GRAY ISSUE
LONG TERM COMMENTARY

9 February 2005
Issue no. 41

From 2004 and into 2005

The primary objective of Allan Gray's investment philosophy is to consistently produce attractive absolute returns on our clients' investments. Outperforming our peers from year to year is therefore not our primary focus. However by producing consistent attractive absolute returns, we are likely to outperform most of our peers over the longer term. For 2004 our absolute returns were attractive, although not as good as those of most of our peers.

In early 2004 we communicated to our clients that we see very little long-term value differences between resource, industrial and financial shares in general, with each category having some expensive and some attractively priced counters. At the time, we also thought that the Rand was fair to strongly valued against its basket of trade currencies. Given this view, and the difficulty of predicting short-term movements in the Rand exchange rate, we thought it prudent to have exposure to those resource counters where we found long-term valuations to be attractive, mainly Sasol and some of the gold counters. We therefore started the year with a portfolio that was, relative to those of our peers, overweight industrials, underweight financials and neutral resources. Our industrial weighting was down from the substantially overweight position in 2002 when industrial valuations were depressed and sentiment was very negative. As we now know, the Rand continued to strengthen with the domestic economy booming during 2004. In this environment, industrial shares appreciated strongly, especially the credit retailers who are geared to the domestic economy, as did financials. Resource shares, and especially the gold shares, which were the most marginal of the Rand hedge counters, came under pressure.

Performance in 2004 was driven largely by movements in macro-economic variables (e.g. Rand exchange rate, domestic interest rates, credit extension and domestic economic growth). In our investment process we give little credence to forecasts of macro-economic variables, as these are extremely difficult to consistently forecast correctly. We rather invest our portfolios in businesses (shares), which we believe to be attractively valued, given long-term normal economic variables. In other words, our portfolios will shift in line with our assessment of where value is to be found in the market. Our ability to correctly identify attractively valued counters is much greater than our ability to predict economic variables and the benefit of focusing on what one does well is borne out by our superior 30-year performance history. Over the long-term undervalued shares will return to levels of fair value (and possibly over-valuation) notwithstanding economic conditions. However over the short-term, factors such as economic variables, sentiment etc. can substantially influence valuations. When this happens, especially when there are few valuation differences to start off with, our valuation based philosophy will tend to underperform. We however remain confident of our ability to produce attractive absolute returns over the long-term.

Now in early 2005, we have a situation where some industrial shares are approaching expensive valuations. Financials, especially the banks, appear fairly valued and selected resource shares are now becoming attractively valued. We also believe that the Rand is now unsustainably strong. Domestic industrials are experiencing boom conditions (i.e. above normal). Not only are they experiencing high volumes, but margins have also expanded aggressively due to reduced input costs resulting from the strong Rand and sustained Rand selling prices. The domestic motor industry is a case in point with volumes at historical highs and no reductions in selling prices. Credit retailers are geared to both these phenomena. It is our view that the high levels of profitability of domestic industrial shares are unlikely to be sustained over the longer term. Thus, despite attractive ratings, industrial shares now appear expensive. In line with our value orientated philosophy, we shifted our portfolio away from industrials (especially the credit retailers, where valuations became stretched and sentiment extremely positive), and into banks (which became relatively more attractive) and selected resource shares, (where some valuations are now depressed and sentiment extremely negative). Our portfolios are now underweight industrials, neutral financials (but mainly in banks) and overweight resources.

Commentary by Arjen Lugtenburg, Director, Allan Gray Limited