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Volatile market presents equity buying opportunities for our asset allocation funds

In light of the significant volatility in the equity and currency markets, we thought it would be useful to briefly review the positioning of our funds.

Equity markets have fallen substantially as prices discount the high level of historic earnings. Based on our concern that company earnings would revert to more normal levels at some stage, most of our equity exposure has been concentrated in high-quality, stable, diversified businesses and those whose earnings lagged over this period of extraordinary earnings growth. These mainly consisted of non-commodity rand hedges such as SAB, which while still unfortunately falling in absolute terms, have held up relative to the overall index. In addition, many of our investors may be aware that our asset allocation funds used index futures to lower the net weighting to equities.

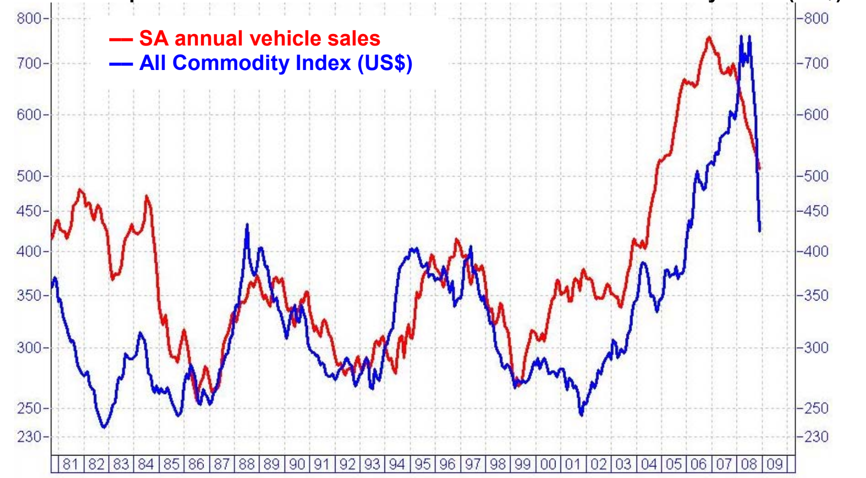
With the sharp sell-off during September to November we have increased the equity exposure in our asset allocation funds. We achieved this mainly by closing out the index futures position. In addition, we have made further purchases of shares we believe are undervalued but have fallen as much, and in some cases more, than the index.

Knock-on effect of world crisis

To date, South Africa appears to have come through the 'global crisis' relatively unscathed, unless you were a dollar investor in our equity market. We fear that the world's problems (which have been transmitted to South Africa through much lower commodity prices and a weaker currency) will have a larger effect on the real economy than is generally expected.
The local economy is influenced by commodity prices. The graph highlights the visual correlation between local motor vehicle sales and the All Commodity Index.

Many domestically focused businesses are still reporting levels of profitability that remain high by historical standards. We believe that the downside to these earnings has not been fully discounted by the current level of some share prices.

Relationship between SA annual vehicle sales and the All Commodity Index (US$)



2002/2003 versus 2008: What's different?

There are two significant differences between 2002/2003, which provided an almost once-in-a-generation opportunity to buy domestically focused South African businesses, and 2008:

1) Earnings were very low in 2002 and
2) The currency had not weakened in response to collapsing commodity prices as in 2008.

We expect continued downward pressure on the domestic profit pool.

Therefore, despite the relative outperformance of many large cap industrial shares, and our research on individual companies which highlights many more opportunities than a year ago, we continue to favour shares such as SAB, BAT, MTN and Remgro due to our relative confidence in their earnings.

We have increased our equity exposure despite our cautious outlook

At current prices, the equities in our portfolios are offering attractive returns on a four-year view – the period on which we base our individual company forecasts. While our (hopefully) conservative earnings forecasts may still turn out to be too optimistic, we are willing to accept possible further price downside given our estimates of their intrinsic value, which is attractive relative to current prices. This explains why we have increased the share exposure in our Balanced and Stable Funds despite our cautious earnings and economic outlook. However, we continue to caution that the future level of excess returns over inflation is highly likely to be lower than the 2003 – 2007 period.

Commentary by Duncan Artus, portfolio manager, Allan Gray Limited