subsequent 16 years. This highlights a related point, namely that the price you pay becomes even more important the poorer the quality of the business. Investors can look for three sources of return when investing in a business:

1. a dividend;
2. growth in the intrinsic value of the business; and
3. an adjustment in the price multiple or the market's assessment or rating of the business.

Good quality businesses compound capital at a higher rate and tend to create more intrinsic value over time. Much of an investor's return from such a company will come from the dividends and growth in intrinsic value rather than the price multiple paid which will have less of a bearing on the outcome 20 years from now. If you paid too much for such a business, the growth in the value of the business is likely to compensate you for the higher price, and then some. On the other hand, for a poor quality business that does not grow its value or does not pay an (attractive) dividend the price you pay will have a major influence on your return.

Price is also one of the only things that a minority investor can control. An understanding of the quality of a business or the strength of its moat and a grasp of its business cycle aids in valuing a business. This in turn helps to identify an appropriate purchase price with a suitable margin of safety. Minority investors have very little control over management actions, corporate activity, and other events that often play a major role in the future returns of a business.

Good returns on capital in the future stem from good capital allocation. And good capital allocation is only possible when, where it concerns:

- reinvestment in its own operations - the business or expansion has attractive economics, in other words favourable returns on capital versus the cost of the capital; and
- mergers and acquisitions - management do not do dumb deals.

Minority investors cannot generally foresee the outcomes concerning future management actions and events. Although it is possible to align with the general philosophy and culture of a firm, where a family owned business like Titan Cement interests are aligned with minority shareholders, the only assessment that is normally justified involves an assessment of the quality of the firm and likely returns on capital given average management.

Even though investors cannot control these business outcomes, they do have full control over the price they pay. This will, given an adequate margin of safety, compensate for negative outcomes and generally have a significant bearing on the investment outcome.

### **An aside on risk adjusted returns**

In addition to considering whether the companies produced real returns over three full market cycles (trough to trough) we can take the analysis a step further by investigating whether it adequately compensated investors for the risk they took when they invested. We do this by comparing the nominal total rates of return in Chart 3 to the cost of capital estimates in Chart 2. Consider that for every risk profile investors require a sufficient return to compensate them. For lending money to the government (investing in a government bond) the risk and therefore acceptable level of return is less than it is for owning a portion of a business (investing in the equity capital of the company). For the bondholders and equity shareholders in the cement companies together these required or acceptable rates of return are reflected as their costs of capital, estimated and illustrated in Chart 2.

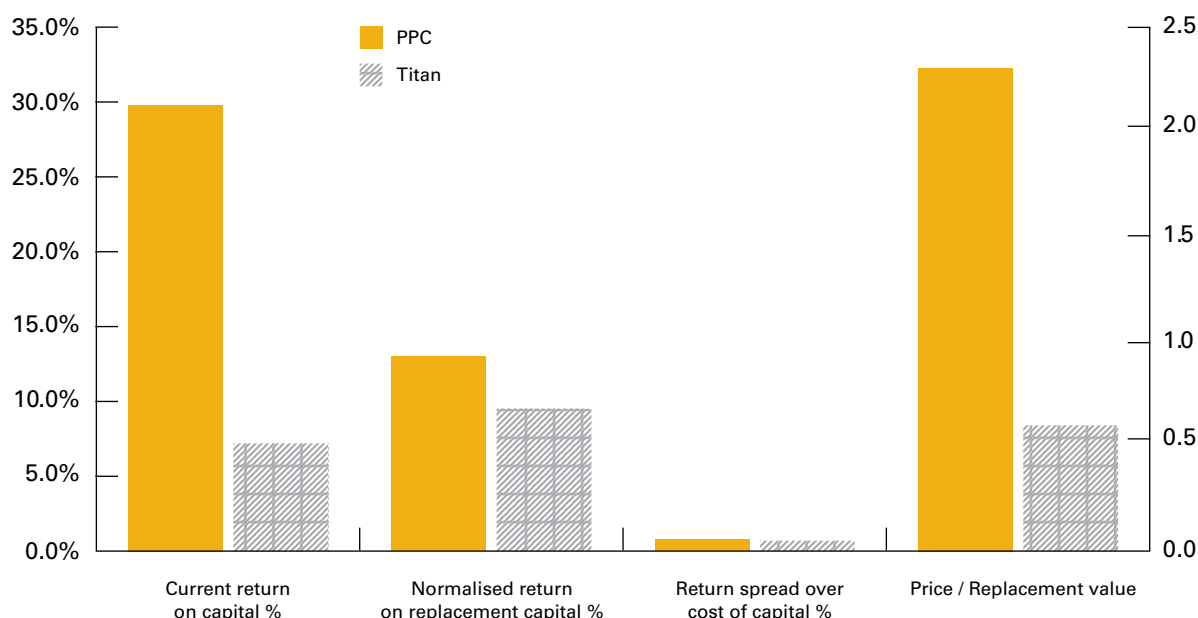
It seems that only Titan, CRH, Vicat, Holcim and PPC rewarded shareholders for the risk they took. Ignoring the trough to trough measurement and simply assessing the last 20 years, it seems that only Titan, CRH and PPC adequately rewarded shareholders for risk.

### **Economic returns versus accounting returns**

PPC's high return on capital relative to their less stellar real returns to investors is an inconsistency that justifies further investigation. The high historic accounting return is unlikely to be a fair representation of the profitability at which it is able to reinvest in its business in the future. One of the drawbacks of accounting returns is that they do not always fully reflect the reality of having to replace assets at a higher cost than in the past. We believe this to be the case for PPC. For long life assets such as cement plants the depreciation charge on plants built 30-40 years ago significantly understates the cost of replacing them today. With PPC bound to replace aging assets, reduced accounting returns on capital are inevitable. In spite of accounting accuracy, it is impossible for one set of rules to accurately reflect the realities of all businesses and all situations all of the time. An alternative measure that may be a more suitable estimate of a true economic return is the returns earned on the capital required to replace the existing plant today. In other words, returns on replacement capital at today's cost as opposed to the return on accounting capital at historic cost.

**PPC and Titan Cement Compared**

**Chart 5: Titan Cement and PPC Returns and Valuation Comparison**



Source: Bloomberg, Company Annual Reports and RE-CM analysis

PPC owns older assets while Titan has followed a strategy of modernisation over the last decade. Its accounting capital is therefore a much closer reflection of what it will cost to replace its capacity today than PPC's. With reference to Chart 5, keep in mind that for PPC, operating margins are currently above long-term averages or normal levels whereas Titan's operating margin is at an all-time low.

It follows that PPC's accounting return on capital is currently overstated because earnings are inflated and capital is understated. This means that normal returns on replacement capital shrinks considerably. Conversely, Titan's current accounting return on capital is the lowest it has ever been and very low compared to PPC, but its normal return on replacement capital is relatively better.

PPC and Titan's normal returns on replacement capital are not directly comparable and should be compared to their respective costs of capital. Both companies seem to earn an economic return in a normalised environment with returns on replacement capital higher than their cost of capital. Based on accounting capital it seemed that PPC had an extraordinarily wide moat. Based on our estimates of what it will cost to replace PPC today it seems that PPC does indeed have a moat, but a much narrower one than initially thought.

This fits with our understanding of the businesses. Most cement regions do not have impenetrable barriers to entry. Yet, setting up a cement plant requires access to quality long-life raw material resource close to a large market, which is not an easy find. In addition it takes about five years and plenty of capital to bring cement production to the market. This sometimes creates inefficiencies that allow excess returns in certain geographic areas. But in the end, excess returns will attract new competitors who will typically find a way to enter. We have seen it here in South Africa with new players like Sephaku securing limestone resources and a partner to help fund a new cement plant.

We can think about the value of these companies as follows:

1. Their net replacement value is higher than the accounting net asset value - the value to replace assets at today's prices costs more than in the past.

2. The cash flows that these companies generate are generally worth more than their replacement value. This has historically been the case for Titan and PPC - they extracted additional value above the value to replace the firm, as there were barriers to entry that prevented competition from eroding excess profits. Importantly, their management teams did not do dumb deals. If there were no barriers new competitors would enter easily until excess profits eroded to the level that the value of its cash flows equaled their replacement value. Evidently, the net replacement value is generally a more accurate measure for most industries, as most industries do not have real barriers to entry.
3. Despite the similarities between PPC and Titan, Chart 5 shows that PPC is trading at more than twice its replacement value while Titan's market price is about half its replacement value.

Titan appears undervalued on most measures. This is not unexpected given the negative news flow surrounding both global cement companies and Greece, Titan's original market. Titan is trading at a discount to Net Asset Value, an accounting estimate of the historic value of its assets minus total liabilities. It is trading at an even larger discount to Net Replacement Value, an estimate that considers the value of its assets today and the state of its assets. The cash flows that Titan generates on average are worth more than the cost to replace it and it is trading at an even higher discount to this more traditional measure of value or its Earnings Power Value. However, the investment case does not rely on these excess future returns because Titan appears undervalued even on the premise that it will be an average business in the future worth only its replacement value.

The conclusion of this process is to invest in a good quality company at a substantial margin of safety. Even though we consider Titan a good quality business that will grow its intrinsic value in the future, we are able to buy it at a substantial margin of safety, at a price that limits the risk of losing money and increases the likelihood of earning meaningful real returns, especially on a risk-adjusted basis. PPC is an example of a good quality company trading at a substantial premium to its intrinsic value. Unsurprisingly, where our mandates allow, RE-CM's funds own Titan but no PPC.

It seems that in this instance the fear surrounding the Greeks is misplaced and we have a real gift in our hands.

Johannes Visser

## THE ADVANTAGE OF PERMANENT CAPITAL: LOOKING WHERE OTHERS ARE NOT

*“The Heisenberg principle in physics provides an analogy for the markets. If something is closely observed, the odds are it is going to be altered in the process...The general rule is: The less observed, the better the trade.”*

**Bruce Kovner, Interviewed in Market Wizards**

*In the short run, the market is a voting machine but in the long run it is a weighing machine.*

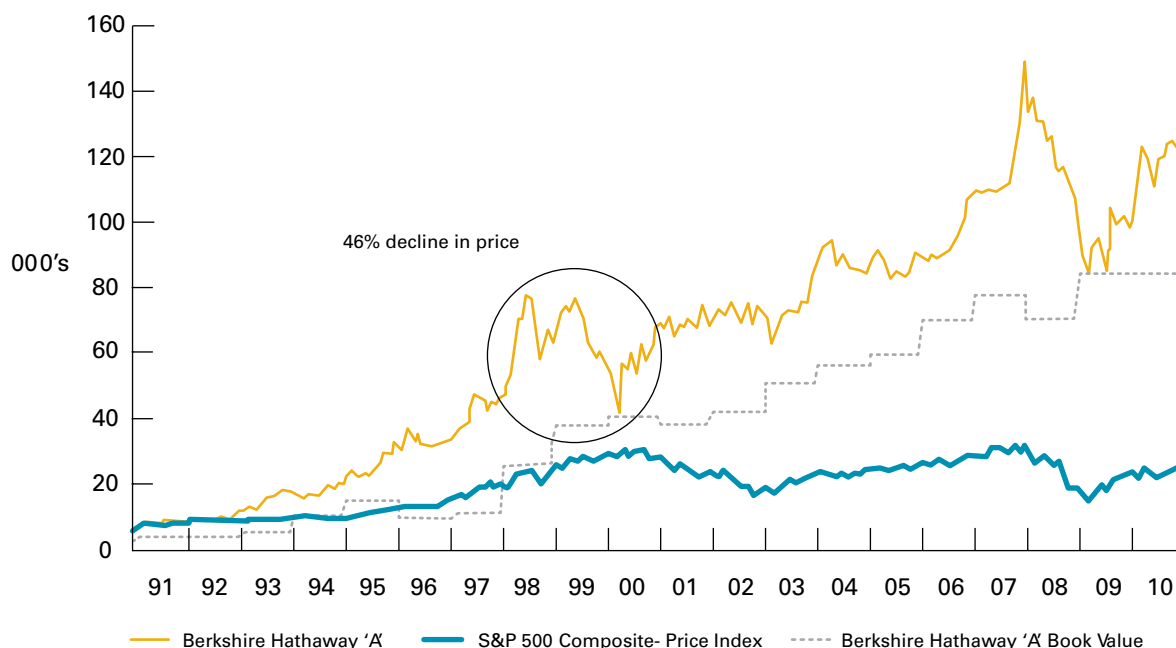
**Benjamin Graham**

One of our competitive advantages at RE·CM is that we are able to take a longer term view because of the support of our ownership structure. Due to the open ended nature of the vehicles we manage on behalf of clients, they are subject to large flows, often at inopportune times. Sometimes large inflows are received when historic performance has been good, and underlying value in the market is scarce, while at other times, large outflows happen when returns have been poor, but there is significant value present. There is a saying in the industry that clients’ emotions are an investment manager’s worst enemy. Short run swings in the market can lead investors to panic and force managers to liquidate positions at the worst possible time.

To counteract such forced buying or selling due to flows, the concept of a closed-end fund is useful. Investors initially commit capital to the fund by taking part in the IPO of the listed entity. Withdrawing capital involves selling the shares in the open market. As a result, decisions by investors to withdraw capital have no effect on the underlying holdings and therefore long-term investment performance. This is a powerful advantage for an asset manager.

The advantage of permanent capital has played an important role in the success of Warren Buffet.

**Chart 1: The S&P500 Versus Berkshire Hathaway’s Price and Book Value Per Share.**



Source: Thomson Reuters Datastream

The performance of Berkshire Hathaway (BRKA) over the last 20 years has been fantastic, yet it would arguably not have survived in 1999 had it been an open-ended fund. Buffet remained within his circle of competence and avoided the tech

boom to the detriment of his relative performance. As a result investors lost confidence in Buffet and heavily dis-invested, resulting in a 46% slump in the price of BRKA. Not surprisingly this was exactly the wrong time to exit Berkshire, as the tech bubble burst soon afterwards whilst Berkshire went on to significantly outperform the S&P 500.

**The power of permanent capital has always interested us at RE·CM**

To this end, RE·CM and Calibre (RAC) listed a preference share to create a closed-end fund. RAC has just over R500mn in permanent capital which gives it the flexibility to seek out investment opportunities that are on few investors’ radars. As Bruce Kovner alludes, the less people pay attention to something, the higher the likelihood of it being mispriced.

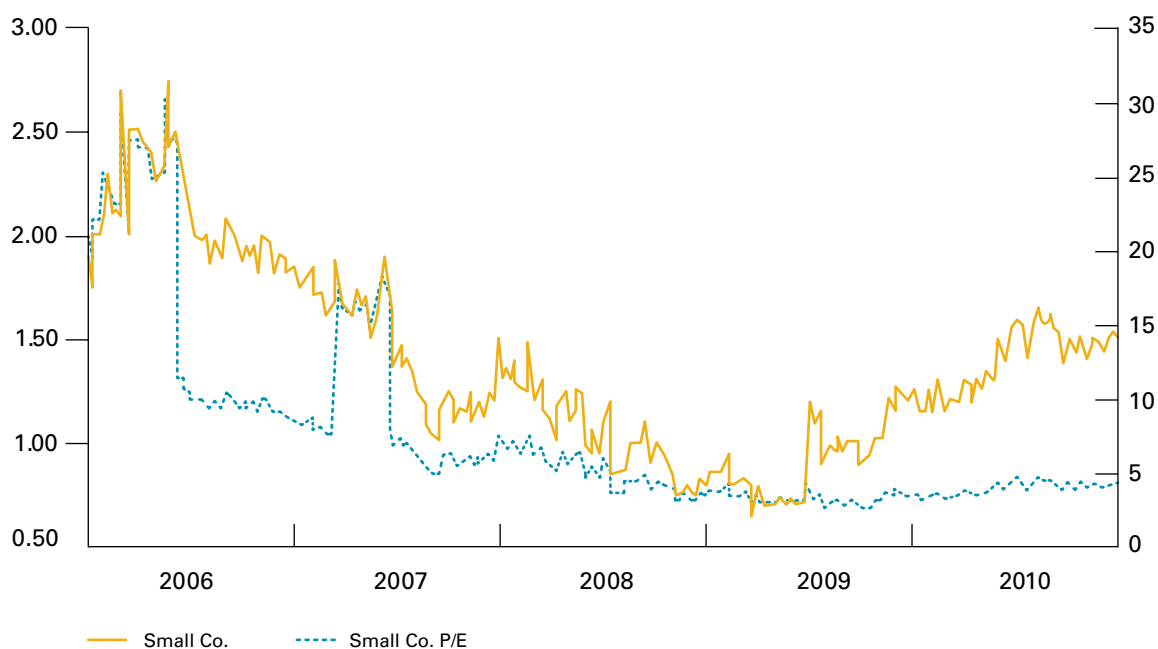
RAC has been focusing on small capitalisation shares (under R500mn), where ignored and often mispriced companies can be found. One of the reasons this investment sphere is less competitive is the illiquid nature of the shares. When open-ended small cap funds face large and sudden redemptions, it can be very painful to be a forced seller of an illiquid stock. This process drives down prices to very low levels. RAC, because of the permanent nature of its capital, is able to avoid the very uncomfortable position of being a forced seller, and can actually take advantage of the forced selling by open ended funds.

**Gaining a research advantage and accessing value in the small cap market**

Small cap stocks can become extremely cheap because emotions are amplified due to the higher risk and the unsophisticated nature of the investors in the small cap market. Companies can deliver great results year in and year out while the share is ignored or sold off with the rest of the market. By competing with unsophisticated investors we therefore gain a research advantage which isn’t always possible with larger, better known companies.

Recently, a very small company, that has been listed for five years, caught our eye. Lets call it Small Co. In Chart 2 below, the yellow line represents the price and the blue line represents the P/E ratio.

**Chart 2: Small Co. Price and P/E**



Source: Thomson Reuters Datastream

**Small Co.: producing consistently good returns and cash flow with strong margins**

Small Co. has a market capitalisation of around R100mn. Many institutions may never have heard of it or will not have paid it much attention. But the performance of the company since listing in late 2005 has definitely caught our attention. Returns on equity have been consistently high, the business generates good cash flows and margins have been very strong.

**We focus on understanding businesses, not just focusing on valuation metrics**

Value investing isn't simply about applying metrics to a share. It is also about understanding the business, the barriers to entry in the industry and the sustainability of margins. Small Co. has very high margins which are largely due to the dominance it enjoys in the radio network market. Regulation has made it more difficult to obtain radio licences especially for the smaller private security companies which operate off radio frequency networks. Small Co. also manufactures radio transmitters which are required to use its network. Combined with equipment switching costs in the private security market, Small Co. has a moat which should allow it to maintain margins and returns going forward.

**The market has undervalued Small Co. in the past but we anticipate that this will change**

To find a good small cap company is rare, as most small cap companies are not what we would call good businesses. For value investors, the prospect of finding a good business which is significantly undervalued and ignored by the market is what gets us out of bed in the morning.

To illustrate how poorly the market has valued Small Co. in the past few years, it is worth noting that for the last three years the Price/Earnings ratio has averaged around four times for a business returning around 20% a year on equity. In fact in March of 2009 it sold at 70cents which was two times its 2009 reported profit. The position we are taking is that we will enjoy the strong cash flows of the business while we remain part owners. We do not have to rely on the market to revalue the share to create an exit opportunity, but if this happens, it is a bonus.

We continue to seek out ignored and mispriced investment ideas in the small cap space while we wait for the market to recognise the underlying value of our holdings. In the meantime, investors in RAC will never have to worry about the fund's underpriced assets being sold due to distress selling.

Faure Heymans



7th Floor, Claremont Central  
8 Vineyard Road  
Claremont, Cape Town, 7700  
PO Box 45040, Claremont, 7735

Tel: +27 21 657 3440  
Fax: +27 21 674 1085  
EMAIL: [info@reem.co.za](mailto:info@reem.co.za)  
[www.reem.co.za](http://www.reem.co.za)

**We value your input on the information we provide you. If you have any comments or suggestions regarding our newsletter please feel free to contact us.**

Regarding Capital Management (Pty) Ltd is a licensed financial services provider authorised in terms of the Financial Advisory and Intermediary Service Act, 2002 to provide advisory, intermediary and discretionary financial services (License number, 18834).

Collective Investment Schemes in Securities (Unit Trusts) are generally medium to long-term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to future performance. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. The manager may borrow up to 10% of the market value of the portfolio where insufficient liquidity exists. A schedule of fees and charges and maximum commissions is available on request from the management company, RE-CM Collective Investments (Pty) Ltd (RE-CM). Commission and incentives may be paid and if so, would be included in the overall costs. A Feeder Fund portfolio is a portfolio that, apart from assets in liquid form, consists solely of units in a single portfolio of a collective investments scheme. Forward pricing is used. Funds are valued daily at 15h00. Instructions must reach RE-CM before 14h00 to ensure same day value. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Different classes of units apply to these portfolios and are subject to different fees and charges. Unit Trust prices are calculated on a net asset value basis, defined as the total market value of all assets in the unit portfolio including any income accruals and less any permissible deductions (brokerage, uncertificated securities tax, VAT, auditors' fees, bank charges, custodian fees, trustee fees and the annual management fee) from the portfolio divided by the number of units in issue. These portfolios may be closed. RE-CM Collective Investments (Pty) Ltd, Company Registration Number: 2004/027540/07, is a member of the Association of Collective Investment Schemes. Trustees: The Standard Bank of SA Limited, PO Box 54, Cape Town, 8000.

Whilst every care has been taken in compiling this document, the information is not advice and RE-CM and/or its associates do not give any warranty as to the accuracy or completeness of the information provided herein and disclaim all liability for any loss or expense, however caused, arising from any reliance upon this information. Please note that there are risks associated with investments in financial products and past performance is not necessarily indicative of future performance.