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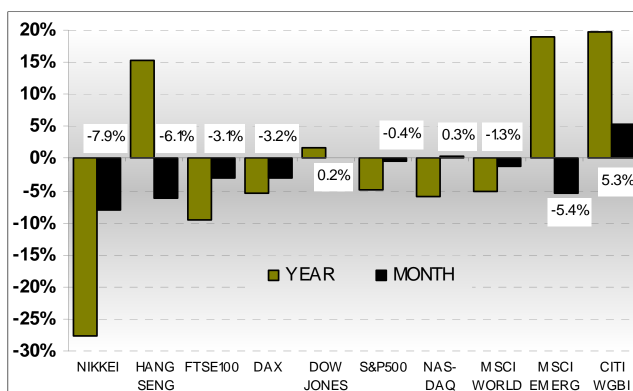
Investment Letter | 8th Edition | April 2008

March in perspective – global markets

At last it's over – the quarter, that is. The first quarter of 2008 will go down in history as an extraordinary one, during which the global financial system was well and truly tested - and found wanting in many areas. We will examine the past quarter in detail in the Quarterly Reports which will be finalized later this month. Turning specifically to March, it proved to be yet another tumultuous month, as you will see in a moment. With the odd exception, returns remained negative: the MSCI World and Emerging market indices declined 1.3% and 5.4% respectively – refer to Table 2 at the end of this letter. Chart 1 shows how poorly markets performed in the past month and year, while Chart 2 shows the quarterly returns of selected indices in local currency terms. With the exception of Hong Kong, China, India and the MSCI Emerging market indices, all the other indices ended the quarter and year in the red!

Chart 1: Global market returns to 31 March 2008

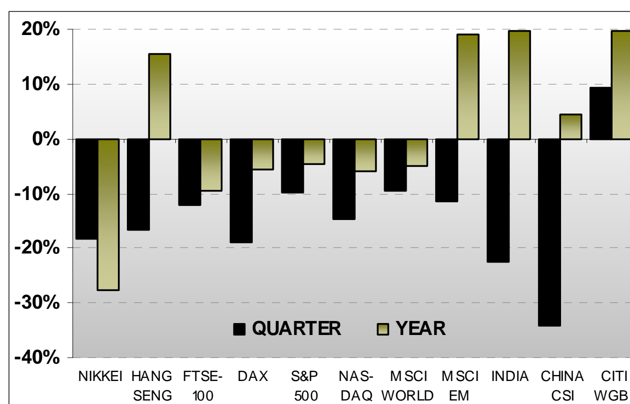


So how bad is it really?

During a recent presentation, I was asked for my view on the markets. My response was that "markets are in a deep state of distress, which is unlikely to get better soon". That might sound too dramatic but consider these examples (of which there are plenty more) and decide for yourself.

- The collapse of 85-year old **Bear Sterns**, Wall Street's fifth largest investment bank, has been adequately covered in the media. At the time of writing the details of JP Morgan's purchase of Bear Sterns are still the subject of much horse-trading. Suffice is to point out that the company's share price, which had traded at $172 in January last year, valuing the group at $20bn, was reduced to $57 in mid-March. Two days later, on the verge of collapse, the initial offer from JP Morgan came: to buy the company at *$2 a share*. That might not sound too dramatic, but think about it for a while: a group that, only two days earlier, assured investors its balance sheet "had not weakened at all" was reduced to virtually nothing as a result of a lack of liquidity and a dramatic change in sentiment.
- The collapse of the **Carlyle Capital Fund** is perhaps even more indicative of the crisis in which financial markets find themselves, specifically global credit markets. This $22bn fund, which invested in mortgage-backed securities and was listed in Amsterdam at $19 in July last year, closed for business in mid-March after failing to meet $400m of margin calls. But here's the catch – it had leveraged itself no less than … wait for it… *31 times!* Now I'm no rocket scientist, but that sounds more than stupid to me; its simply irresponsible and reckless, no matter how rosy those "returns" might have seemed. Investors will lose all their money. For the record, this Fund was brought to the market and was part of the Carlyle Group, one of the world's biggest and most reputable private equity firms.
- In early March **Peloton Capital's** $2bn ABS Fund, which also invested in asset backed securities, also folded after being unable to meet its margin calls. The reason I mention this Fund is two-fold: firstly only last month it won an industry award for being the top new fixed income fund for 2007. And secondly, it won the award on the back of its 86.6% return last year. I'm sure many investors were still celebrating the outstanding returns as the Grim Reaper came knocking.

Chart 2: Global index returns to 31 March 2008



- The **ongoing volatility** in markets continues to bring challenges on all fronts. As the dollar has weakened, the yen has strengthened and brought into focus billions of dollars involved in the "carry trade" which we have discussed on previous occasions. Japanese bonds have also been volatile and have been the undoing of many hedge funds who manage their portfolios on the basis of "relative value". In the middle of March – this period proved to be the nemesis of many a hedge fund – many funds were tripped by the severe volatility in Japanese bonds. There were rumours of losses of between 5% and 20%. **Endeavour Capital** has informed investors it lost 27% of its $3bn fund on one day (17 March). The Fund was leveraged 18 times.

- Moving away from hedge funds, **Iceland** has again been in the news - recall that in the March 2006 and April 2006 editions of *Intermezzo* we covered developments relating to the krona in some detail. Having survived the storm back then, it is again in the news, with the currency coming under pressure in March and threatening to make Iceland the first *country* to fall victim to the current turmoil. The central bank raised interest rates to 15% in an effort to stem the tide against the krona, which has come under renewed pressure on concerns about the quality of the banking sector and perceived imbalances in that economy. The krona has fallen about 22% so far this year against the euro. Daily movements in the currency and equity market in excess of 5% are now the order of the day.
- **Money market funds** and US ones in particular, are facing unique challenges and coming under renewed pressure. Some of them invested in high-yield securities, which have been trashed in recent months, resulting in these funds coming close to "breaking the buck" i.e. when the value of the fund's unit declines below par. Remember money funds are expressed in yield (%) terms (for example the current rate on a SA money market unit trust is about 11.0%) and their price does not move away from unity or par. In contrast, growth or equity-related funds' unit value changes daily. Many of the banks which sponsor US money funds have committed hundreds of millions of dollars to their respective funds in order to prevent the value of the unit from declining below par. It seems that only a short while ago money funds were generating attractive yields. But with the Fed having cut rates so aggressively – the Fed funds rate is now only 2.2% and the 3-month US Treasury bill only yields 1.3% - some funds are even waiving their management fees in order to ensure that investors get at least some return. With yields at such low levels, a 1.0% investment fee consumes most of the annual return.
- **Investment bank write downs** have become so frequent they are hardly noticed these days. But one should not underestimate the extent of the write downs and the longer-term effect they will have on the global economy in general. At last count, the world's top banks, which incidentally number about ten to fifteen, have written down an aggregate amount of $232bn.
- I have lost count of the extent of **additional liquidity that global central banks** have placed in the market to improve their liquidity. The US Federal Reserve has been the most aggressive in their accommodation (as they should, seeing they are at the epicentre of this mess), going so far as accommodating investment banks in a number of innovative – some would say risky – ways. These banks are traditionally excluded from Fed support for capital markets. When Bear Sterns folded, for example, the Fed agreed to fund the first $30bn of Bear Sterns' illiquid assets, something quite unprecedented in Fed history.
- And to state the obvious, **the behaviour of markets has been extremely difficult to predict**. For example, when UBS announced another $19bn of write downs (bringing their total write downs to $36bn) and another round of capital raising to shore up their balance sheet (this time they need about $10bn), you would have expected the share price to decline sharply. As it turned out, it rose 14.3% on the day of the announcement and at the time of writing has risen 46.3% since that day, which also marked the recent trough in the share.

The purpose of this diatribe about financial market conditions is to share with you just how unprecedented these times are. I don't mean to be alarmist, but we at Maestro have always sought to share with our clients and "friends of the company" exactly what lies behind the action in and movements of their investment portfolios. In remarkable times such as these, it's worth going into detail in order to help you understand prevailing conditions a bit better. A casual glance at some of the events that have occurred in recent months, namely banks failing, currencies under severe threat, hedge funds collapsing or experiencing severe losses, the injection of trillions of dollars into global capital markets by central banks to "reliquify" the system, billions written down by banks, commodity prices at record levels, countries imposing restrictions on the movement of staple foods (see below) – these can hardly be described as normal times. When reviewing their investment returns, investors should bear these conditions in mind.

I should also add that my intention is not to scare you off hedge funds for life. Despite all the "doom and gloom," apart from credit and fixed income funds, in my humble opinion hedge funds in general and equity-oriented funds in particular have coped admirably under the circumstances. Many of them have posted respectable positive returns, which is no mean achievement in the current circumstances. One must be careful of generalizing attitudes and comment across hedge funds. Contrary to many predictions, hedge funds (with the exception of fixed income-related funds) have held up well in the midst of the volatility and mayhem. Ironically, it has been the private equity funds, investment banks and government sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac in the US that have given investors and regulators the biggest headaches.

Some odds and ends worth bringing to your attention

- Fourth quarter **SA economic growth** came in at 5.3%, which was greater than expected. Manufacturing rose 8.2% although the base off which this was measured was distorted by a strike in the motor industry last year.

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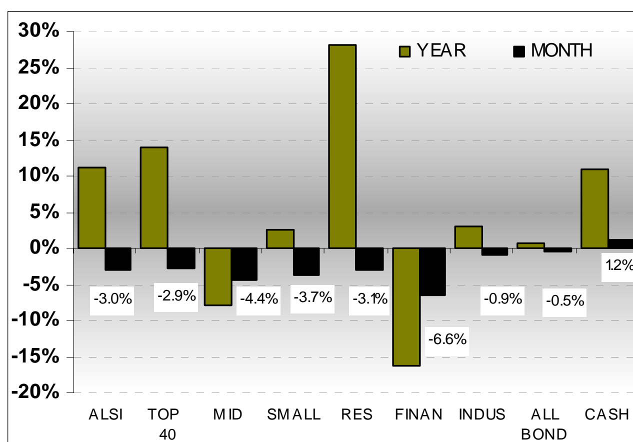
Construction grew 14.2%, not surprising for a country scrambling to prepare for the Soccer World Cup in 2010 and playing infrastructural catch-up. The effects of all the power outages have not yet filtered into these numbers.

- Annual **Eurozone inflation** rose to 3.5% in March, which may not seem high in absolute terms, but it is above the ECB's target rate of 2.0% and is at a 16-year high. No wonder the ECB are reluctant to lower interest rates. Refer also to the section of food inflation, below.
- In the midst of the market turmoil and declining prices, particularly those of financial companies, comes **the IPO (listing) of Visa**, the world's largest credit card network. On 19 March the company raised $18bn in the largest IPO in US history. The shares have fared very well so far. Offered at $44, the shares closed at $56.50 on the first day of trade and at the time of writing were trading at $64.17, 45.8% higher than the IPO price. Crisis? Who said anything about a financial crisis?
- Recent data I came across that might be of interest to you is that the **Chinese mutual fund (unit trust) industry** consists of 350 funds totalling $450bn assets under management. That compares to the SA mutual fund industry with 831 funds totalling R653bn ($96bn) assets under management at the end of December. The SA industry is split as to 24% institutional and 76% retail ownership, where a retail fund is defined as one in which an individual investor can invest directly and the investment is registered in his or her own name.

Chart 3: Local market returns to 31 March 2008



March in perspective – local markets

Similar to the overseas experience the SA equity market experienced more volatility and weakness during March. The first two thirds of the month were weak – the All share index was down as much as 7.4% on the month - but the last third saw something of a recovery, enabling the market to trim its losses. As can be seen from Chart 3 no sector posted a positive monthly return, while some of the annual declines in the major indices are starting to look a bit "ugly". The annual decline in the financial index, for example, is 16.3%, in stark contrast to the 28.2% gain in the basic materials index. It highlights how dichotomous the market has been, particularly during 2008 so far. Sectors to register gains included the beverage sector up 8.6% and industrial metals 7.2%; the biggest declines were in healthcare equipment -10.3%, banks -9.4% and general financials -8.7%.

For the record

Table 1 lists the latest returns of the mutual funds under Maestro's care. You can find more detail, including the latest Maestro Equity Fund Summary, by visiting our website at www.maestroinvestment.co.za. Returns include income and are presented after fees have been charged.

Table 1: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Mar	**-3.2%**	**-2.2%**	**7.9%**
Maestro equity benchmark *	Mar	-2.6%	-1.0%	5.8%
JSE All Share Index	Mar	-3.0%	2.9%	11.1%
Maestro Long Short Equity Fund	Feb	**2.8%**	**-6.1%**	N/A
JSE All Share Index	Feb	12.4%	6.2%	21.9%
JSE Financial and Indus 30 index	Feb	7.8%	-5.0%	3.1%
Central Park Global Balanced Fund ($)	Feb	**1.5%**	**-3.4%**	**4.4%**
Benchmark**	Feb	0.2%	-2.5%	4.8%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Citi World Government Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills

An update on the "other" scourge of 2008

In the January edition of *Intermezzo* we listed the threat of inflation as *the* scourge of 2008. We underestimated the extent of the global credit crunch, which has now also fallen into the "2008 scourge basket", but events on the inflation front are developing faster than we originally imagined. By now you are familiar with the fact that metal and oil prices are trading near record highs. Last month we drew attention to the fact that soft commodities such as wheat, corn and soyabeans had also risen to record levels. During March the commodity food complex continued to scale new heights, taking other commodities with it, including rice. The rice price has risen more than 50% in the last two weeks, which has forced governments to take dramatic steps to secure supply for internal use. Vietnam, China, India and Egypt have all banned the foreign sale of rice. If you don't think this is a big issue, remember that rice is the staple food of nearly one half of the world's population! The governments of Argentina and Philippines, the world's largest buyer of

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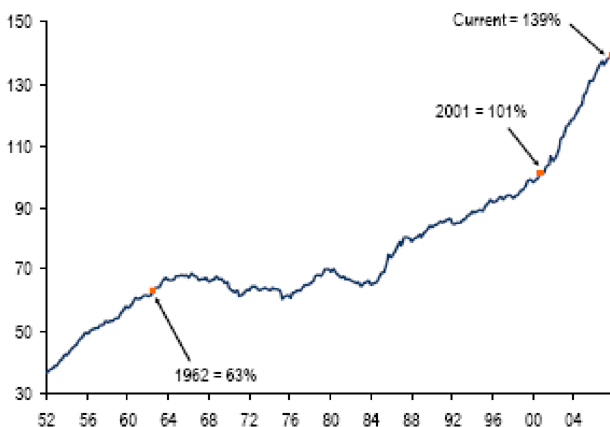
rice, have in one way or another also taken action in recent weeks as a result of the sharp escalation in food prices.

Hot off the press is the news that negotiations for the 2008 contract price of *coking coal* have just been finalised. Steel makers agreed to price increases of between 206% and 215% (!!), which comes hard on the heels of the 65% to 71% price increase in the *iron ore* prices they agreed to last month. No wonder the price of steel is rising so sharply around the world.

We are watching these developments very closely and continue to believe that global inflation will remain a larger problem than most investors imagine. The financial turmoil experienced so far this year has grabbed the headlines, but if and when it recedes, inflation will be next in line to plague governments and financial markets. Watch this space ...

Chart 4: US household debt-to-income ratio (%)



Source: Merrill Lynch

Chart of the month

We at Maestro are more concerned than most, it would seem, about the state of health of the US consumer. Given that the latter is one of the single largest drivers of global economic growth it is imperative that his financial well-being is closely monitored. In this regard, the news is not good. Home prices are plunging, equity prices are falling, unemployment is rising and petrol and food prices are rising. These conditions should be seen in the context of the fact that US households are still massively overly-indebted, as can be seen from Chart 4. The US consumer's level of debt has risen by the same amount in the last six years as it did in the preceding 39 years. Real consumer spending has risen for 64 consecutive quarters and just to make matters worse, although the Fed has cut rates dramatically (by 3.0%) the rate cuts have not filtered down to the consumer yet. The average private sector rate is down by only 0.45%. This is one of the reasons why, despite the prevailing consensus view of a short US recession, we hold the view that the recession will last longer than most people think.

File 13: Items almost worth remembering

I'm still on my personal "China journey" so here's some more interesting but forgettable information for you. Do you know how many "common" surnames are used in China, bearing in mind that the Chinese population exceeds 1.3bn? According to statistics published in the "Chinese surnames dictionary" there are a total of 11 969 surnames which appeared in Chinese history. However, nowadays only about 200 surnames are commonly used. And the most common surname? You guessed it: it is "Li" or to use the local vernacular, 李. You can find more on http://en.wikipedia.org/wiki/List_of_common_Chinese_surnames. Enjoy!

Table 2: MSCI Emerging Market March returns (%)

Countries/Regions	March	Q1-08
Morocco	7.9	33.8
Chile	7.7	9.4
Egypt	0.9	7.8
Argentina	5.8	6.9
Taiwan	2.5	5.3
Mexico	5.7	4.9
Peru	-5.1	4.6
Thailand	-3.3	2.2
Czech Rep	0.9	-0.4
LatAm	**-3.6**	**-1.9**
Jordan	-4.9	-2.4
Poland	7.9	-3.9
Israel	-6.1	-5.3
Brazil	-7.8	-5.7
Indonesia	-12.1	-6.5
Malaysia	-8.5	-10.0
MSCI EM	**-5.4**	**-11.3**
Russia	-1.8	-11.5
EMEA	**-4.0**	**-12.0**
Hungary	-1.6	-13.7
South Korea	-4.4	-14.1
Asia	**-6.8**	**-14.5**
South Africa	-7.9	-15.4
Philippines	-7.4	-18.5
China	-12.2	-23.7
India	-12.7	-27.1
Turkey	-20.4	-38.6

Source: Merrill Lynch

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