MAESTRO

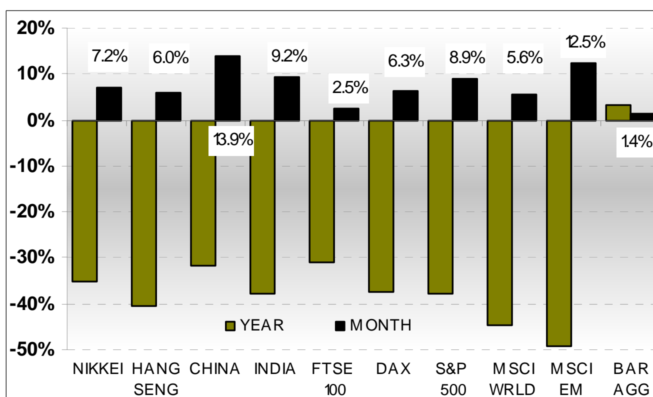
# INTERMEZZO

Investment Letter | 9th Edition | April 2009

**March in perspective – global markets**

Well, it had to happen some time didn't it? A "bear market rally" (otherwise known as a "dead cat bounce") struck global equity markets with vengeance during March. The problem is it only struck *equity* markets. We note a few telltale signs that lead us to treat this rally with great caution and scepticism: the traditional "fear gauge," the Vix index, didn't decline much and the bond market didn't really join in the party. And most tellingly, the global economy continues to deteriorate, with no sign – at least from where we are sitting – of an improvement from any quarter. But we will deal with these and other matters in more detail in our March Quarterly Report. For now let us enjoy and analyze the recent market strength. Chart 1 shows how strong equity markets were; the MSCI World and Emerging market indices rose 5.6% and 12.5% respectively. Emerging markets were supported by the upturn in commodity prices: the S&P GSCI (commodity) index rose 3.7%, bringing its year-to-date gain to 8.1%. The CRB index rose 3.9%. China led the way with a 13.9% gain in March – it is now up 30.3% so far this year. India rose 9.2% and Russia rose 26.6%, off a very low base and supported by a firm (+6.2%) oil price. Developed markets were also strong but their gains were more muted. Table 2 at the end of this edition depicts the returns for the major MSCI emerging markets. The dollar lost ground against most currencies and the bond market posted a 1.4% gain.

**Chart 1: Global market returns to 31 March 2009**




Forgive all the data, but we don't often get such a powerful equity rally in such a short space of time, so its worth spending a little bit longer analysing it. For the record, the S&P500 rallied from a low of 666 on 9 March to a peak of 832 on 26 March; that's a 24.9% gain in only 13 trading days. We saw a similar gain between 20 November and 6 January (from 752 to 934). During the 1929 – 1932 bear market there were four rallies where the market rose more than 20%, yet the market declined nearly 90% during that time. There were three rallies greater than 20% in the 1937 - 1942 bear market, two in the 2000 – 2002 tech wreck, and we have now seen two such rallies in the current market meltdown. And during all of these periods, despite the rallies, the "Big Picture" trend has been down.

There have been 15 days in the past 60 years when the S&P500 posted a daily gain greater than 5% and nearly two thirds (9) of those have been in the current bear market! Going back ever further, there have been 70 occurrences since 1920 that the US equity market has risen more than 5% on a day; the 45 largest daily gains all occurred in the bear market of the early 1930s. Japan was no different, in the 18-year Japanese bear market that began in 1990, there have been no fewer than six rallies in excess of 20%, yet that market is down 80% since the rally began. The point here is that if history is anything to go by, *sharp rallies are more often than not characteristic of bear markets*, as counter-intuitive as that may seem.

**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.

**What's on our radar screen?**

We remain focussed on the changing economic landscape and list below a couple of developments in this regard:

- *The Chinese economy:* the annual inflation rate in February was -1.6% i.e. prices *declined*, versus the 1.0% rise in prices in January.
- *The global economy*: The IMF released its revised forecasts for the global economy; the latter is forecast to shrink 0.6% in 2009 - its previous forecast was for growth of 0.5%. The IMF forecast a contraction of 2.6% for the US, 3.2% for the Eurozone and 5.0% for Japan.
- *The European economy*: the annual inflation rate in the Eurozone declined to 0.6% in March, down from 1.2% in February –testimony to our belief that deflation is a larger problem in the short-term than inflation. The unemployment rate rose to 8.5% from 8.3% in January.
- *The US economy*: as you are well aware by now, we are very concerned about the level of "solvency" of the US at the moment. Simply put, they have so much debt, which they continue to issue at an alarming rate, one wonders if they have any concern about their ability to repay it. Call us conservative or alarmist, but this worries us, not least because the dollar is the world's reserve currency. If anything happens to the dollar (which it will eventually if the US continues to issue more debt) we will all feel the ramifications. By way of example over and above the debate surrounding the immediate Budget deficit (which grows every time you look at it) the Congressional Budget Office completed

a report in March that estimated that Mr Obama's budget plans would result in $ 9 300bn ($9.3 trillion) of deficits over the next decade. Nothing like leaving your children a bit of debt, I guess, but can the world absorb so much US debt? What happens when investors decide they have enough US Treasuries (debt) and where will that leave the dollar? These are things the Maestro team is actively discussing internally.

- *The SA economy:* The SA Reserve Bank (SARB) reduced interest rates by 1.0% on 24 March, bringing to 2.5% the rate cuts since December. The Governor of the SARB alluded to the slowing domestic economy and the improvement in the medium-term outlook for inflation, which concurs with the consensus view, which we share, that rates are likely to be cut again in the next three to four months.
- *US corporate earnings:* we are heading into another round of quarterly reporting in the US. Not surprisingly we are seeing large cuts to analyst company forecasts. Merrill Lynch and Deutsche Bank are forecasting a notional S&P500 earnings per share (EPS) of $40 for 2009 i.e. the aggregate index-weighted total of the underlying company earnings is $40. Historically the long-term average price earnings ratio (PE) of the S&P500 *at the trough of bear markets* in the past 80 years has been 12 times (x). As they say in the US, "Go figure." A 12x PE on $40 of earnings yields an S&P500 level of 480 (12x40 - 480). That's about 40% below where the index is trading at the moment. That's not a forecast on our part (although we aren't excluding the possibility that the S&P500 will get there), it is just one of the reasons why we believe the huge rise in the US equity market in March is not sustainable.

**Table 1: Returns of funds under Maestro's care**

| | Period ended | Month | Year to date | Year |
|---|---|---|---|---|
| **Maestro Equity Fund** | Mar | **7.3%** | **-3.8%** | **-27.3%** |
| Maestro equity benchmark * | Mar | 11.2% | -6.5% | -25.4% |
| JSE All Share Index | Mar | 11.0% | -4.2% | -28.5% |
| **Maestro Long Short Equity Fund** | Feb | **-5.3%** | **-10.9%** | **-33.8%** |
| JSE All Share Index | Feb | -9.9% | -13.7% | -32.6% |
| JSE Financial and Indus 30 index | Feb | -11.7% | -17.2% | -29.8% |
| **Central Park Global Balanced Fund ($)** | Feb | **-2.3%** (estimate) | **-4.6%** | **-17.9%** |
| Benchmark** | Feb | -4.4% | -7.8% | -24.6% |
| Sector average *** | Feb | -4.6% | -7.7% | -33.5% |

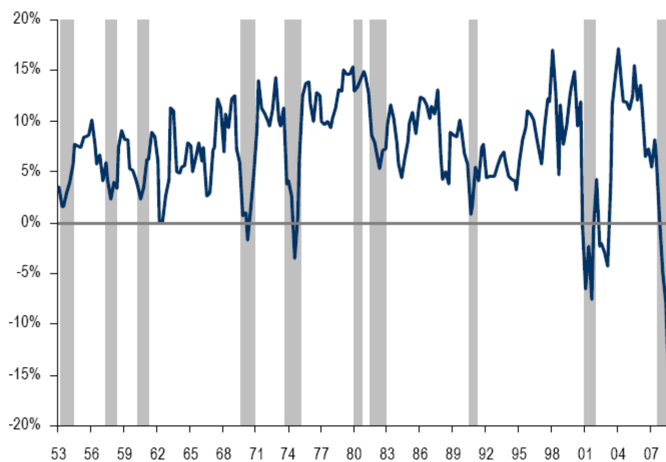
* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
*** Lipper Global Mixed Asset Balanced sector ($)

**Chart of the month**

Clients and regular readers of *Intermezzo* will be aware that our cautious outlook on the global investment environment is predicated to a large extent on our concern about the financial well-being of the US consumer, who constitutes around 18% of the global economic "pie". Given the pounding the US property and equity market have taken in the last eighteen months, you can imagine the effect this has had on the consumer's balance sheet. Add to this the fact that he is heavily indebted, and the result looks something like Chart 2, which depicts the annual change in US household net worth. The chart speaks for itself.

**Chart 2: US household net worth (annual % change)**

Shaded areas represent periods of US recession

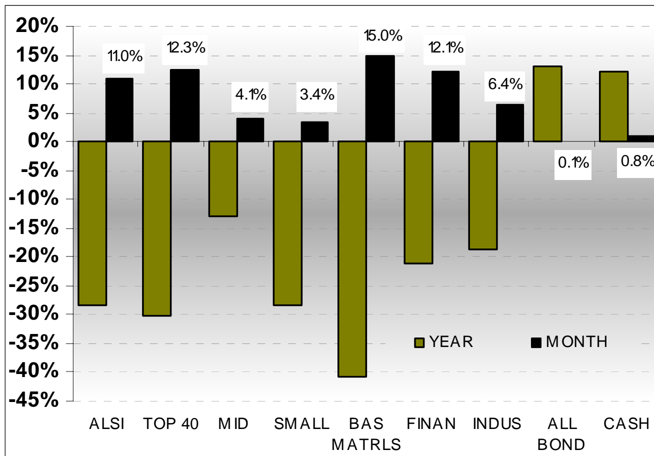



Source: Merrill Lynch

**March in perspective – local markets**

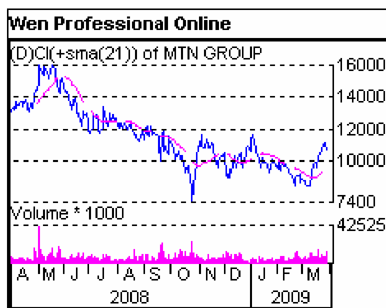
Given the strong rise in global equity markets in March, it was not surprising to see the SA equity market head higher. Two points are worth noting here: *firstly*, we at Maestro are more optimistic about the prospects for the SA equity market and the rand than we are about global, developed markets. So it was encouraging to see a strong SA equity market. For the record, large caps (+12.3%) again led mid (+4.1%) and small (+3.4%) caps, and led the All Share index up 11.0% on the month. Despite these good returns, the market actually ended well off the peak it reached intra-month. *Secondly*, the market was lead by the basic materials (resources) sector, which ended up 15.0% despite the strong rand. Although we think the strength of the market in March is premature, it did provide a glimpse of what to expect when the bulk of the prevailing storm is passed. Once again, we will develop this theme in more detail in the March Quarterly Report. The rand ended the month up 5.6%, which if you think about it, boosted the dollar return for March of the SA equity market to just more than 17.0%.

**Chart 3: Local market returns to 31 March 2009**



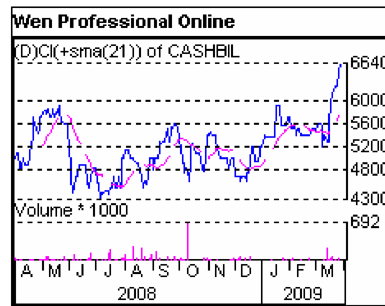

**A closer look at the "Maestro Equity portfolio"**

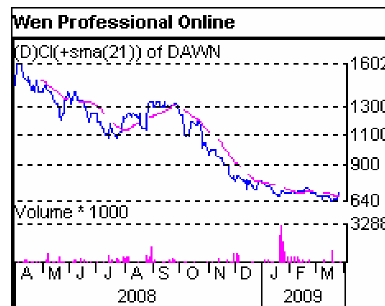
In our past correspondence with clients, we have drawn attention to our belief that most of the companies in which we and they are invested should deliver above-average earnings growth and at least maintain their dividends. We committed ourselves to communicate with you when the companies presented their results. What follows are short comments on some of these companies. The comment and list is by no means comprehensive. It is *also not our "final word" on the company and our comments should in no way be seen as a recommendation to buy the shares.* Please keep this in mind – we are merely highlighting some of the salient features of the companies in which our clients are invested. The graphs are sourced from PSG Online.




**MTN** has been a core holding in our equity portfolios for a long time. The company produced its final results for the year to December, which illustrated yet again the defensive nature of the company. Turnover rose 40% to R102.5bn - that's an extraordinary number when you consider that MTN did not exist 15 years ago – it was only incorporated in 1994. The number of subscribers rose 48% to 90.7m and the company's adjusted headline earnings per share (HEPS) rose 33%. The dividend per share (DPS) rose 51%. Despite capital expenditure (capex) of R27bn during the year, cash on hand at year-end still rose R10.1bn to R25.6bn. During the year to end-March the share price has declined 14.36% and at its current price has a dividend yield of 1.7%.

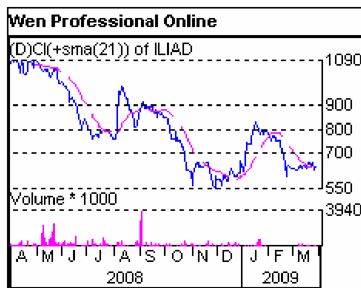
**Cashbuild:** in one of the highlights of the current reporting season, for us at least, Cashbuild produced a stunning set of results under difficult trading conditions. In the six months to end-December, turnover rose 28%, operating profit 39% (operating margins therefore rose) and HEPS and DPS 42%. Thanks to strong cash flows cash on hand at the end of December rose to R584m from R381m in June 2008. In addition, the company issued a positive outlook statement, which made the results all the more enjoyable. This company bears most of the hallmarks that we believe makes companies great: excellent and stable management with a long record demonstrating their operational ability, strong cash flow and a conservative approach. In addition, they serve a unique sector of the market that remains largely untouched by the global credit crunch. Cashbuild is one of the largest holdings across our equity portfolios and is likely to remain there for some time. During the year to end-March the share price has *risen* 36.0% and at its current price has a dividend yield of 4.0%.



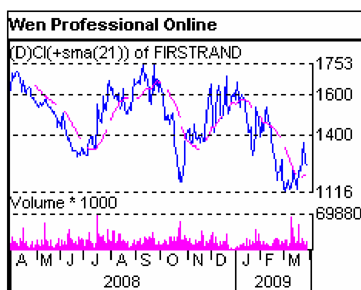




**Dawn:** is involved in the manufacture and wholesale distribution of hardware, sanitary ware, kitchen, plumbing and engineering products. At the time of writing Dawn had a market cap of R1.3bn. In the six months to December, turnover rose 15% to R2. 2bn and HEPS rose 11%. No dividend was declared as the company has a policy of only paying a dividend once a year (in June). The deterioration in the general economic climate was evident on Dawn's results and in their outlook comment management acknowledged that conditions remain tough. They believe that the company is in good shape to "weather the storm" – and we have no reason to disagree with them. The company has quite a lot of debt; its net financial gearing ratio is 61.8%, but this is seasonally driven. The gearing ratio at the end of June 2008 was 37.3%. During the year to end-March the share price has declined 52.4% and at its current price has a dividend yield of 5.1%.

**Iliad** is not too dissimilar to Dawn, they are just higher up the retail chain i.e. they have more exposure to retail shoppers and less wholesale activity. Iliad is a tightly run operation that uses a business model that has worked well




over the years. Despite the tough economic conditions (in our opinion Iliad is quite exposed in this regard) in the year to end-December Iliad raised turnover 10% and HEPS by 5%. In our opinion this was a commendable achievement under the circumstances. The dividend was maintained at last year's level. The company is also facing tough times, but it has virtually no debt (its gearing ratio is 6%) and we are happy to retain the company in our equity portfolio. During the year to end-March the share price has declined 41.3% and at its current price has a dividend yield of 8.1%.




**Firstrand:** lets be honest, Firstrand's results were not good; but they were a whole lot better than the results of banks in other parts of the world. HEPS declined 16% in the six months to end-December (normalised earnings declined 23%) and in what was the most telling sign, the dividend was reduced by 23.2%. Management were downbeat in their assessment of the coming months and guided expectations lower. By now you will appreciate the difficult environment the banks are facing. With the benefit of hindsight we should have sold our Firstrand holding in 2007 (CGT considerations aside) but we didn't. We simply underestimated the severity of the downturn and its effect on the financial sector. We would suggest it is far too late to sell the holding now and will therefore retain it, drawing comfort from the fact that the management team is very capable and experienced, and that we have little other financial exposure in our portfolios. The other financial holdings are those in Investec and Abil – we hold no insurers, having not held any for a number of years. During the year to end-March the share price has declined 24.6% and at its current price has a dividend yield of 6.0%.

Let me remind you that the purpose of this section is to relay the results of some of the companies in which we have invested and most importantly to keep track of the dividend implications in these difficult economic times. We retain our view that the greatest benefit of investing, at least in the long-term, is the rising dividend stream from the portfolio. For this reason we continue to focus on the companies' financial well-being and their ability to increase dividends over time on the back of a profitable earnings base.

**The shape of things to come**

Time and time again in our internal discussions we (the Maestro team) highlight the speed at which the world is changing. Due to the crises that broke last year and the economic turmoil in which the world now finds itself, the world as we knew it only two years ago no longer exists. New relationships are forming between nations, old ones have broken down; old power bases have been blown apart and new ones are emerging. It is our humble view that in a couple of years time a New Order will exist in the world which will be unrecognizable from the one of two years ago. In an attempt to focus on this phenomenon, we plan to highlight some of the events indicative of this process of change in a section entitled "The shape of things to come".

Source unknown

On the face of it, the **SA government's decision to reject a visa application by the Dalai Lama** to enter the country to take part in a 2010 Soccer World Cup-related Peace rally, together with Nobel Peace Laureates Desmond Tutu and FW de Klerk, seems rather innocuous. But scratch a bit deeper for the reason behind the rejection and an important factor in the SA government's thinking comes to the fore. The "official" reason given for refusing the Dalai Lama entry into the country: "in order to protect the country's trade relations with China."

Changing tack, but still on the theme of "signs of the times" the financial services profession is bracing itself for **a significant increase in regulation and government interference.** That in itself begs a whole separate debate. Having been caught on the wrong foot – most of the regulation is in place, its just that the authorities never applied it – governments are now scrambling to find and fix every little loophole and regulatory gap, even if it isn't there. Governments are also under pressure to chase up and recover any potential tax receipts that have "leaked" by fair

means or foul, out of the system. This is likely to remain a theme for many years to come, and one which will affect financial professionals and investors alike. I read with interest, then, that certain Swiss private banks have banned senior executives from travelling outside of Switzerland, for fear of them being detained as part of the global crackdown on bank secrecy. Who would ever have imagined, even two years ago, that once admired and highly sought after Swiss bankers would be unable to even leave their country for fear of being arrested by other first-world governments?!

I'm sure you have followed with some amusement US policymakers' response to the **AIG debacle**, specifically the **payment of bonuses** totalling $165m to ex-employees who were at the centre of the company's calamitous self-destruction; that, *after* AIG received $170bn in government aid. In a stunning example of how quickly US legislators can act when they want to, the House of Representatives approved a bill that imposes a 90% income tax on bonuses paid to employees whose gross income exceeded $250 000. President Obama immediately hinted that he may veto the Bill, showing just how divided policymakers are about how to deal with prevailing mess in the US financial sector. As we watch the minutiae of the slow but steady "collapse of the US Empire" one thing is clear to us: this mess is going to take a lot longer to unravel than most believe, and it will continue to stymie any meaningful recovery of not only the US economy but the global one as well.

Source unknown

Another "sign of the times" comes in the form of **the changing shape of the global banking sector.** The dramatic collapse in many share prices of global banks, particularly the giants-of-old such as Citigroup (not to mention the banks that are no longer around) makes it appropriate to reflect on the relative size of global banks. The changes are enormous. On 31 May, 1999, the world's five largest banks were Citigroup ($151bn market cap), Bank of America ($113bn), HSBC ($94bn), Lloyds TSB ($72bn) and Fannie Mae ($70bn). Today (March 17) the top five are the Industrial and Commercial Bank of China ($175bn market cap), China Construction Bank ($129bn), Bank of China ($112bn), JP Morgan Chase ($95bn) and HSBC ($78bn). In 1999, there was not one Chinese bank in the top 20 banks in the world, whereas today there are no less than five, three of which occupy the top three positions. In 1999 11 of the 20 largest banks were American; today there are only four US banks left in the top 20. In 1999 four of the top 20 banks were British; today only one is.

Source unknown

**File 13 – things almost worth remembering**

We often refer to the nebulously defined **"Law of large numbers,"** a term we invented to explain the effects of a relatively small event when "the numbers behind it" are large. Not surprisingly, we often use it in the context of India and China. Here's a good example: rising unemployment is a major factor all over the world right now, and shows little prospect of declining in the near-term. That poses a problem for the 6 million students in China who are graduating in June. Some 35 500 have found work in the banking sector although the 300 000 engineers China produces each year may not be so lucky.

In past editions of *Intermezzo* we have commented in detail on the antics of that very profitable German hedge fund that makes cars on the sideline. I refer of course to **Porsche** and am immediately reminded to tread carefully - two of our clients are avid Porsche aficionados (and owners). You may recall the saga of Porsche and VW – refer to Appendix 3 in the November edition of *Intermezzo* – which not only cost (primarily hedge fund) investors billions of dollars but sadly also cost the life of German industrialist Adolf Merckle (refer to File 13 in the January issue of *Intermezzo*). Porsche recently posted their interim results to end-January. Net profits jumped from €1.3bn to €5.6bn, but it was the make-up of the profits that made for even more interesting reading. Of its €7.3bn pre-tax profits, €6.8bn came from its

investment in VW. €385m went to finance the company's debt, which has tripled to €9bn in its attempts to take over VW. Oh yes, I almost forgot: only €60m came from making "Cayennes and Carreras." Still, as Lex from the Financial Times points out, Porsche's 50% share price decline is still a whole lot better than many other listed hedge funds.

**Chart 4: When Porsche comes to shove …**

Porsche share price: 3-year history (€)

Source: FT.com

And finally, does the name Muntazer al-Zeidi mean anything to you? How about George Bush? Well, put the two together and you may recall that he was the Iraqi journalist who threw his shoes at ex-US President George Bush. You may be interested to know that on 12 March he was sentenced to 3 years in jail for his behaviour. Al-Zeidi, now a hero across the Arab world, told the court Mr Bush's "icy smile" made him do it. He is appealing his sentence.

**Table 2: MSCI Emerging Market March returns (%)**

| | Mar'09 | YTD |
|---|---|---|
| Per | 26.7 | 6.3 |
| Kor | 26.3 | -1.5 |
| Pak | 22.5 | 36.0 |
| Indo | 21.0 | 1.0 |
| Rus | 20.3 | 5.4 |
| Cze | 19.9 | -15.7 |
| Aust | 17.0 | -3.3 |
| S.Afr | 16.3 | -5.2 |
| **Asia** | **15.8** | **1.2** |
| Taiw | 15.8 | 8.3 |
| Pol | 14.7 | -31.4 |
| **AP ex Jap** | **14.6** | **-0.8** |
| **MSCI EM** | **14.2** | **0.5** |
| China | 14.1 | 1.3 |
| **MSCI EM Small Cap** | **13.8** | **2.5** |
| Mex | 13.6 | -14.0 |
| Hun | 13.5 | -28.8 |
| **EMEA** | **13.5** | **-4.7** |
| Egy | 12.3 | -13.6 |
| India | 12.1 | -1.6 |
| **LatAm** | **10.6** | **4.5** |
| Bra | 10.3 | 11.9 |
| Sing | 8.4 | -9.2 |
| Tur | 8.2 | -13.0 |
| **MSCI DM** | **7.2** | **-12.5** |
| Phil | 6.5 | 4.2 |
| HK | 3.6 | -0.9 |
| Chil | 3.1 | 13.2 |
| Thai | 2.9 | -5.9 |
| Arg | 1.8 | -15.1 |
| Isr | 0.9 | 5.4 |
| Mal | 0.0 | -3.8 |
| Mor | -3.9 | -8.7 |

Source Merrill Lynch

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