RE·VIEW

Portfolio and Investment Insights - Volume 17
July 2011

RE·CM

PORTFOLIO & INVESTMENT INSIGHTS
VOLUME 17: JULY 2011

RE·CM

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INTRODUCTION

Despite strong markets over the past year, economic events continue to be unsettling. Europe is undergoing a debt crisis, the USA is suffering from the after effects of one, and in China...well, probably only the state planners there know whether there will be a crisis – and until that happens, we will continue to see a misallocation of capital. The only area that seems to be free of any crisis (pre, post or planned) is the emerging markets.

However, it is very important to realize that investment returns are not generated by economic growth. There have been numerous studies that have shown the link between economic growth and subsequent stock market returns are tenuous at best. In fact, the dominant driver of returns is the starting valuation. When prices are low relative to intrinsic values, long-term returns tend to be high, while the converse is true when prices are high relative to intrinsic value. Regardless of the state of the economy.

Very simply, that is why we here at RE:CM enjoy the luxury of spending less time reading the news, studying each economic statistic as it comes out and trying to tease out second and third order economic effects. We spend most of our time studying the companies we are investing in, or thinking about investing in. This is a much more rewarding line of activity – we are spending all our time on the one thing that drives returns - valuation - and no time at all on the thing - economics - that has almost no link with investment returns at all.

As a result of our efforts to focus our work on where we can make the most difference, we seldom have a clear view of what the economic future holds. Many of our clients are disappointed in our inability to give them a forecast of the future, at least in economic terms. I think there are two points that are very important here. Firstly, the only difference between RE:CM and some of the more public market prognosticators are that we freely admit that we don't know what the future holds. And secondly, most of the economic "analysis" that is rolled out serves mainly to act as a form of comfort blanket for investors. We do not think investors are well served by such comfort blankets. Better to realize that one doesn't know the future, and plan and act accordingly, than to base one's strategy on systematically incorrect economic forecasts.

The question then becomes – if we don't know much about the future, how do we deal with the uncertainty that comes with making investment decisions? The answer lies in two areas: firstly, we demand a large margin of safety before investing (i.e. a market price well below our estimate of intrinsic value) and secondly, our willingness to hold cash in the face of a lack of cheap valuations.

That is why we are currently running with large cash positions in all our funds, as you will see when you read the fund managers' comments later on in this RE:VIEW. As an aside, it is worth reading James Montiers latest research piece for GMO, called "A Value Investor's Perspective on Tail Risk Protection: an Ode to the Joy of Cash". In this piece he shows how cash is an investor's best defense against "black swan events", or those type of out-of-the-blue events that tend to knock the stock market from time to time. At RE:CM, this is something that we have implicitly known - and implemented - for a long time, but we had to wait for someone of the caliber of James Montier to actually prove it to us.

So, for those clients that are nervous about market valuations, and economic events – as we also are – we again cannot give you the false comfort of an economic forecast, or roadmap. What we can offer you is the knowledge that risk management sits at the front and center of our portfolio management process, and that we are substantial co-investors with you in our funds. The only thing we are actually optimistic about is mankind's ability to dig themselves out of deep holes. We have no doubt that we – collectively – will be able to do so again. In the meantime, while we wait for this to happen, we will maintain large cash positions, and only own stocks that actually pay us for the risk of owning them through a deep discount to their intrinsic value.

For those clients who do not find these assurances comforting enough, or for those that cannot afford to sit through temporary price declines, we launched a new fund nine months ago. It is called the RE:CM Money Market Fund. Thompson Ganyeka manages it with the aim of providing better returns than one can get from call deposits at a bank. The fund is managed with a very low risk approach, only investing in the highest quality money market paper. This means that it does not buy higher yielding low quality paper. But it makes up for this by being the lowest cost money market fund available to retail investors in the South African market. RE:CM only charges a fee of 15 basis points for Thompson's efforts in this fund.

You will find a report on this fund in the first section of this edition of the RE:VIEW. It is followed by reports on all our other funds as well. I would especially like to point out the reports on both our Australian Equity Fund and our Global Fund. RE:CM is competing head on with the giants in the fund management world, and doing quite nicely. We believe the consistent application of our investment philosophy and process enables us to do so. Our geographic location or nationality is not relevant.

In the Investment Insights part of this RE:VIEW you will find four articles by our analysts. The first one, "Using our Competitive Advantages to Optimize Your Investment Outcome" is a transcript of a talk I gave at our annual report back to clients in May of this year. In it, I discuss the competitive advantages we have at RE:CM, and how we use them to your benefit. It is important to understand that a competitive advantage is something that others find difficult or impossible to copy. In the fund management industry, brains are seldom a competitive advantage. The industry attracts far too many smart people - who should most probably rather be doing something more intellectually demanding and socially useful, like building bridges. We think competitive advantages in this industry lie more in how fund management firms are structured, and how this enables investment philosophies and processes to be implemented.

The second article deals with how the market values growth and low growth companies, and the investment results from that process. It is called "Smoke 'em and Dope 'em – the Tale of the No-Growth Ruse" and was written by Daniel Malan. It compares the valuation and subsequent investment return of pharmaceutical companies (which are a large holding in both our Global Fund and our Australian Fund) with Tobacco companies (which are not held by any of the RE:CM funds.)

The third article "Managing the Moat" was written by Johannes Visser, and gives a fascinating insight to the business models and competitive advantages enjoyed by banks – if any! Johannes shows that the best banks are the most boring ones, i.e. the ones who focus on getting the things right that make a difference – cheap deposits. As a result of Johannes's work, we have started to selectively buy into the banking sector in the USA – our first financial exposure in the global fund since the global financial crisis.

Finally, Wilhelm Hertzog has, as always, written a well-researched piece on stock buybacks. It is called "The Smoke, Mirrors and Shattering Truth of Share Repurchases". In it, he explodes some myths around share buybacks, and points out what we (and the boards who authorise the buybacks) should be looking out for.

Good Investing!

Piet Viljoen
Executive 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	2.8%	11.0%	11.5%	15.8%
CPI + 8% p.a. (ZAR)		7.3%	12.6%	13.5%	13.7%
RE:CM Flexible Equity Fund (ZAR)	Mar-05	0.0%	13.8%	15.3%	17.7%
ALSI p.a.(ZAR)		0.5%	24.6%	4.5%	18.1%
RE:CM Global Fund (USD)	Mar-06	9.1%	22.9%	8.8%	6.1%
MSCI World (USD)		5.9%	31.2%	1.0%	2.6%
RE:CM Global Feeder Fund (ZAR)	Mar-07	9.6%	4.1%	0.8%	1.4%
MSCI World (ZAR)		8.2%	15.7%	-3.8%	-2.0%
RE:CM Australia Equity Fund (AUD)	Mar-10	2.9%	11.3%	n/a	5.2%
ASX 300 (AUD)		-1.3%	11.9%	n/a	-0.6%
RE:CM Money Market Fund (ZAR)	Oct-10	2.7%	n/a	n/a	4.0%
SteFI Call (ZAR)		2.6%	n/a	n/a	4.0%

MAJOR MARKET RETURNS (annualised, in US Dollars %)

Index	6 Months*	1 Year	3 Years	5 Years
S&P 500	5.0%	28.1%	1.0%	0.8%
FTSE 100	3.9%	29.8%	-5.2%	-2.4%
Nikkei 225	-2.6%	15.0%	-1.4%	-2.1%
MSCI World	5.9%	31.2%	1.0%	2.8%
MSCI Emerging	-0.4%	24.9%	1.8%	8.9%
FTSE/JSE ALSI	-3.3%	37.4%	6.6%	9.7%

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

Currency	6 Months*	1 Year	3 Years	5 Years
South African Rand	-2.1%	13.4%	4.9%	1.2%
Euro	8.3%	18.5%	-2.7%	2.5%
UK Sterling	2.8%	7.4%	-6.9%	-2.8%
Yen	0.7%	9.8%	9.6%	7.3%
Swiss Franc	11.2%	28.2%	6.7%	7.8%
Australian Dollar	4.8%	27.5%	3.8%	7.6%

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

* Not Annualised

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

Fund Details

Fund Size	R1,086m
Benchmark	SteFI Daily Call
Annual Fee	0.15% Excl VAT

Top 5 Holdings

Instrument	Portfolio Weight %
SARB 05/06/2011	20.7
Nedbank Step Up Notes	18.4
Investec Step Up Notes	16.1
FSR 26/09/2011	11.9
ASABA 17/08/2011	7.4

RE:CM MONEY MARKET FUND

This is the inaugural six month report for the Money Market Fund. The fund was launched nine months ago in October 2010.The fund was created for investors who were either looking for a place to park their capital until they were ready to commit to one of our other funds, or for investors who had a requirement for funds to be available to satisfy their short term liquidity needs. As such the fund is managed with the following principles in mind:

Capital Preservation

Protecting capital is a key part of our day-to-day life at RE:CM. All our funds have risk management at their core. But we cannot offer a guarantee – to earn inflation beating returns, one has to take some risk. As such, we recognised the need for a fund that took no capital risk. The RE:CM Money Market Fund will only invest in the highest quality, short term money market assets. It will not "reach for yield" by buying poor quality, lowly rated securities. We are very aware of losses suffered by other money market funds by investing in assets of a dubious quality or structure. The fund is managed in accordance with the CISCA regulations for money market funds. These include a maximum weighted average portfolio duration of 90 days, and a maximum duration of 12 months for any specific security held by the fund. The regulations also specify a minimum rating of F (the third highest rating category for money market assets). However, our internal rules for the RE:CM Money Market Fund go further than that. We will not invest in securities of lower rating than F1 (the second highest rating) and we will not invest in any complicated structured products, where credit risk is often obfuscated. In short, the RE:CM Money Market Fund will generate low risk income by investing in more secure deposit takers.

Liquidity

The fund aims to provide overnight liquidity to our clients. We do this by managing the expiry profile of the securities we invest in very carefully.

Income

The fund aims to generate income that exceeds the SteFI Call rate. We make up for the very conservative nature and correspondent lower yield of the assets the fund invests in, by charging the lowest fee on such a fund available in the retail market. This fee amounts to 0.15% excluding VAT.

Investment Results

Your investment result (after fees) for the six months to the end of June 2011 was 2.7%. This compares to the benchmark (SteFI Call) of 2.6%.

The last six months have been characterised with the sovereign debt crisis of the PIGS (Portugal, Ireland, Greece, and Spain) countries. This has had an effect on the level of global currencies and commodity prices. The European Central Bank (ECB) raised rates for the first time in three years in order to combat inflation in the Euro area. The majority of emerging markets such as China, India and Brazil have also been hiking interest rates to contain rising inflation in their domestic economies.

In South Africa we have witnessed lacklustre economic growth on the back of weaker retail and private sector credit growth. The local commercial banks

Largest Investments

	Value Rmn
Nedbank Step Up Notes	200
Investec Step Up Notes	175

continue to take deposits at reasonable rates but with low corresponding increase in lending to the private sector. This shows that there is limited business and industrial activity requiring significant funding. The lacklustre growth in private sector credit borrowing is likely to result in less aggressive interest rate hikes from the Reserve Bank because of the slowing investment and consumption activity. Although local inflation has been increasing steadily, the Reserve Bank has kept interest rates unchanged since the last cut in 2010.

Management Actions

The RE:CM Money Market Fund has deposits that mature on a regular basis. However it is important to highlight the major investments that we have made in the fund.

The fund has invested R375 million in step-up deposit notes. These are deposit instruments that will pay a set spread over the base rate – and this spread increases the longer one holds the note. Initially, they pay a slight negative spread, i.e. a yield slightly below the interbank rate. At reset (generally every three months) one has the choice of either liquidating the deposit, or of keeping it, in which case the spread "steps-up" to a higher level. If one keeps the note until it matures in three years' time, it ultimately ends up paying over 2% better than the interbank rate. They are thus effectively low risk deposits similar to other three months bank deposits, with the important difference that the fund is incentivised to keep them for the long term. At RE:CM, we are by our very nature long term investors, so the fact that someone is willing to pay us to express our preferred view, strikes us as being a good deal!

The fund currently has a duration of 68 days. The money market yield curve is fairly flat, and one is not being paid very much for the risk of investing further out on the yield curve. Until this changes, we will keep the duration of the fund at current levels.

Thompson Ganyeka, Piet Viljoen
Portfolio Managers

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	R1.1 bn
Benchmark	ALSI
Performance Fee	20% above/ below ALSI +2.5%
Annual Fee	0.5% annual fee excl. VAT

Portfolio Diagnostics

	Fund	ALSI
P/E Ratio	15.7	15.1
Dividend Yield	2.4%	2.6%
Volatility	14.3%	18.4%
% Maximum Drawdown*	-27.1%	-40.4%
% Positive Months*	68.0%	65.3%
% Turnover Rate**	21.0%	n/a
Number of Holdings	41	163
Concentration of Top 10 Holdings	48.6%	53.8%

*Life of Fund
**Trailing 12 months

TER is 0.83%. Inclusive of the TER's herewith, a performance fee of 0.27% was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

RE:CM FLEXIBLE EQUITY FUND

Investment Results

Despite a great deal of drama over the past six months on both the local and global stage (nationalisation arguments in South Africa, popular uprisings in North Africa and the Middle East, Greek debt restructuring talks in Europe, etc.) the JSE's All Share Index ended the six months within a hair's breadth of where it started the year (on a total return basis, i.e. including reinvested dividends), delivering a return of 0.5%. Your fund followed suit and, on a total return basis, finished the six months at exactly the same level as where it started the year. This is of course pure coincidence, and not at all a reflection of the resemblance your fund's composition bears to the constituents of the index.

An interesting aspect to this outcome over the last six months, is that the Basic Materials (i.e. resources and mining) sector of the JSE lagged the overall market substantially. With your fund being far less invested in these businesses than their index weights, one would have expected your fund to deliver commensurately better performance. The reason for this not being the case is principally the absence of the mega cap industrials MTN and Richemont from your fund. Richemont seems to have been swept up in the excitement about the increasing consumption of luxury goods in China. As a consequence, the share is now exceedingly expensive. Richemont is a fantastic business, and RE:CM clients have been shareholders in the past (in the fund's last ownership cycle of the stock we sold out completely in May 2010), but when a share moves from expensive to ridiculously expensive, RE:CM clients are unlikely ever to participate.

MTN is a stock we took a good look at early in 2010, and its valuation is certainly not as expensive as that of Richemont. However, it was just never so compellingly cheap as to spur us into action. Being the number one or two operator in most of its markets, it is certainly a good business, and one we continue to keep a careful eye on.

Management Actions

Something of particular interest that occurred over the past six months, is that for the first time in many years, we have allocated meaningful fund capital to a mining business (outside of the gold mining sector).

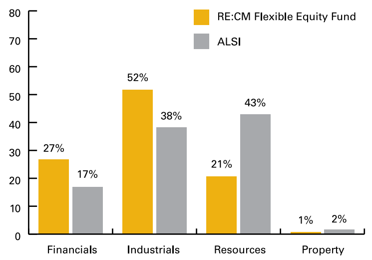
Despite more than doubling from its lows reached in late 2008, the platinum price has vastly underperformed the price movements of other industrial metals since early 2009. Meanwhile, production costs at mine level have kept increasing, and exacerbated by a strong currency, profitability of South Africa's platinum miners has not been fantastic of late. Partly as a result of this, the share prices of the platinum miners have lagged the platinum price (in common currencies) materially over the same time period. This has resulted in share prices that are now beginning to look interesting to us compared to long term fundamentals. In this context, we have made a meaningful investment in Anglo Platinum over the past six months – a stock that is now trading at price to book levels in line with the troughs reached in the mid-1990's and early 2000's. Those proved to be fantastic buying opportunities.

Another notable change in the fund is that Hosken Consolidated Investments (HCI) now makes it into the top ten holdings of the fund. HCI's management team has a track record of capital allocation over the past decade that ranks second to none

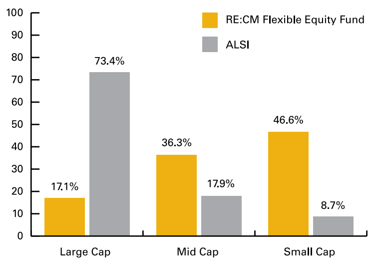
Top 10 Positions (%)

Sun International	9.0
Discovery Hlds Ltd	6.0
Telkom SA Ltd	5.3
Harmony Gold Mining	5.1
Tiger Brands Ltd	4.6
Anglo American Platinum	4.1
Old Mutual	3.9
HCI	3.7
Imperial Hldgs	3.5
Omnia Hldgs	3.5

Sector Split



Equity Allocation



in South Africa, in our opinion. With gaming now constituting a large part of the group, and gaming in general being a sector of the economy that is yet to recover from the recession, prices assigned to gaming businesses are generally modest (Sun International is still the top holding in your fund, for example). Being able to invest into HCI at a modest discount to its sum of the parts value, and getting management's capital allocation skills essentially thrown in for free, strikes us as an attractive proposition.

On the disposals front, the most notable action (dwarfing any other sale) has been our selling out of Brait completely. We wrote about our motivations for this action in the last issue of RE:VIEW (Volume 16), and we are happy that we achieved a good average price of in excess of R18 per share in the process.

Good ideas that worked
Trans Hex
Nedbank

Trans Hex's share price performance has been exceedingly volatile over recent years. This past six months, the company reported much improved financial results, and the market has responded by pushing up the share price substantially. Although a small holding in your fund, we continue to see it as an attractive investment.

Nedbank has been rated most lowly of the large local banks for many years now. Low expectations typically result in pleasant surprises, and that has been true over the past six months. While not compellingly cheap, we still consider Nedbank to offer more attractive value than the other three big four local banks.

Good ideas at the time
Brait
JD Group

As mentioned above, we have commented on the impact of and our thinking around the Brait restructuring in the last issue of RE·VIEW (Volume 16). Suffering a permanent impairment of value in an investment is never pleasant, and it is something our process is designed to avoid, but it will invariably be impossible to avoid all such situations.

JD Group has also delivered disappointing investment results over the past six months. The performance of the credit furniture retailers has been notably worse than that of most other retailers in the period following the 2008/9 recession, and stock prices generally reflect that fact. JD Group also announced a major transaction over the past six months, whereby it will enter the automotive retailing business. We are sceptical about the strategic merits of this transaction, but at least the company does not seem to be paying an exorbitant price for the business.

Return Expectations

The equities in your fund are currently priced at about 80% of fair value. However, as has been the case for some time now, the discount is concentrated in a small number of stocks. Only three of the stocks that are substantial holdings in the fund are trading at less than 70% of fair value, which is not a very exciting prospect.

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/ below ASX 300
Annual Fee	0.8% p.a. (excl. GST)

Portfolio Diagnostics

	Fund	ASX 300
P/E Ratio	14.8	18.6
Dividend Yield	5.4%	4.2%
Volatility	5.4%	10.7%
% Maximum Drawdown*	-4.3%	-11.4%
% Positive Months**	75.0%	58.3%
% Turnover Rate	28.3%	n/a
Number of Holdings	30	295
Concentration of Top 10 Holdings	40.4%	51.3%

*Life of Fund
**Trailing 12 months

RE:CM AUSTRALIA EQUITY FUND*

*This fund is not FSB approved and therefore not available for distribution in South Africa. The following is provided for information purposes only.

Investment Results

For the six months to the end of June 2011, your fund returned 2.9% (after fees) versus the benchmark's negative 1.3%. As investors alongside you, we are very pleased with this outcome. We have, since we last reported in January, increased our lead on the market since inception. We attribute this outcome to strict adherence to our process, which more than anything has kept us from acquiring assets at or near full prices. For the past year, our returns are almost on par with the market, albeit with considerably less volatility and with an invested position that did not exceed 75% of the fund.

We achieved this in a year that might have kept one very busy with all manner of important questions, such as:

- Has the AUD/USD cross rate reached a permanently high plateau?
- What will happen to iron ore prices given the prospect of sustained Chinese demand and massive supplier expenditure on new capacity?
- How profitable will Australia's new LNG projects be considering forecast capital investment and rising Japanese demand due to tsunamis and aversion to nuclear power?
- Are Australian residential property prices in a bubble?
- What impact will the proposed carbon tax have on Australian manufacturers?
- What will happen if the Fed goes ahead with QE3?
- What will happen if the Eurozone disintegrates?

In truth there was nothing unusual about the amount of noise in the past twelve months. Clients can be assured that our focus is on finding quality businesses and cheap assets. More than anything, it is good ideas that will drive good outcomes for clients.

Management Actions

This table summarizes the five largest capital commitments and realizations in the period under review.

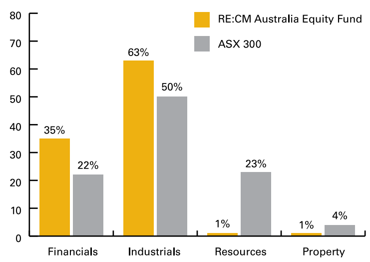
Purchases	Sales
Sonic Healthcare	Sigma Pharmaceuticals
Sigma Pharmaceuticals	Sonic Healthcare
Perpetual	Caltex Australia
Sky City Entertainment	Brambles
ALE Property Group	Fosters

If you recall we bought into Perpetual for the second time. We had originally exited the position on the back of a mooted, albeit highly conditional, takeover that was subsequently withdrawn. Two new stocks in the fund worth mentioning are Sky City Entertainment and ALE Property Group. In addition to owning casinos in Adelaide and Darwin, Sky City is the largest and practically only operator of casinos in New Zealand. It is a high quality business and cheap.

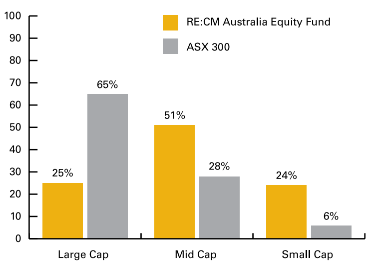
Top 10 Positions (%)

Sonic Healthcare Ltd	6.0
Cabcharge Australia Ltd	5.8
Aristocrat Leisure Ltd	5.1
National Australia Bank Ltd	4.0
Telstra Ltd	3.6
Qbe Insurance Group Ltd	3.4
Echo Entertainment Group Ltd	3.4
Perpetual Trustees Australia Ltd	3.3
Caltex Australia Ltd	2.9
Macquarie Group Ltd	2.9

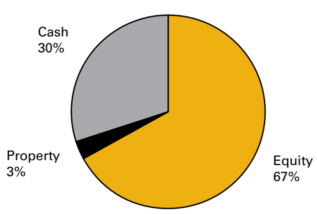
Sector Split



Equity Allocation



Asset Allocation



ALE Property Group is a management company stapled to the underlying property trust, which is one of Australia's largest pub landlords. All of ALE's pubs are leased on long duration, inflation linked terms to a subsidiary of Woolworths - itself Australia's largest pub manager and a tenant of the highest quality. Interestingly, the terms are very attractive - to Woolworths! However, this inequity cannot persist forever, and ALE stands to benefit considerably upon renegotiation.

We duly profited from our timely entry to the global pallet pooler Brambles during a wave a poor sentiment last year. This might have been included in good ideas that worked, below, had we initially recognised it as a high quality business. With this hindsight we may have committed more capital to this idea. Nonetheless the stock has reached fair value and we are no longer invested.

We bought Fosters with the belief that the value of its distribution network (to a global beer producer) was not fully reflected in the share price. This, despite the fact that Foster's prospects as a likely target were widely known. As it turned out, very recently SABMiller made an offer for Fosters at approximately our estimate of fair value, prompting us to liquidate the position immediately. The market has decided SABMiller must sweeten their price and the stock has traded higher since the announcement was made. Time will reveal this story's conclusion – we are very happy to have made money and will leave it to others to second guess trade buyer intentions.

Good ideas that worked
Sonic Healthcare
Sigma Pharmaceuticals

For much of the period we assigned to Sonic our maximum weight of 9%, underlining our understanding of both the quality and risk of its earnings, as well as cyclical headwinds and regulatory uncertainty - read 'unpopularity'. While the stock hasn't shot the lights out, it held steady during a period of significant market weakness. The last few days of June saw an early indication of Australian pathology volumes picking up and on the back of a positive market reaction we were able to able to reduce our position accordingly.

We came to understand how Sigma, apharmacy wholesaler fell alarmingly from grace in the eyes of the market. A capital raising that left investors deep underwater within months, a highly indebted balance sheet and executives dismissed for mismanagement, all contributed to Sigma trading at a price well below its tangible current assets less all liabilities - a rare "net-net". Despite Sigma's relatively poor history of generating shareholder returns, we were able to commit a meaningful portion of client capital to this idea. The past six months saw the market rerating Sigma's assets to book value and we are subsequently no longer owners.

Good ideas at the time
Aristocrat
Cabchange

The reasons for Aristocrat's unpopularity and cyclically low earnings that we cited in January are still very much, and more, apparent. High unemployment in the US is driving an extended delay in casino operator spend, regulatory reform in Australia is unresolved and ever pending, and the strong AUD continues to reduce overseas earnings. While reliant on cyclical factors, there is another cycle internal to this business - the product development cycle - which having lagged those of competitors' is also very low. As latest technology gaming product is brought to market, Aristocrat is leveraged to an improvement in conditions, which we, as mean reversion enthusiasts, are betting on happening.

Having maintained Cabcharge as one of our largest positions for the past nine months we might be a little disappointed in its performance to date. However, given the potential for further client inflows we are more than happy to have a high quality business available at an attractive price. Cabcharge has a stellar record of shareholder wealth creation, canny management and a formidable moat. The market has recognised these all too well in the past, grossly overestimating their value. A share price that has halved over four years is perhaps evidence to some of tainted goods, as are the recent penalties imposed on Cabcharge by the competition authority. We look forward to realising our assessment of fair value, with patience.

Investment Return Expectations

Our opportunity set so far consists of the 70 odd companies we have understood and valued with confidence. Just as the discount to fair value in this universe of ideas guides our bottom up construction of the fund, so too it guides our expectations for future returns. Should the discount be 10% or less, we are inclined to expect average returns. Anything greater than 25% and we start to get really excited.

At this point, the discount to fair value of the entire fund is 18%. This is after accounting for our 30% cash position, meaning that taken alone on a weighted basis our 30 stocks are priced at 75c in the dollar. This is only marginally better than six months ago. The good news is that recent market action has thrown up some new ideas, as well as brought long watched ideas back to the table thanks to widening margins of safety.

High quality stocks make up 70% of our invested position - this a tenet of our process and one of several ways in which risk management is fully integrated in the way we manage clients' capital. High quality businesses can be relied upon to achieve their required returns with time and, provided one does not overpay, these returns can be expected to feed through to investment results.

Chris Boehmke, Piet Viljoen, Daniel Malan
Portfolio Managers

RE·CM

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	R1,2 bn
Benchmark	CPI + 8%
Performance Fee	20% above/ below CPI + 8%
Annual Fee	1% annual fee excl. VAT

Portfolio Diagnostics

	Fund	ALSI
P/E Ratio	15.4	15.1
Dividend Yield	2.3%	2.6%
Volatility	7.7%	18.4%
% Maximum Drawdown*	-11.5%	-40.4%
% Positive Months*	73.5%	65.3%
% Turnover Rate**	28.1%	n/a
Concentration of Top 10 Holdings	32.8%	53.8%

*Life of Fund
**Trailing 12 months

TER is 2.28%. Inclusive of the TER's herewith, a performance fee of 1.00% was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

RE:CM GLOBAL FLEXIBLE FUND

Investment Results

As our co-investors in this fund we have compounded our capital at 15.8% p.a., after fees, since inception in April of 2003. This compares favourably with the targeted return of inflation plus 8% which equates to 13.7% p.a. However, in the 6 months January to June 2011 the fund price increased by 2.8%, well behind the targeted return of 7.3%.

It is generally not considered polite to say 'We told you so', but at risk of you thinking we are hatching the old 'flashback scenes from previous seasons because we're out of ideas' trickery we quote from the July 2010 fund comment; "...it is quite normal for a period characterised by strong absolute returns to be followed by a period of low absolute returns"

As happened in 2007/8, this has come to pass again, and it is to be expected. Importantly it's not because we think we are so smart that we can now also predict the future. We all know that's a fool's errand. We do believe we work very hard at figuring out and valuing businesses so that we can fairly confidently spot when they are cheap or expensive and make sensible investment decisions with your capital.

Getting Back to You on Fees

Besides investment results, the second most important determinant of your long term investment outcomes will be fees. We review our fee structures from time to time as we wish to charge a fair fee for our efforts. As significant co-investors in the fund (fund management staff, directors and their direct families have a combined R292mn invested alongside you) we are also sensitive to the fees that are charged on our investments. The volatility we have seen in stock markets over the past 18 to 24 months has brought to our attention the fact that the rolling 12 months period resulted in the fund paying performance fees that were too far misaligned to full market cycles. As such we engaged with the FSB and successfully changed the measurement period to a rolling 5 years commencing 1st April, 2011. It is not possible to retrospectively adjust the calculation, or 'look back' the 5 years of fund history.

What this means, in plain language, is that until we have built up a rolling five year performance record, your fund will pay zero performance fees. Should there be an investment result above the performance fee hurdle of inflation plus 8%, a performance fee will still accrue and be reflected in the fund price, but it can only be paid once the five year performance record has been established. It will then continue rolling forward from that date.

Fund Composition

Please refer to the table and the pie-chart on the next page. Key changes since December 2010 are:

1. SA Equity exposure has continued to decline, from 49% to 42%.
2. Global Equity exposure has nearly doubled, from 17% to 33%.
3. Overall equity exposure has therefore increased from 66% to 75%.
4. Exposure to assets denominated in currencies outside SA has increased from 28% to 40%.

Top 10 Positions (%)

Sun International	5.8
Johnson & Johnson	4.8
Harmony Gold Mining	3.5
Telkom SA Ltd	3.2
Discovery Hlds Ltd	2.9
BP Plc	2.6
Tiger Brands Ltd	2.6
Tokyo Gas	2.5
WalMart	2.5
Anglo American Platinum	2.4

Asset Allocation

Equity	SA	41.7%
	Offshore	32.7%
		74.4%
Cash	SA	11.8%
	Offshore	7.3%
		19.1%
Bonds	SA	4.7%
Prefs	SA	1.4%
Commodity		0.3%

These changes reflect Fund Management's continuing conviction that quality cheap assets remain scarce in SA. It is important to us that you understand that the increased offshore exposure does not solely reflect a view on the currency. Your fund is positioned this way because you trusted us and gave us the flexibility to invest in the best investment ideas we can find, anywhere in the world. Our team of analysts uncovered many great ideas in offshore markets over the past two years that are competing successfully for the attention of your fund capital. The fact that the Rand is overvalued only strengthens this argument.

We believe there are two ways of protecting and growing capital: firstly, by having the flexibility to own cash as a store of value, and secondly, by owning cheap assets. Based on the way businesses are priced currently and the ideas we are seeing from our investment team we expect the global equity component to continue increasing and the SA component to continue decreasing.

Change to Top Holdings Disclosure

In the table on the left showing the top 10 positions we have now included the offshore equities (some of which are held directly, as well as through the RE:CM Global Fund) to give you an accurate reflection of the reality that Johnson & Johnson is currently your second largest holding and that Wellpoint and Tokyo Gas are also in the top 10.

Management Actions

This table summarises the five largest purchases and sales for your fund in the first half of 2011.

Capital Allocations	R m's	Capital Realisations	R m's
BP	9.7	Sasol Ltd	-13.2
Johnson & Johnson	9.4	Omnia Hldgs Ltd	-12.8
Amgen Inc	7.9	Harley Davidson Inc	-11.5
Intel Corp	7.8	Remgro Ltd	-10.0
Hosken Consolidated	7.1	Brait S.A.	-8.3

We completely sold out of your positions in Harley Davidson and Brait. In the case of the former it was simply a matter of selling an asset when it reached our estimated fair value. We were able to commit capital to this wonderful business during the midst of the global market selloff below US$15 per share when it was available at 40 cents in the Dollar. After our initial purchase, the price eventually bottomed out at just US$8 per share, proving again just how brilliant we are at market timing, before recovering to over $40 per share, where we promptly sold (because it's at fair value). As one fund manager put it, a company that sells a product to people that tattoo the brand name on their bodies has a very good thing going! We definitely agree, but not to the extent that we will compromise our investment philosophy by holding out to sell to the greater fool (please note this is not a dig at other market participants or our competitors in the fund management industry, it refers to the aptly named 'greater fool theory' whereby one buys an overpriced asset in the hope that you can sell it on to a greater fool at an ever higher price).

We discussed our views on Brait at length in the January 2011 RE:VIEW Volume 16. Suffice to say that we sold our entire position. It remains on our radar screens.

Globally domiciled businesses dominate the buy side of the ledger. Fully seven of the top 10 capital allocations during this time were made offshore. In every single case the investment thesis meets our key criteria, being that they are:

1. High quality businesses with long track records and sensible management;
2. Cheap;
3. Considered unpopular by the investment community at large, and;
4. Experiencing low to average business cycle operating conditions at present.

Using Johnson & Johnson (hereafter referred to as J&J) as an example we will illustrate why these opportunities are attractive to you. If you are invested or interested in the RE:CM Global Fund you will know that J&J is also that fund's largest position at the moment.

Johnson & Johnson selected metrics		
	2002	2011
Sales (in billions)	$36.2	$61.6
Operating Profit (in billions)	$9.4	$17.4
Operating Profit Margin	26.6%	27.3%
Net Income Margin	18.0%	21.0%
Earnings Per Share	$2.16	$4.78
Dividend Per Share	$0.79	$2.11
Number of Employees	108300	114000
Price	$60	$60
Multiple of Operating Profit	22	10
Multiple of Sales	5.5	2.9
Dividend Yield	1.3%	3.7%

Source: Company Accounts, Thomson Datastream, RE:CM Analyst Calculations

J&J's share price has gone absolutely nowhere for the past nine years, in nominal terms. This could lead some to cry 'foul', others like RE:CM to say 'just reward for paying more than intrinsic value for an asset'. We paid less than $60 per share during the past 18 months for your stake in J&J, the same price as was available in 2002, but revenues, profits and dividends have all just about doubled or more since. The company is also more efficient, evidenced by constantly improving profit margins provided by the scalability to grow revenues without a commensurate need to employ more people. We really like what that last sentence means for us as future long term shareholders, as we expect J&J to continue along that path of continuous learning and improvement.

At its core J&J enjoys access to a very rare commodity, the public trust. We all use their products daily. The market is disillusioned with J&J because they've recalled a few of their defective products and they're being brutally honest about their mistakes, but this is true to the 125 year old core company values of putting their customers' needs first. This is definitely something that resonates with all of us here at RE:CM.

Investment Return Expectations

At the recent annual report back to you we stated emphatically that the strong 10% real returns after fees that you have achieved over the past eight years are not sustainable over the coming years. We all have to tone down our return expectations for the near term.

Your portfolio managers and the rest of the RE:CM investment team are working flat out to add as many high quality businesses to our circle of competence as possible, in anticipation of being able to continue repositioning your savings into the best available opportunity set. Your fund also has over 20% in cash that good new investment ideas can compete with.

With our savings invested next to yours in this fund's collection of great cheap businesses we are continuing to sleep well knowing that the hundreds of thousands of people that work at these businesses all over the world get on with making more money with our money, 24 by 7.

Daniel Malan
Portfolio Manager

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 $240m
Benchmark	MSCI World
Performance Fee	20% above/ below MSCI World +2.5%
Annual Fee	0.5% annual fee

Portfolio Diagnostics

	Fund	MSCI World
Volatility	12.6%	19.0%
% Maximum Drawdown*	-33.3%	-53.7%
% Positive Months*	60.3%	55.6%
% Turnover Rate**	29.1%	n/a
Number of Holdings	79	n/a
Concentration of Top 10 Holdings	44.3%	9.1%

*Life of Fund
**Trailing 12 months

RE:CM GLOBAL FUND

Investment Results

The RE:CM Global Fund has returned 6.1% p.a. (in US$) since inception. Over the same period the MSCI World, including dividends, has returned 2.6% p.a. The bulk of the excess return was earned over the last three years, as the fund compounded at 8.8% p.a. against the MSCI's 1% p.a. This is despite the fund returning almost 10% less than the MSCI over the past 12 months.

RE:CM's investment strategy is one of capital preservation first, and growth second. We believe that our main job is to preserve our client's capital - and let the growth look after itself. We have been doing this in various markets for many years now - and it is a strategy that works. Not all of the time or every time, but over long periods of time it delivers strong returns, well in excess of inflation.

How do we do this? Very simply by only buying assets which are cheap, ignoring daily news flow (and associated emotional highs and lows) and maintaining significant cash buffers when assets are expensive. We are often criticized for holding cash in our funds. But we believe cash is the best hedge against so-called "black swan" risk (Michael Mauboussin of Legg Mason recently wrote a fascinating article on this topic). Many investors prefer alternative investments such as hedge funds, commodity funds or some of the more arcane ETF's. The past three years have shown up the flaws in many of these types of investment vehicles. They are expensive, many are simply leveraged trend followers and most did not provide investors with sufficient downside protection when they needed it in 2008/09. We prefer to keep it simple, low cost and rational. Our investment returns prove that this is a good way to do things.

Management Actions

Management initiated new positions in the following stocks: Sonic Healthcare, Intel Corp, Zimmer Holdings, Amgen, Sun International, Wells Fargo, Hellenic Exchanges, Visa and Net1.

Sonic is particularly interesting, as it is also the top holding in the RE:CM Australia Equity Fund. Although it is only listed on the ASX in Sydney, it operates in Australia, Europe and the USA. It essentially runs pathology labs, which are costly to set up, but once they reach a certain scale, operations are very profitable. As most tests are outsourced to such labs by doctors and hospitals, and they only make up a small part of patients accounts, they have some degree of customer stickiness, which creates a barrier to entry. We believe this is a high quality business, with strong free cash flows - and is scalable, which puts it in a position to grow its cash flows over time.

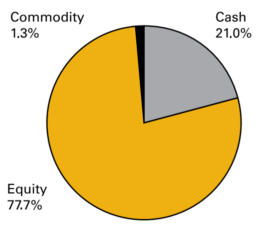
Due to continued strong inflows into the fund, coupled with price weakness, management has also increased the holdings of existing positions in the following stocks: Johnson & Johnson (now our top holding), BP, Tokyo Gas, FamilyMart, H&R Block, Vodafone, Titan Cement, Hamamatsu Photonics, Old Mutual, Dell and WalMart.

By and large, the fund continues to be dominated by holdings of companies that operate in the healthcare sector. Later on in this RE:VIEW, in an article called "Smoke 'em and Dope 'em" Danie Malan discusses why we find these businesses attractive

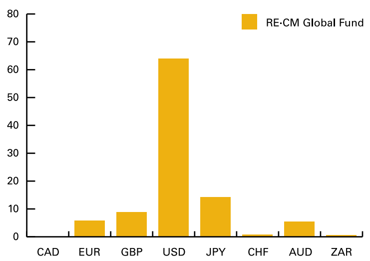
Top 10 Positions (%)

Johnson & Johnson	7.8
Wellpoint Inc	5.5
Dell Computer Corporation	4.6
Tokyo Gas	4.5
BP Plc	4.2
Familymart	4.1
Sonic Healthcare	3.7
Vodafone Group Plc	3.6
Titan Cement	3.4
Wal-Mart Stores Inc	2.9

Asset Allocation



Currency Exposure



as investments today. Just recently, we have started adding some financials to the fund - a sector we have not been involved with since 2008. We now own a share in what we believe is one of the best quality banks in the USA (Wells Fargo) as well as one of the best providers of financial services in the world (Visa).

The fund has slowly reduced its exposure to the US$, as management has invested into other geographies. However, one must be very careful not to take the currency exposure at face value - for instance, Sonic Healthcare operates globally, but is denominated in Australian dollars (a currency we think is very expensive). Also, Titan Cement operates in Africa and Europe, although it is listed in Greece and accounts in Euros. When evaluating the investment prospects of any business, we take its underlying operating exposure to different currencies into account; not the currency it happens to account in for these activities.

Management completely sold out of the following positions: Washington Post, Harley Davidson, Western Union, EBAY and Legg Mason. Most of these businesses are cyclical in nature, and were acquired during the financial crisis when such businesses were selling at bargain basement prices. This is no longer the case; necessitating our sales. They remain good businesses, just not good investments. The same can be said of many of the companies of which we reduced our holding positions: Dish Networks, Home Depot, Harmony, Coca Cola, Heineken, WellPoint, ADP and Aristocrat.

Good ideas that worked

Harley Davidson
Hamamatsu photonics
Dish networks

These shares were all sold during the past six months, after their share prices increased substantially to our estimate of fair value. The only "theme" here is that they were all bought at prices very far below what we thought was intrinsic value at the time of purchase. Harley Davidson and Hamamatsu were bought during the market meltdown caused by the financial crisis of 2008, while Dish was bought even earlier. Dish was depressed due to fears about market share losses to some of their well-financed competitors. Even though market share was lost subsequently, the fears that had been priced into the shares at the time proved to be overblown. This is a common characteristic of many of the shares that we own - bad things happen and even worse things get discounted into the prices, so that even if the bad things happen, the outcome - from an investment point of view - is a good one.

Good ideas at the time

Washington Post
Harmony
Aristocrat Leisure

Washington Post was recently sold, after having suffered what we regard to be a permanent impairment to its intrinsic value. Originally we bought it on the premise that it was priced like a newspaper stock, although its main business was that of education. Unfortunately, recent regulatory changes in the USA have the potential to damage the earnings power of this part of the business too. We still think management may be able to negate some of the changes, but the upside is now far less than our original thesis had anticipated.

We have written about Harmony many times before. We regard it as one part of our insurance program - the other being the fund's holding of cash and physical gold. Although Harmony has done well since its original purchase, it has done poorly just recently, as the share prices of most gold mining companies have lagged the physical gold price substantially. We continue to hold Harmony in the hope that the insurance policy doesn't pay off - for then our many other equity holdings should do very well! Thus, paradoxically, this is one holding of the fund that we hope stays in the "good ideas at the time" column.

Aristocrat Leisure is an Australian listed global provider of gaming technology and machines to casinos - i.e. a provider of the ubiquitous "one-armed bandits" As it is also a holding in our Australia Equity Fund, please refer to that fund's report in this RE:VIEW for further comments on why it has done so poorly since purchase, and why we continue to hold it.

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

TER is 0.95%. Inclusive of the TER's herewith, no performance fee was recovered from the Net Asset Value of the class of participatory interest of the portfolio.

USING OUR COMPETITIVE ADVANTAGES TO OPTIMISE YOUR INVESTMENT OUTCOME

"So what is your AUM now?"

An often-overheard question between asset managers

"If you are doing science you need to understand the world, but if you are doing business or investing you need others to misunderstand the world to be successful."

"Economists cannot digest the idea that the collective or the aggregate is much more difficult to forecast than the individual."

From: The Bed of Procrustes by Nassim Nicholas Taleb

For most asset management companies assets under management (AUM) is one of the most critical measures of success. This is valid from a pure business point of view (from the perspective of the asset management company) because fees, paid as a percentage of AUM, rise as the asset base rises. But what is good for the asset manager isn't necessarily good for their clients.

A Fixed Investment Universe Can Constrain the Performance of a Growing Asset Manager Over Time

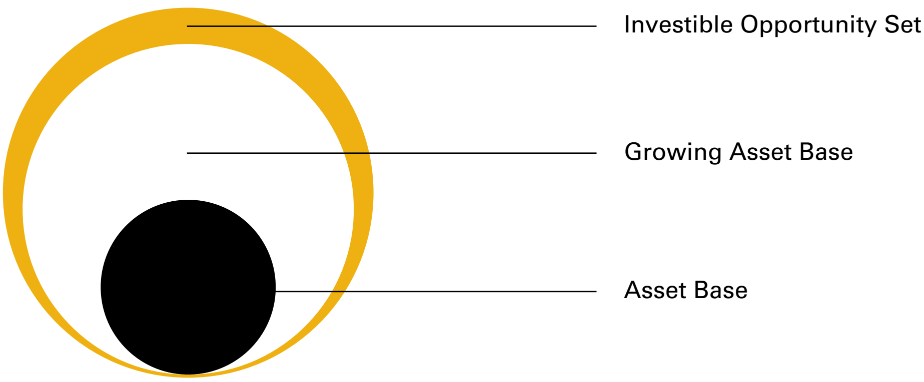
Looking at Scenario 1 below, an upcoming asset manager is enjoying success and attracting large inflows of client money. An increasing size of AUM causes them to get to a point where their asset base becomes large relative to the investable opportunities. This can hamper their ability to generate performance, especially for a value manager with an inherently limited set of investable opportunities in most market conditions.

In the face of a reducing set of opportunities, the consequent performance limits and career risk (from a business point of view, many fund management firms are accountable to external vested interests and shareholders - which can put increasing pressure on the investment team in such circumstances) that this implies, an asset manager is faced with a dilemma. We believe that there are two viable options:

Expand the set of investible opportunities (which is difficult, time consuming and costly); or
Close the funds to new investors (which, with reference to the fee structures above, is undesirable since internal business performance is directly related to the size of asset under management.)

In the face of this hard choice, some asset managers simply take a flexible approach to their investment philosophy or relax their investment criteria to justify full equity exposure in expensive markets.

Scenario 1: Typical Asset Manager in a Growth Phase



What Have We Done in the Past in the Face of Expensive Markets and a Limited Investment Universe?

We put our existing investors' capital first. What does this mean in practise? With a limited investment set in 2006 due to an expensive and rising local market, there were few investible opportunities for value investors such as ourselves. It was a tough decision, but we stayed true to our investment approach by closing our funds to new investors to ensure that our asset base (our clients' money) remained small relative to the available investable opportunities to optimise our ability to do our job for our existing clients. This wasn't a totally altruistic decision: our money is invested alongside our clients. We also knew that values and client commitments on paper are easy to write - but if we were to act in line with these, we would have to make the hard decision. In hindsight, the decision to close was therefore the correct one because it was consistent with our values of protecting our clients' capital and the long-term view we take on investing.

And Today - What Does The Future Hold for RE:CM?

We still cannot control prices or forecast prices. Neither can anyone else. We can however control our competitive advantages and use these to the best of our ability to generate investment returns without taking undue risk. We have remained true to our values and through leveraging our skills, expanded our investment universe without compromising our philosophy and process.

Our Competitive Advantages

We believe we have three key advantages. The first is the consistent application of our philosophy and process. The second is our second competitive advantage, our ability to retain a small asset base relative to the available opportunity set. Lastly, our most important advantage is that we have a client base that understands and seeks to grow their understanding of our approach - which is why we are able to manage money in the first place, and without whose commitment we would not have the luxury of sticking to an approach that they know will generate long-term returns.

Competitive Advantage 1: A Clear Philosophy and Process

Philosophy (What we are going to do)	**We are unashamedly value investors who place a lot of emphasis on quality businesses.** • We like to buy assets that are cheap, i.e. priced below their intrinsic value. We are fallible, so we want to ensure that there is a margin of safety in case we have it wrong. Just like when you build a bridge, you build it to take a weight far in excess of that which you are anticipating. We do the same from an investment point of view. We pay a far lower price than we think the investment is worth. • We buy good quality businesses for the same reason. Again, if we are wrong, the company can grow its intrinsic value into the price we paid.
Our Investment Process (How we are going to do it)	**We have a repeatable and consistent process.** A good philosophy does not always guarantee a good outcome. But if you apply a disciplined process consistently and you have a good philosophy, over time it will be successful and generate a good outcome. **Bottom-up analysis drives all our decisions.** • We look at companies one by one. We analyse them from the bottom up. We analyse the economics of a business and try to acquire a portion of a business at a discounted price to its intrinsic value. • We don't invest based on themes, markets or on the basis of macro-economic variables like the latest interest rate change. We analyse securities, not markets. • We put our portfolios together from the bottom up. **Risk management lies at the heart of what we do.** Our key point of departure is that we manage risk. If we manage risk effectively the returns tend to take care of themselves. We regard risk as a permanent loss of capital. **We are contrarian investors.** We try to buy assets that are unpopular and that nobody else wants. When there is pessimism, forced selling and stressed business conditions, prices drop. It is generally at such times that good quality assets are priced below intrinsic value.
People	**Our people are interested and passionate about generating a good investment outcome.** While they are smart and talented, they may not be the smartest in the world or the most talented - but they are curious about investments. They are inquisitive about markets and are incentivised to care about your outcome. Most importantly, they are a pleasure to work with.

Competitive Advantage 2: A Small Asset Base Relative to the Available Opportunity Set

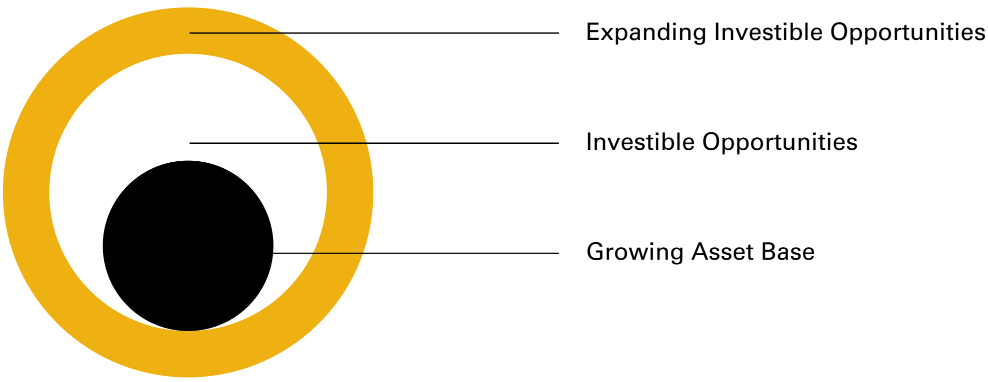
We have a small asset base relative to the opportunity set. Furthermore, we are continuously expanding the available investment opportunities relative to our asset base. We are expanding our investable universe by doing the following:

1. **Increasing our Global Asset Management Capability**
   In the last five years with the RE:CM Global Fund we have proven our capability to manage global assets. This is our most aggressive fund (in the RE:CM range) simply because of the deeper and broader opportunity set in global markets and the fact that we can still find investment opportunities. We have opened a research office in Sydney, and are looking at other geographies as well.

2. **Increasing Our Skills in Private Equity Through the Listing of our investment company RECM and Calibre Ltd.**
   The successful listing of RECM and Calibre has allowed us to start making investments in unlisted companies and small listed companies. This is advantageous to our clients, as most regulated funds do not allow them to invest heavily in these types of assets. Generally, a lack of buyers leads to lower pricing.

3. **Leveraging Our Research Capabilities to Invest Across a Company's Capital Structure Including Debt**
   Asset managers have traditionally focused on equity analysis and investment. Companies are funded through many instruments such as equity, structured debt, senior debt, junior debt etc, each one with either a claim on a different portion of the company's cashflow or with a different type of claim on the company's cashflow. We are actively expanding our ability to analyse claims outside of vanilla equity on a company's cashflow.

RE:CM Expanding the Investment Universe



Competitive Advantage 3: Our Top Quality Client Base

Because we are contrarian value investors, our approach only appeals to a limited group of investors that are comfortable with being different to the crowd and with consequent short-term periods of relative underperformance. This is not easy for investors to stomach, but it does provide rewards. We therefore invest time and effort in communicating with you, deepening our relationship with you and hopefully building a long-term investment partnership with you that helps you achieve investment success.

In conclusion, we are proud of where we have come from. Eight years ago when RE:CM started, we had R0 assets under management and three people. In 2011 with around R18 billion in assets under management globally, we are still using our competitive advantages to put your capital first.

Piet Viljoen

SMOKE 'EM & DOPE 'EM - THE TALE OF THE NO-GROWTH RUSE

"Tobacco companies have been great investments for those who can live with a nasty taste in the mouth. They are not selling many more cigarettes (indeed, smoking is declining in the developed world). Instead, these global companies have increased prices merrily with little effect on demand.

Yet in Spain, this cosy picture has fractured and a price war is under way. Prices have fallen by about 10% in reaction to a drop in sales volumes"

Source: Financial Times, June 14th, 2011

If you travelled back in time to March 2000 and were offered the opportunity to invest in tobacco businesses, you, like most market participants at the time, would probably have said no thank you. These businesses had no future. Their products were proven medically to harm and eventually kill people. As a result, large court cases against these companies were the order of the day. Slam dunk. And, they had nothing to do with the internet! No brainer. AVOID.

We will now focus your attention on four global tobacco businesses: British American Tobacco, Imperial Tobacco, Reynolds American International and Altria (formerly known as Philip Morris). In March 2000 they were, on average, trading at a price to earnings ratio of 5 and a dividend yield of 11.5%, covered 1 ½ times by earnings. These lowly ratings reflected what can only be described as investor fatigue, or disinterest. These companies were considered to be ex-growth, and you could go so far as to say they were no longer considered going concerns. Table 1 shows what happened to these four companies since then.

Table 1: Selected Metrics of Global Tobacco Businesses

		In British Pounds	In US Dollars	In British Pounds	In US Dollars
Company		**British American Tobacco**	**Reynolds American International**	**Imperial Tobacco**	**Altria**
Price Per Share	March 2000	2,30	4,00	2,30	4,50
	June 2011	26,63	38,35	20,10	27,37
Sales (in millions)	FY 2000	10 900	8 160	1 300	63 200
	FY 2010	14 900	8 550	15 000	16 900
Operating Profit (in millions)	FY 2000	1 950	916	542	15 100
	FY 2010	4 420	2 370	2 700	6 200
Share Count (in millions)	FY 2000	2 170	405	720	9 540
	FY 2010	1 980	583	1 000	2 080
Employees	FY 2000	86 805	9 100	4 915	178 000
	FY 2010	92 285	5 750	38 300	10 000
Operating Profit Margin	FY 2000	18%	11%	42%	24%
	FY 2010	30%	28%	18%	37%
Earnings Per Share	FY 2000	0,29	0,86	0,45	0,86
	FY 2010	1,45	1,91	1,48	1,87
Dividends Per Share	FY 2000	0,29	0,78	0,23	0,47
	FY 2010	1,14	1,84	0,84	1,46
PE Ratio	March 2000	8,1	4,7	5,1	5,2
	June 2011	18,4	20,1	13,6	14,6
Dividend Yield	March 2000	12,6%	19,5%	10,0%	10,4%
	June 2011	4,3%	4,8%	4,2%	5,3%

Source: Thomson Datastream, Company Accounts and RE:CM Analyst Calculations

These four companies' share prices have multiplied by between a factor of 6 times (Altria) and 11 times (British American Tobacco). This is a fantastic absolute return even before you take into account that the MSCI World Index was perfectly flat over the same period. Chart 1 shows the significant positive re-rating that Reynolds American in particular, and tobacco businesses in general, have enjoyed as a tailwind since March 2000. Add the huge starting dividend yields and the growth in dividends and the numbers are mind boggling.

You can attempt to drive all sorts of wedges into this crude analysis. For example, two of these companies have undergone significant business changes during this time. Altria spun off Kraft Foods and Philip Morris International and refocused on its remaining tobacco businesses. Imperial Tobacco went the other way and became a serial acquirer of other tobacco businesses. This is reflected in the numbers in Table 1 and we will spare you the boring detail. We don't believe these arguments obfuscate the obvious: these dogs (at the time!) have been diamonds in disguise.

The two 'steady state' companies, British American Tobacco and Reynolds American International, have maintained revenue and even increased it. But it turns out the biggest benefit has come from driving efficiencies and this has for the most part resulted in operating profit margins literally going through the roof. So, in spite of the scaremongering, a universal belief in their demise, governments all around the world clamping down on the industry with advertising bans, no smoking zones in public spaces, excise duties, the direct link to lung cancer and increased health insurance premiums and treatment costs for smokers; the industry consolidated and in the absence of capital availability and new business formation (i.e. competition) the few remaining companies quite simply thrived ever since. As an aside, and on a completely different topic, this is a beautiful illustration of the unintended consequences of even well meaning regulation.

On the one hand it may sadly indicate that humans don't care about their health. But we are not paid by our clients to make judgments on social matters. Fact is that these companies continue to sell something that their customers want and are clearly willing to pay a premium for. This is a sure sign of a very good business.

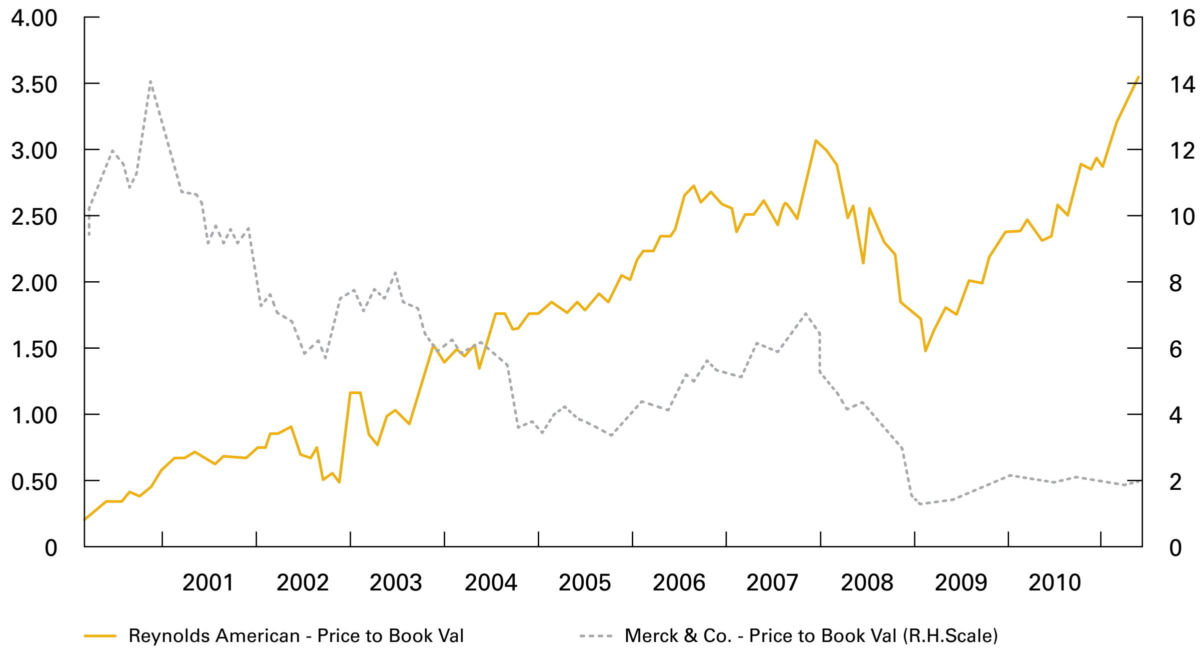
After ten years of massive outperformance and because they are currently trading on reasonably high multiples on very high levels of profitability, these businesses are not successfully competing for the attention of your fund capital now. Remember, the fantastic returns generated from owning these stocks over the last 10 years stemmed from two factors:

1. Low starting valuations.
2. Expansion of profitability.

Factor 1 does not exist today and the scope for factor 2 going forward is limited. The unfolding Spanish pricing situation illustrated by our opening quote from a recent Financial Times article is also a timely reminder that tobacco pricing can also decline. That concludes the Smoke 'em section, on to the Dope 'em section.

Chart 1 compares the enormous growth expectations priced into the share price of a leading pharmaceutical business, Merck & Co, at 14 times NAV in late 2000, with the near-death situation over at Reynolds American International around the same time. But, here we are in June 2011, and almost everyone today knows tobacco businesses are diamonds and healthcare businesses are dogs. What a strange world we live in. The roles have been completely reversed.

Chart 1: Price to Book Comparison of Merck & Co. vs. Reynolds American International



Source: Thomson Reuters Datastream

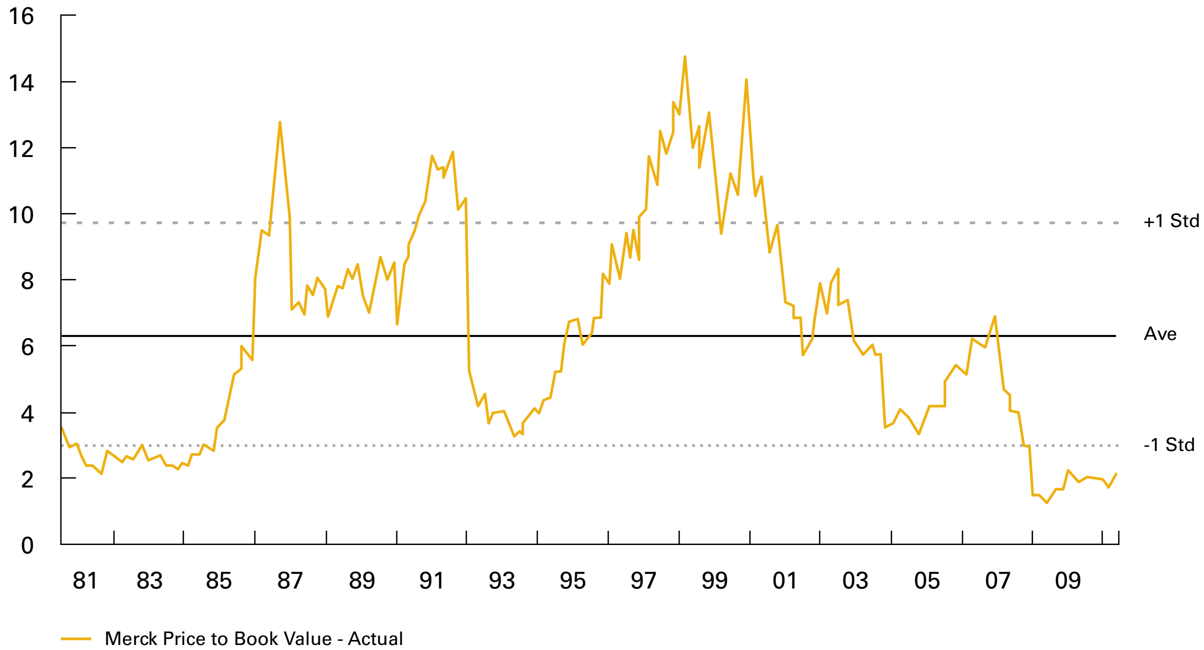
It should not surprise you to find that our funds are meaningfully invested in a collection of leading global healthcare businesses. Our current single largest holding in the RE:CM Global Fund is Johnson & Johnson. We also hold Zimmer, Amgen and Sonic Healthcare. More specifically, this collection includes a basket of 15 leading pharmaceutical companies. These 15 companies, together, account for more than 75% of the industry's total annual spend on research and development (R&D) of new pharmaceutical drugs. It amounts to many billions of dollars, each year.

Their share prices have all significantly underperformed world markets since 2000 and this pharmaceutical group currently trades on a free cash flow yield (after all capital expenditure - including R&D) of 12% and a trailing dividend yield of just over 4%. The market is disillusioned with this industry because there appears to be a consensus opinion that their product pipeline has dried up and they are not generating enough new products to replace the ones coming off patent. In short, they are considered ex-growth.

We counter this argument by pointing out that these companies have their own rapidly growing generics businesses; that the global industry is consolidating; and that sooner or later R&D does tend to pay off. It is not in our skillset to confidently predict which individual company will win the race to develop a new blockbuster drug. But it did strike us that investing in a collection of 15 such companies and capturing 75% or more of the world's combined annual R&D spend in new product development represents - at a low price - a sensible way of shifting the odds in our favour.

In an ageing world that is becoming more and more densely populated, with rapidly rising standards of living in regions with large populations, we propose that healthcare in general and specifically pharmaceutical drug development will continue to play a critical role. If the collective global pharmaceutical industry turned off the taps on drug R&D because it becomes uneconomic to spend the capital, there would in time be no patents to come off patent for the generics manufacturers to copy. The generics manufacturers would stagnate too and imagine for a moment what would happen if a new global virus or other serious illness appeared?

Chart 2: 30 Year Price to Book History of Merck & Co.



Source: Thomson Reuters Datastream

In almost exact contrast to the tobacco group, this pharmaceutical group of companies were the market darlings 11 years ago. They traded at huge multiple premiums to the market with consensus for a rosy future - growth as far as the eye could see. Unfortunately, the eye cannot see very far into the future.

Using one example out of the group of 15 companies, Merck & Co, in Chart 2 one can clearly spot both the enormous growth expectations priced into the share in the period 1999-2000, as well as the significant de-rating since then that culminated in the attractive free cash flow and dividend yields offered by today's price.

This investment idea fits into how we think about acceptable investment odds that competes successfully for the attention of our clients' fund capital; heads we win, tails we don't lose much - and preferably not at all.

Daniel Malan

MANAGING THE MOAT

"Such, I fear, are the bitter fruits of that which I have described above: a financial services industry unmoored from its traditional role in the commercial economy; a regulatory regime which protects outsized compensation just for sheer trading; a failure to distinguish between such activity and traditional banking, as well a failure to recognize that the activity of an institution, not its form, should be the proper focus of regulation. (Put another way, not all bank holding companies are created equal.) Surely this is not a "system" we would plan; it has grown up over time and has come to distort our labor and capital markets - and puts our economy at great risk".

Robert Wilmers, 2010 M&T Bancorp Annual Letter to Shareholders

"Capital - usually a mix of equity and debt - is what a bank must hold in reserve to support its businesses. A bank uses capital to invest and grow consistently over time and to absorb any unexpected losses along the way. Coming into the credit crisis two years ago, for example, Wells Fargo was very well capitalized. This enabled us to acquire Wachovia and double the size of our company."

John Stumpf, Wells Fargo 2010 Annual Letter to Shareholders

"Let me underscore that the results noted above - as regards to credit quality, prudent capital allocation and management, and efficiency - should not be understood narrowly as the result of responses to the financial crisis and its aftermath. Rather, they are the product of our long-established way of doing business - of a culture which has led to a consistently positive financial performance over more than a generation.

Robert Wilmers, 2010 M&T Bancorp Annual Letter to Shareholders

"Why invent new ways of losing money if the old ways are working just fine."

"We're not a hedge fund disguised as a bank. We're not a proprietary trader (which produces no customer benefit) disguised as a bank."

"The best way to grow capital is the old-fashioned way: earn it yourself internally rather than relying on unpredictable markets. We've grown our capital internally at a higher, more consistent rate than any of our large peers because we've earned more per dollar of assets than they did. How do we do it? Our foundation for this growth is not a financial equation, but, rather, our very clear, time-tested vision that we've made steady progress toward for almost a quarter century. We want to satisfy all our customers' financial needs and help them succeed financially."

"If anyone tells you it's easy to earn more business from current customers in financial services, don't believe them. We should know. We've been at it almost a quarter century. We've been called, true or not, the "king of cross-sell." To succeed at it, you have to do a thousand things right. It requires long-term persistence, significant investment in systems and training, proper team member incentives and recognition, taking the time to understand your customers' financial objectives, then offering them products and solutions to satisfy their needs so they can succeed financially. You can't expect much progress in earning more business from current customers in just one quarter or even in a year or two. That's why many banks give up on it. The bad news is it's hard to do. The good news is it's hard to do, because once you build it, it's a competitive advantage that can't be copied. If it were easy, everyone would be doing it."

John Stumpf, Wells Fargo 2009/10 Annual Letters to Shareholders

"The U.S. banking system has gone from approximately 20,000 banks 30 years ago to approximately 7,000 today. That trend likely will continue as banks seek out economies of scale and competitive advantage."

Jamie Dimon, JP Morgan 2010 Annual Letter to Shareholders

"In 2007, for instance, I noted that fully $71 million of M&T's expenses, or 7.4 percent of pre-tax income, were the result of regulatory compliance; our latest analysis indicates that they have grown some 25.6 percent and now total $89.7 million."

Robert Wilmers, 2010 M&T Bancorp Annual Letter to Shareholders

"Like all businesses, banks must continue to earn adequate returns on capital - investors demand it. Some argue, however, that if regulation results in better capitalized banks and a more stable financial system returns demanded on capital would be lower to reflect the lower risk involved. This probably is true but not likely to be materially significant."

Jamie Dimon, JP Morgan 2010 Annual Letter to Shareholders

"In fact, the recent proposal to designate all U.S. bank holding companies with more than $50 billion in assets as "Systemically Important" and the implication that they should be subject to higher capital standards regardless of the riskiness of the underlying activities in which they engage has likely already led to increases in our cost of extending credit. In other words, those who will pay for the sins that sparked the financial crisis will be the small business owners, entrepreneurs, innovators, and individuals who rely on Main Street banks like M&T."

Robert Wilmers, 2010 M&T Bancorp Annual Letter to Shareholders

"The biggest negative that people point to is that home prices are continuing to decline, new home sales are at record lows and foreclosures are on the rise. Our data indicates that the rate of foreclosures will start to come down later this year. Approximately 30% of the homes in America do not have mortgages - and of those that do, approximately 90% of mortgage-holding homeowners are paying their loans on time. Housing affordability is at an all-time high. The U.S. population is growing at over 3 million a year, and those people eventually will need housing. Additionally, the fact that fewer homes are being built means that supply and demand will come into balance sooner than it otherwise would have. That said, housing prices likely will continue to go down modestly because of the continuous high levels of homes for sale. The ultimate recovery of the housing market and housing prices likely will follow job growth and a general recovery in the economy."

Jamie Dimon, JP Morgan 2010 Annual Letter to Shareholders

"The argument is made that there are just too many investment question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: Maintain buying reserves until current uncertainties are resolved, etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long term values."

Warren Buffett, August 1979

Winston Churchill said that Americans will always do the right thing after they have tried everything else. Judging by the direction on the US regulatory front following the fall-out of the financial crisis, it seems that the practice of slaying Wall Street firms (or - as Rolling Stone Magazine described them - great vampire squids wrapped around the face of humanity) will continue for some time to come.

Doing the 'right thing' remains elusive. It would go a long way if regulators only distinguished between trading activities which benefit a few at the expense of society, and traditional banking that is the lifeblood of the economy. Once the distinction was made they could then take steps to discourage the former and encourage the latter.

Nevertheless, one thing we have learned from experience is that where there is bad news and ambiguity there is often opportunity. And with regulatory proposals pending and the real estate market and economy struggling there is great uncertainty surrounding US banks. Accordingly, we have continued to look for investment opportunities in this space, negating the opacity by reviewing those banking characteristics that are likely to persist and judging the risks involved. These fundamentals and risks are concealed in the initial quotes and we hope to illuminate them in the writing that follows. To make them easy to recognise, the quotations and text follow the same sequence.

Culture and Management is Crucial in a Banking Business

It has been said that a banker is someone who lends you an umbrella on a sunny day and wants it back the minute it starts to rain. It seems that well-managed banks like Wells Fargo, M&T Bancorp and JP Morgan largely avoided the implied dangers of the reckless lending binge in 2005 - 2007. Although they did make mistakes during the sunny days leading up to 2008, they did not put their shareholders' capital at undue risk with a combination of high leverage and irresponsible lending and trading activities. So when it started raining they were able to create significant value by being providers of capital, buying up troubled banks at a fraction of their worth and expanding their lending operations as opposed to looking for handouts.

The Only Sustainable Advantage in Banking: the Funding Model

A good management team ensures first and foremost that a bank does not take excessive risk and stays in business. Assuming prudent capital allocation, the full-cycle profitability of a bank is influenced most by its business model. Table 1 illustrates the profitability and certain banking metrics for the four largest banks in the US. We excluded M&T Bancorp, a bank that we hold in high regard but which smaller size, business model similar to Wells Fargo and (un) availability of a comparable data point make it less suitable in this discussion. Suffice to say, it generated a return on its total assets over the past many years far in excess of three of the four banks listed below.

For the most part RE:CM's (preferred) mandate is to select securities from a global investment universe. Naturally this implies a vast opportunity set. As a result we have the prerogative to consider only high quality businesses, those with a moat or competitive advantage, when investing outside of South Africa. To find these businesses, our modus operandi is often to understand the profitability of companies.

Table 1: Comparison between US bank

	Wells Fargo	JP Morgan	Bank of America	Citi Group
10 Year Average Return on Equity%	14.70	8.35	11.76	8.86
Q1 2011 Return on Equity%	11.45	11.51	-2.20	5.69
10 Year Average Leverage (Assets/Equity) Times	10.73	13.05	12.38	11.21
10 Year Average Return on Assets%	1.37	0.64	0.95	0.79
Q1 2011 Return on Assets%	1.23	1.07	0.36	0.63
10 Year Average Net Interest Margin%	4.86	2.43	3.05	3.36
Q1 2011 Net Interest Margin%	4.05	2.89	2.66	2.91
10 Year Average % of Total Funding From Deposits	63	45	51	41
Current % Of Total Funding From Deposits	67	45	45	44
Average Cost of Deposits%	0.30	0.40	0.33	0.84

Source: Bloomberg, Company Reports and RE:CM Analysis

For banks, Return on Equity ('ROE') is the most suitable measure of profitability. It relates the earnings available for equity shareholders relative to the equity capital they have invested. Due to the liquid nature of a bank's assets and equity capital, it is a particularly useful measure for banks. Historically, Wells Fargo has been the most profitable bank, earning substantially more per dollar of equity capital invested than its three large banking peers.

But ROE does not tell the full story. Banks that failed or needed bailing out, like Lehman, Bear Stearns and Merrill Lynch earned joyous returns on equity just before they failed. One has to account for leverage before comparing bank profitability. Leverage is the amount of assets a bank has relative to the equity capital invested and enhances the returns the bank earns for equity shareholders. For a bank that is leveraged 20 times as Goldman Sachs is currently, it means that the return generated on the total assets of the company is multiplied 20 times for equity shareholders. But higher leverage also increases the risk of loss and the risk that the bank will go bankrupt. For a bank that is geared 20 times a 5% decline in the value of the assets would wipe out all the equity. For a bank that is leveraged 10 times, like

Wells Fargo, Return on Assets ('ROA') is enhanced only 10 times but the risk is lower as assets would have to fall by 10% before the company fails.

We can exclude the impact of leverage altogether by comparing ROA. Wells Fargo has in fact earned the highest ROE using the least amount of leverage. By implication, it generated even higher relative core profitability, evident in its elevated ROA.

But, is this higher ROA simply reward for higher risk inherent in its particular banking activities or, equivalently for higher risk taken in pursuit of those activities?

The answer is no. While the other banks' operations include fairly large trading and investment banking activities which are more risky, this makes up a fairly small part of Wells Fargo's business. Its operations do not appear to be more risky. Likewise, taking on excessive risk in pursuit of those activities may lead to excess comparable returns in the near term but the chickens always come home to roost. Over the longer term there is no additional reward for taking more risk in banking. In fact, the converse may be true. It appears that Wells Fargo wrote off marginally fewer loans than JP Morgan and Bank of America and substantially less than Citi Group over the last 10 years, which seems to suggest that it took less risk in pursuing its lending activities.

This brings us to the final question: How did the bank with the least risky business mix, taking on a fairly similar (if not smaller) amount of risk generate such superior profitability?

As you may have noticed, the answer lies in the bottom half of table 1. Wells Fargo has a funding advantage.

The Net Interest Margin encapsulates the age-old manner by which a lender makes money. It borrows at a low rate, lends out at a higher rate, and bags the difference. Over the past 10 years Wells Fargo lent out at 4.86% higher than it borrowed at, which is a substantially higher spread than the other banks.

Logically, the only way it could achieve this was to borrow for less, lend out for more or a combination of the two. Wells Fargo did it primarily by borrowing for less. It is largely a retail bank and uses its vast amount of savings and checking deposits as a source of funding. The rate on these deposits is considerably lower than the cost of conventional debt or equity funding. In addition, the rate Wells Fargo pays on its deposits is even lower than for the other banks, a result of having more checking deposits. With deposit funding making up significantly more (67%) of total funding, having the cheapest deposits and lending out at a similar rate to other banks, Wells Fargo earns a higher Net Interest Margin. In this way, it has earned more per dollar of assets.

Excess returns normally attract competition but it seems that Wells Fargo has sustained its advantage for some time. It is true that the typical retail banking customer does not simply walk out the door. People tend not to switch banks due to the hassle of doing so. This characteristic of sticky retail customers makes this kind of funding quite enduring. It is especially the case for Wells Fargo given the bank's relationship orientated, community bank approach with a decades' long strategy of cross selling. The more products a customer has with them the less likely they are to abdicate to a competitor. In this way by focusing on 'satisfying their customers' needs and helping them succeed financially', Wells Fargo has created a mutually beneficial relationship with their customers. Customers have the convenience of a central point of communication for many of their financial needs while Wells Fargo receives robust low cost funding. Persisting with this strategy means that Wells Fargo entrenches their deposit funding advantage and grows it incrementally, year by year.

There is an additional scale benefit for a large bank over a small bank given comparable banking systems. Banks have continued searching for this benefit, evident in the consolidation in the US banking industry over the past many years. Higher fixed regulatory cost, as with other costs of a fixed nature, places smaller banks like M&T at a disadvantage relative to bigger banks like Wells Fargo which can spread that cost over a larger user base.

Based on our understanding of its profitability, Wells Fargo ticks our quality box.

The Topic of Lower Returns on Capital in the Future is the Most Pertinent Issue Facing Banks

The introduction of Basel III and other regulations will see banks have to hold more capital than in the past. With less leverage magnifying core profitability this implies lower ROEs. In turn, this suggests lower valuation multiples for banks.

There are some offsetting factors to consider:

- Wells Fargo has never been in the business of leveraging up poor ROAs to generate its considerable ROE. The converse is true - it has always been very well capitalised and as we have seen, its core profitability is very high. For Wells Fargo the proposed capital rules does not imply leverage substantially different than from the past and it seems that out of all the banks its overall profitability will be least affected by the new rules.

- Banks are pricing for the increased regulatory burden. It appears from the comments made in the quotes that at least some of the higher regulatory burden is already being passed on to borrowers.

- Holding more capital i.e. less leverage is equivalent to less risk. Lower risk equates to a lower return demanded by the providers of debt and equity capital. This suggests lower valuation multiples.

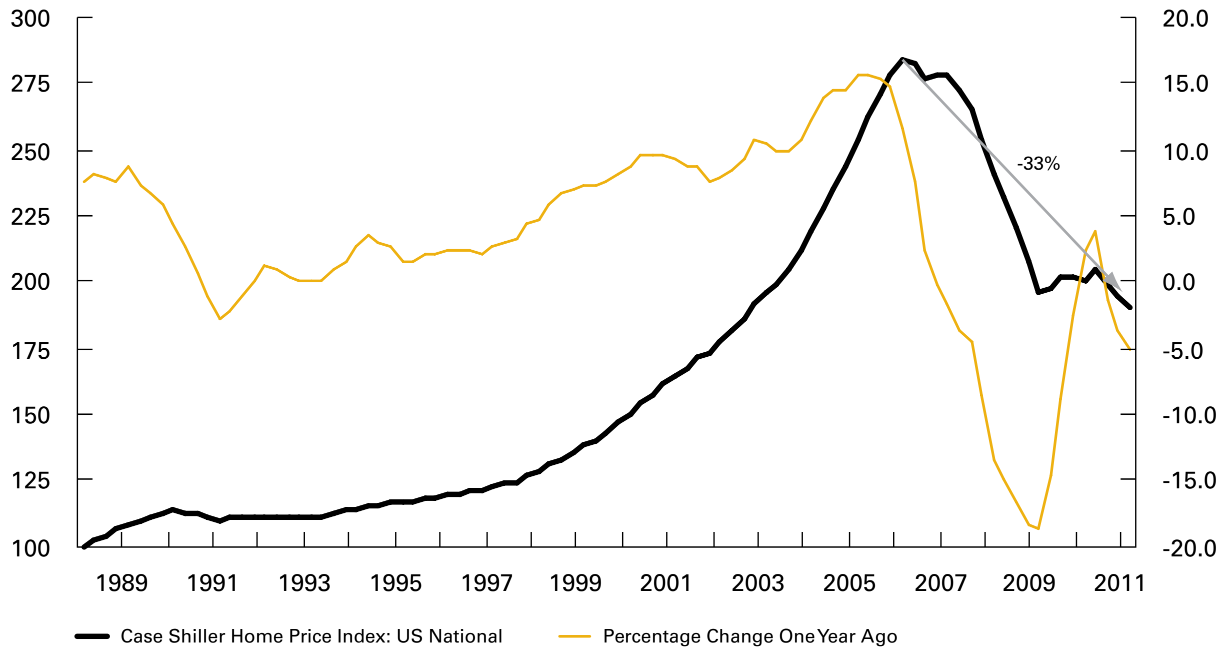
Returns on Capital are likely to be lower going forward, but economic principles dictates that overall, the banking sector will continue to earn a return that covers its cost of capital. In turn, a well run bank with a competitive advantage like Wells Fargo will continue to earn a positive return over its cost of capital.

The Risk of Real Estate

The fundamental risk for a shareholder in a lender like Wells Fargo is, of course, that it makes poor loans. It is possible to evaluate the underlying risk in a bank's lending operations by monitoring its loan exposures to the related real estate markets. If a bank is making 100% loans to borrowers placing overvalued properties as collateral, alarm bells should go off. This is exactly how 297 banks or thrifts in the US went out of business over the past two years.

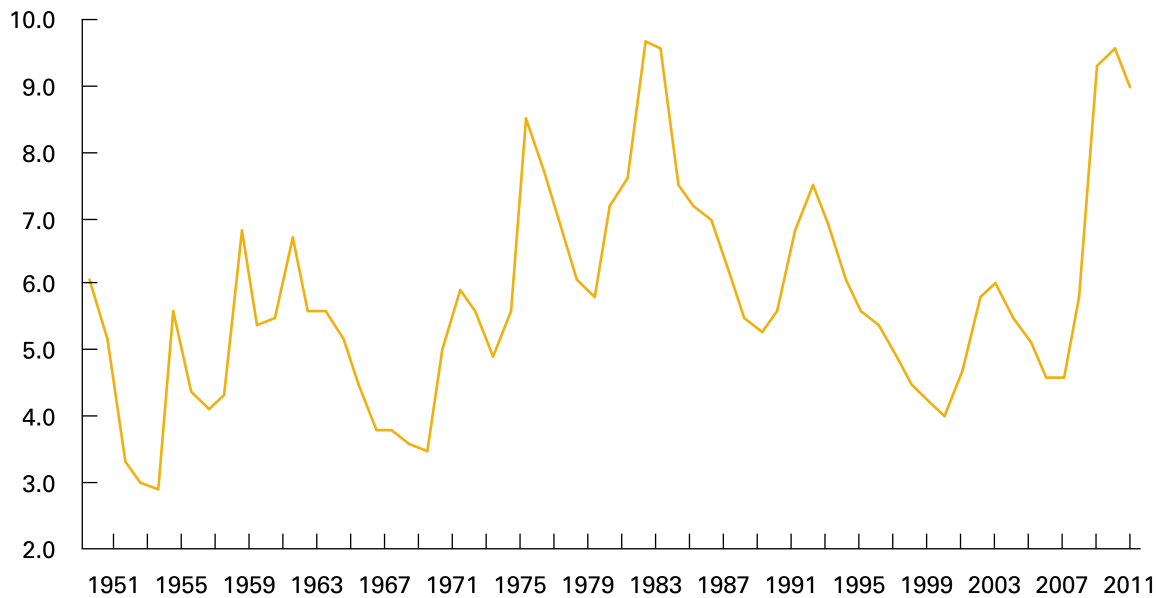
For a large national bank like Wells Fargo the valuation of the broad US property market is a reasonable indicator of the underlying risk. Charts 1-4 paint a picture of the US real estate market and how it relates to Wells Fargo.

Chart 1: US House Price Index



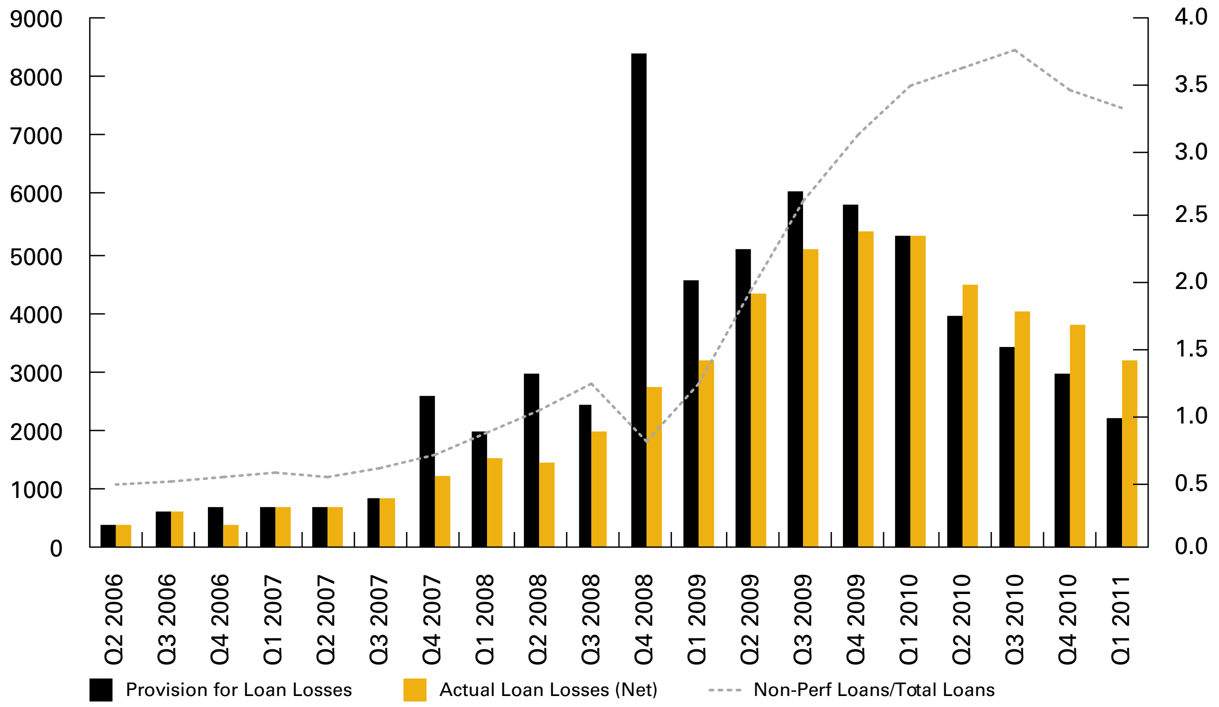
Source: Standard & Poor's/Case Shiller Home Price Indices, RE:CM Analysis

Chart 2: US Unemployment Rate (Annual)



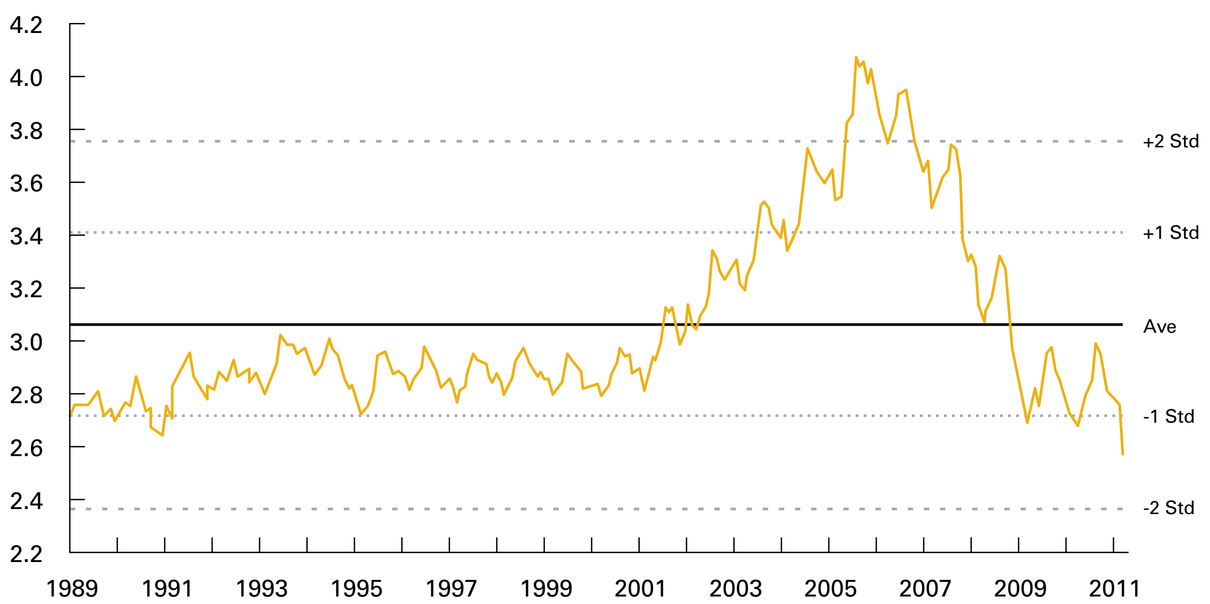
Source: US Bureau of Labor Statistics

Chart 3: Wells Fargo Non-Performing Loans, Loan Losses and Provision for Loan Losses



Source: Wells Fargo Company Reports

Chart 4: US Housing Affordability: Median House Price / Median Income (US National)



Source: National Association of Realtors, RE:CM Analysis

For homeowners and lenders alike, the pain experienced over the last few years is captured in Figures 1-3. From the peak in the second quarter of 2006, the price of the average home in the US has fallen by 33%. To make matters worse, unemployment has risen to historic highs. As a result non-performing loans have escalated further and lingered longer than they otherwise would have. Wells Fargo has also experienced its fair share of discomfort.

The good news is that the worst is over. Although we will see further write-offs, they do not pose a risk to Wells Fargo's survival. Non-performing loans are working out of the system as bad loans are written off. As long-term investors we also know that unemployment will normalise. Judging by history, this will be sooner rather than later. This will further reduce non-performing loans. Similarly, with the poorest quality loans off the books, loan losses have continued to improve and with Wells Fargo providing for a large amount of loan losses early on in 2008 already, provisions for loan losses have improved even more.

What is most encouraging, evident in Chart 4, is that real estate in the United States is the most affordable that it has been in a very long time. This equals a low risk secured lending environment. In other words, collateral values that are worth more than the collateral placed are backing the loans that banks are making. This bodes well for future credit loss and earnings.

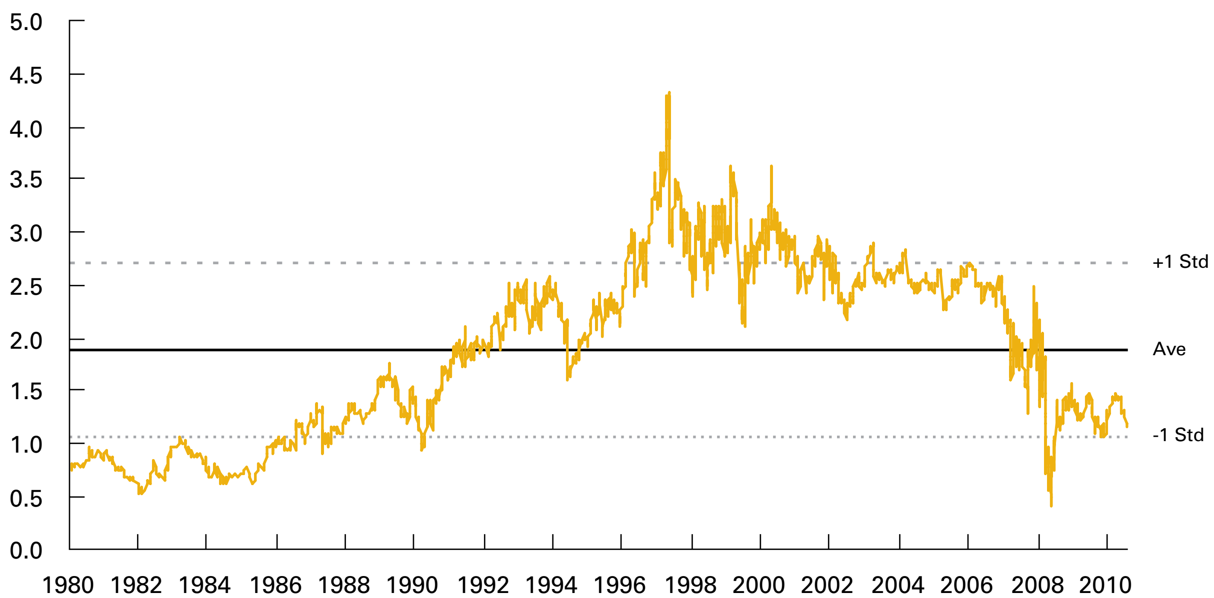
Another positive is that a fair bit of capacity (via bank failures and increased capital commitments) has been taken out of the market and having been burned, the remaining players are lending in a more responsible fashion. Pricing has improved.

Wells Fargo's Share Price is Discounting a Very Poor Future Outcome

The preceding discussion revolved around quality and the risks involved. Wells Fargo received high marks for quality and it appears that the risk of loss relating to poor lending is as low currently as it has been for some time.

But what about the risk relating to valuation, is it attractively priced?

Chart 5: Wells Fargo Price / Net Asset Value



Source: Datastream, RE:CM Analysis

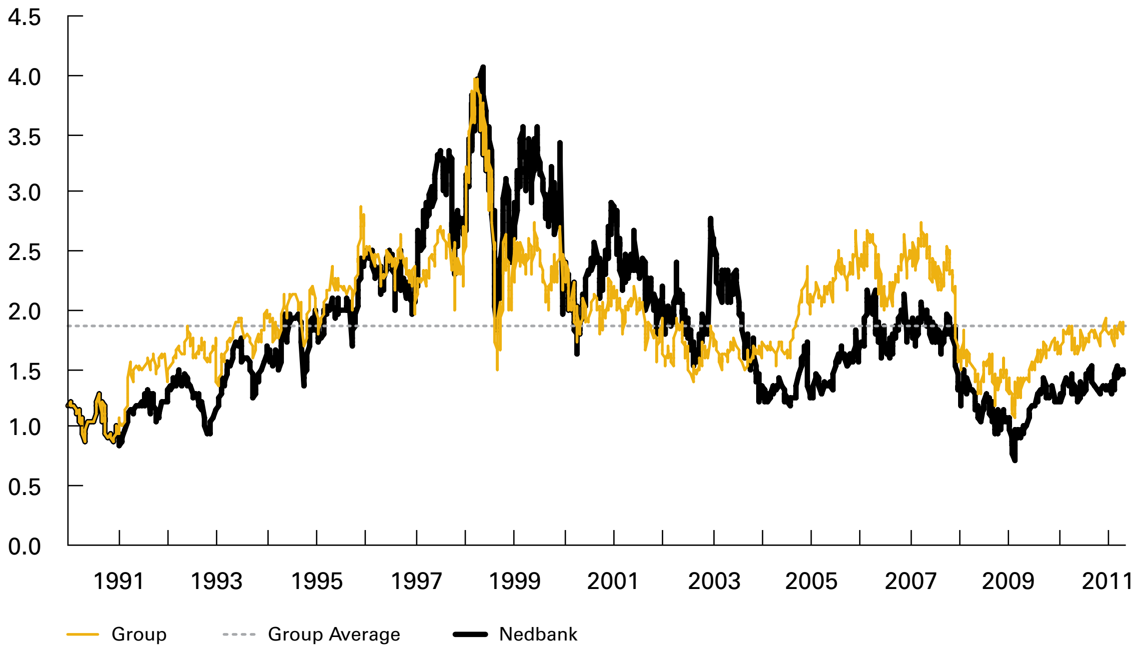
Trading at close to Net Asset Value or the equity capital invested in the business, the market is effectively betting on a worst case scenario that assumes Wells Fargo will be an average business going forward - unable to earn an economic return.

The South African Banking Sector Appears to be Fairly Valued while Nedbank Offers Some Value

As an aside, Wells Fargo has also been more profitable than South Africa's big four banks in the past. It earned a higher ROE relative to the cost of its equity than South African banks have, and what's more, using less leverage. This is quite remarkable and somewhat surprising given the general competitiveness of the US market and the notion in South Africa that our banks are too profitable and are fleecing consumers.

Although South African banks are facing the same issues as US banks the market appears to be pricing in a full recovery today, with the large four banks as a group (ABSA, Standard Bank, Firstrand and Nedbank) trading close to intrinsic value. Only Nedbank seems to offer some value, trading at a much lower Price to Net Asset Value compared to all the other South African banks.

Chart 6: South Africa's Four Large Banks and Nedbank Price / Net Asset Value



Source: Datastream, RE:CM Analysis

The Risk Reward Trade-off for Wells Fargo Appears Very Attractive to Us

Wells Fargo has a management team that understands the competitive advantage of the firm, manages the bank around those strengths and continuously tries to improve on it. For shareholders in a quality business, this is exactly what we want from a management team. By managing its moat Wells Fargo increases the odds of compounding shareholder capital at higher rates for an extended period.

In turn, by paying an attractive price for a business that earns more than acceptable returns on capital over time, we tip the odds in our favour of earning above average returns from the investment.

Where our mandates allow, we have invested in Wells Fargo on behalf of clients while we have trimmed most South African bank holdings, only retaining an investment in Nedbank.

Johannes Visser

THE SMOKE, MIRRORS AND SHATTERING TRUTH OF SHARE REPURCHASES

RE:CM analyst: "So what would be your preference between dividends and share repurchases as a way of returning capital to shareholders?"

Company representative (after a long pause): "Probably share repurchases, as long as it does not damage our reputation".

RE:CM analyst: "Why? And what do you mean by share repurchases potentially damaging your reputation?"

Company representative: "With a share repurchase, you have more flexibility. When you increase dividends, shareholders expect the higher dividend levels to be maintained, which can sometimes become problematic. As for the reputational issue, being seen to buy back shares soon after having had to issue shares will not reflect favourably on the company".

Extract from a discussion between a RE:CM analyst and a representative of a major Japanese shipping company at a recent investor conference.

"We want, to the maximum extent possible as a company that has not cut a dividend since the great depression, our shareholders to see that as an annuity and we will continue to grow that dividend basically in line with the company growth is.

The major way and the way that benefits the shareholders in aggregate has historically been off-market buybacks in Australia and on-market buybacks of the PLC register that is from time to time traded at a discount and, therefore, are the most economical units to retire to the benefit of all of the shareholders."

BHP Billiton CEO Marius Kloppers, discussing the company's strategy of returning capital to shareholders at the company's interim results presentation, 16 February 2011.

The global economy has improved in a stuttering but noticeable fashion since the lowest point of 2009 and many companies are sitting on vast amounts of cash. Share repurchases have therefore become a topic that is high on the agenda of many company management teams again. Rational discussions of the economic merits of share repurchases as opposed to dividends don't seem to be as high on the agenda.

In Theory, the Choice Between Buying Back Shares and Increasing Dividends Should be Simple

If a company cannot reinvest cash in projects that they expect to generate returns higher than its cost of capital, it should return that cash to shareholders. But it would be quite rational to buy back shares if the company's own shares are trading at a discount to their intrinsic value because in that scenario buying back shares creates more than one dollar of value in the hands of the remaining shareholders for every dollar spent buying back shares (as opposed to a dividend that gives shareholders exactly one dollar of value for every dollar of dividend declared). However, as the discussion quoted above shows, the choice between share repurchases and dividends are often driven by many factors other than economically rational decision-making.

While Japanese companies probably have a stronger culture than most when it comes to avoiding the loss of face, nobody wants to suffer errors of judgement and be seen to do so. In the case of the shipping business above, the funding requirements for ships ordered during the boom years of 2006 - 2008 forced the company to issue shares at a deeply discounted price during 2009. This was clearly very embarrassing for management, and fear of being embarrassed again seems to be holding them back from even mentioning what should be the prime motivation behind buying back shares: whether the shares can be bought at a discount to intrinsic value or not.

But, the Fear of Cutting a Dividend Can Cause Irrational Decisions

Shareholders typically like companies to pay steadily increasing dividends year after year. However, the fear of cutting a dividend that this preference instils in management may cause economically irrational decision making. A case in point was about two years ago, when a South African company (that shall remain anonymous but whose management we generally respect and admire) that is known for its high dividend payments approached us to discuss raising equity capital. The company was not particularly highly geared, but one of the company's consortium of bank lenders was playing hardball, which was why the company needed some equity capital to pay off a loan. In all likelihood, the business would have generated enough cash to meet all payments due under the loan without having to issue new shares, but this would have required the company to cut its dividend. Out of fear of the potential impact on the share price of cutting its dividend, management decided to issue shares at prices that they considered cheap, instead. The result was that shareholders got their dividend, management saved face, but they destroyed shareholder value. They reacted to our alternative suggestion of cutting the dividend and then buying back shares out of internally generated cash if the share price imploded as a result (not a foregone conclusion, of course) with polite smiles and complete disregard.

Share Repurchases Can Manufacture Earnings Per Share Growth in a Low Interest Rate Environment

A further problem when it comes to weighing up dividends and share repurchases is that it is quite easy to manufacture earnings per share growth in a low interest rate environment with share repurchases. As long as the after-tax interest rate earned on cash and/or the after-tax interest rate paid on debt is lower than the earnings yield (the inverse of the price earnings ratio) of the shares a company buys back, earnings per share will grow because of a share repurchase. By way of illustration, consider two companies, A and B, the same in all respects, with excess cash on their balance sheets on which they are earning 5% interest after tax. Let us also assume they are no-growth companies, worth about net asset value (about right for a global business earning a 10% return on equity with no growth). However, their shares are nicely overvalued, trading at an earnings yield of 6.7% (a price earnings ratio of 15) in the market.

	A	B
Balance Sheet		
Fixed Assets	900	900
Cash	100	100
Total Assets	1000	1000
Equity	1000	1000
Shares in Issue	100	100
Net Asset Value Per Share	10,00	10,00
Income Statement		
Net Profit	100	100
Earnings Per Share	**1,00**	**1,00**
Share Information		
Return on Equity	10%	10%
Earnings Yield	6,7%	6,7%
Share Price	15,00	15,00

Source: RE:CM Analyst

Company A decides to pay out all of its cash as a dividend, and company B decides to buy back its overvalued shares. As a result, both companies have a decrease in their total assets and equity, as well as their net profit (due to the loss of interest on the cash), but the effect on earnings per share is quite different.

	A	B
Balance Sheet		
Fixed Assets	900	900
Cash	0	0
Total Assets	900	900
Equity	900	900
Shares in Issue	100	93
Net Asset Value Per Share	9,00	9,64
Income Statement		
Net Profit	95	95
Earnings Per Share	**0,95**	**1,02**
Share Information		
Return on Equity	10,6%	10,6%

Source: RE:CM Analyst

After A's dividend and B's share repurchase, B has a higher net asset value per share, shows earnings per share growth for the year (compared to A that has a decline), has the same gearing level as company A and is earning the same return on equity as company A. Better in every respect then, right? Not so fast.

After the share repurchase, company B's shareholders are left with a share with a net asset value of 9.64. Company A's shareholders are left with a share with a net asset value of 9.00. But, very importantly, A's shareholders also have 1.00 of cash in the bank, for a total value still equal to the 10.00 net asset value prior to the dividend. Therefore, despite company B's management being able to report better financial performance than company A in almost every respect, company B's share repurchase has destroyed value.

Management Incentives are Stacked in Favour of Share Repurchases When Interest Rates are Low

Management is typically measured on the reported financial numbers of their company (cash in shareholders' pockets typically do not feature as prominently in the equation), and market participants usually cheer on earnings per share growth more than any other metric. Management incentives are accordingly stacked in favour of doing repurchases in a low interest rate environment even if value is destroyed in the process.

There is another angle on this matter though, and that is the fact that both company A and company B are now earning higher returns on equity. The equity capital of a business earning a higher return on equity is clearly worth more than one earning a lower return on equity, given similar levels of growth and financial and operational risk. For no-growth businesses, this relationship between the fair value of equity and the book value of equity scales linearly with return on equity earned versus cost of equity (which we assumed to be about 10% for company A and company B initially). So for a business with a 10% cost of equity (the return required by equity investors) that is earning a 10% return on equity, the fair value of its equity is equal to the book value (according to the financial statements) of its equity. However, a business earning an 11% return on equity with a cost of equity of 10% is worth 11/10 of the book value of its equity. So after company A's dividend and company B's share repurchase, an argument could be made that the shares are now worth 10.6/10 of the net asset value per share. That would mean that after the dividend and share repurchase, the two companies' shareholders now own assets worth the following:

	A	B
Net asset value per share	9,00	9,64
Multiplier (10.6/10)	1,06	1,06
Fair value per share	9,5	10,2
Cash (via dividend)	1,0	0,0
Total shareholder value	10,5	10,2

Source: RE:CM Analyst

This certainly makes it look like the value destruction argument is less convincing - and will become more so the higher the initial return on equity is that is earned by a company buying back shares. But is this right? We would argue no.

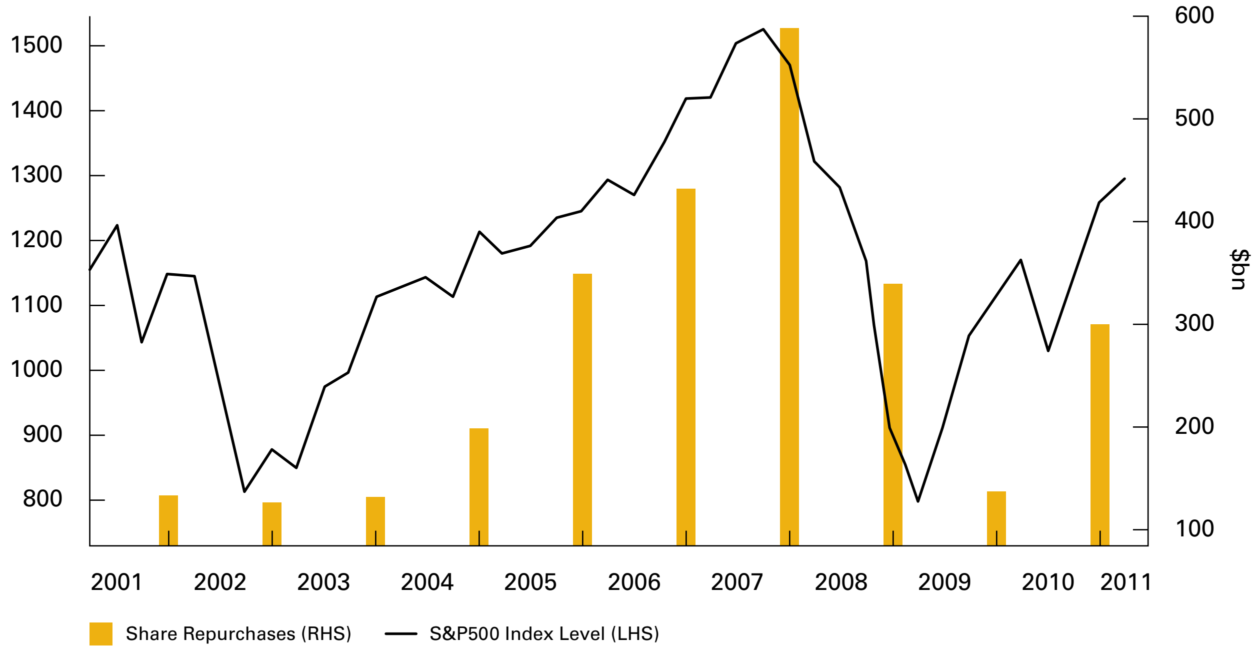
Reduced Cash on the Balance Sheet Should Require a Higher Rate of Return

Prior to company A's dividend and company B's share repurchase, both companies had a substantial amount of cash on the balance sheet. Cash is a low risk asset, and shareholders will demand a similarly lower rate of return from a company that has a lot of cash on its balance sheet. Paying a dividend and buying back shares means that this leaves company A and company B with only fixed assets on their balance sheets. Fixed assets are inherently more risky than cash. Accordingly, shareholders should demand a higher rate of return from a company that has only fixed assets and no cash on its balance sheet. The required rate of return should therefore rise, which means that the multiplier in the calculations above will revert to one, and we will be back to the conclusion that company B's share repurchase has destroyed value. The same argument holds true where a company borrows money to fund a share repurchase.

Repurchase Activity in Recent Years Shows That Companies Tend to Buy Back Shares Expensively

While there have been academic studies that have concluded that the shares of companies that engage in share repurchases have subsequently outperformed those of companies that haven't, the U.K. firm Fundsmith raises the point, in a piece of work well worth reading[1], that the outperformance is due to the fantastic performance from the shares of companies where shares were bought back cheaply, rather than simply due to fact that shares were bought back at all. Shares of companies that were bought back expensively underperform a randomly chosen reference portfolio despite the repurchase activity. Unfortunately, repurchase activity in recent years suggests that, on average, companies buy back shares expensively. In an illuminating chart in the Fundsmith work, it is quite clear that share repurchase activity in the US has followed the market quite closely: when share prices are high, more shares are bought back, and when share prices are low, fewer shares are bought back.

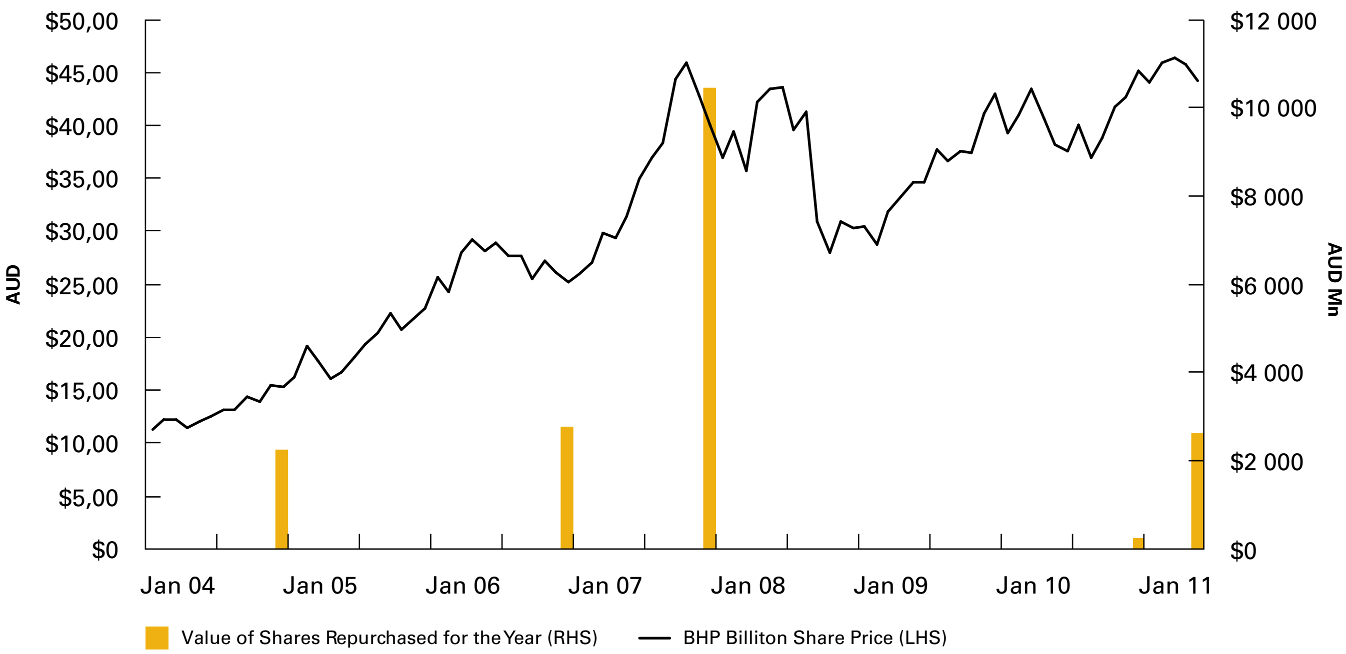
Chart 1: S&P500 Share Repurchases Compared to Index Price Level



Source: Fundsmith

BHP Billiton is a case in point, as Chart 2 below illustrates. The last bar in the graph represents repurchase activity for the year to date. Note that in 2009, when the share price was the lowest over the past four years, there was no buyback activity.

Chart 2: BHP Billiton Share Price and Value of Share Repurchases



Source: Thomson Reuters Datastream, Company Reports

2009 was a year of great uncertainty about future prospects for the mining industry; but it is only under such circumstances that share prices become cheap. BHP has always had a very strong balance sheet (unlike some of its main competitors), so conducting share repurchases in 2009 would not have placed the business at undue financial risk.

Momentum Investors Welcome Increased Demand for Shares - Which is Why Value is Destroyed

Our earlier calculations illustrated the attraction of share repurchases for management, but why do shareholders put up with such value destruction, because they typically have to approve any share repurchase? The problem seems to us that there is no natural shareholder constituency to vote against proposed share repurchases. Almost by definition, the shareholders of a listed company view the shares of the company they are invested in as a good investment. By implication, the shareholders of most businesses would see buying back shares as a good allocation of capital. Amongst the ranks of the shareholders of a company with an expensive share price there is no value investor that can push management to do the sensible thing when a share repurchase is proposed, hence the destruction of value. Unfortunately, there seems to be no simple way out of this conundrum: the momentum investors typically invested in an expensive share are likely to welcome more short term demand for the shares of the company, as this will support (or boost) the share price.

To Defend Value for Shareholders of all Companies we Hesitate to Give Blanket Approvals for Share Repurchases

Because of the insidious way in which share repurchases can sometimes destroy value, we are hesitant to give blanket approval for share repurchases when we are asked to vote on the matter on behalf of our clients. The shares our clients own may be cheap, and so a repurchase may well enhance shareholder value; but as a matter of principle, we like to see that management have applied their minds thoroughly to the matter. Can they clearly demonstrate that a repurchase will enhance shareholder value, and not just be “accretive to earnings per share” - the mantra under which most share repurchases are justified? We would venture to suggest that in aggregate, company shareholders would be better off if they held more management teams to this standard.

Wilhelm Hertzog

1. References: https://www.fundsmith.co.uk/Blog/11-04-14/Share_Buybacks_-_Friend_or_Foe.aspx

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