INTERMEZZO

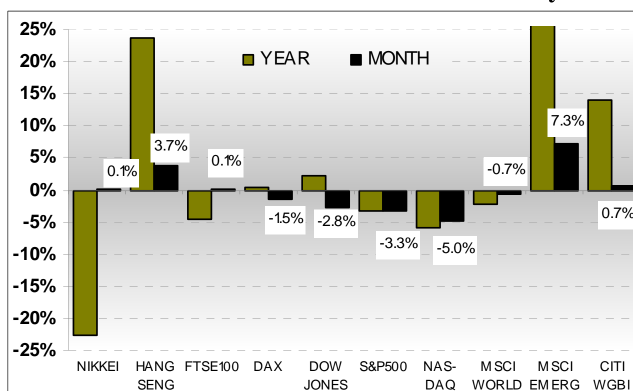
MAESTRO
Investment Consulting

Investment Letter | 8th Edition | March 2008

February in perspective – global markets

The past month was another tumultuous one on global markets although the outcome wasn't as negative as in January. For the most part monthly returns of the major bourses remained negative – the MSCI World index declined 0.7% but emerging markets rebounded from their 12.6% January decline to post a gain of 7.3% in February (refer to Table 1). US markets declined the most, which seems appropriate given that most of the recent "implosion" originated there and it is the region whose economy is slowing the most. The dollar declined 2.5% against the euro, which led to huge gains across the entire commodity complex. The prices of platinum and palladium, which rose 24.2% and 46.4% respectively during the month, were pushed higher by the Eskom-induced supply problems in South Africa. The S&P GSCI index, the old Goldman Sachs Commodity Index, a broad measure of commodity prices (metals and soft commodities [food]), rose 12.6% during February. Virtually every commodity, be it a metal or corn, wheat, sugar, soyabeans, palm oil, tea, you name it, is trading close to or at an all-time high. And of course the crude oil price remains on the charge, rising 8.7%, which is the last thing a slowing global economy needs right now.

Chart 1: Global market returns to 29 February 2008



Odds and ends

I draw your attention to the following relevant information:

- 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. 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 **SA inflation** rate rose to 9.3% in January, which will add more upward pressure to interest rates. When one considers that the rand has weakened dramatically since the January rate was measured and given the huge (61 cents per litre) increase in the price of petrol this past week (and it will rise further next month) you will understand that local inflation is headed higher in the coming months. That will add more pressure to the Reserve Bank governor to again increase interest rates in the future.
- We have persistently highlighted **Chinese inflation** as a risk to the well-being of not only China but also the global economy. At present it is rising strongly and we are monitoring it closely. In the year to January Chinese inflation rose to an 11-year high of 7.1% from 6.5% in December. The major contributors to rising prices were food and energy (coal in particular) price increases. This is adding pressure to the renminbi, which although officially pegged to the dollar, has been allowed to appreciate about 13% since mid-2005.

Rising commodity prices

We have mentioned it on a number of occasions before but must again draw your attention to the fact that commodity prices are rising at an unprecedented rate. The more ominous and recent event has been the dramatic rise in the price of food, specifically wheat and corn. The CRB Soft commodity sub-index has risen 21.2% so far this year and the price of wheat, corn and many other soft commodities are close to or at record levels. In the January edition of *Intermezzo* we highlighted the risk to global markets of rising inflation around the world, going so far as to call it the "scourge of 2008". Sadly this concern is materialising before our eyes and we draw it to your attention again.

In theory slowing economic activity should subdue rising prices, and in certain areas it will do so, but the problem is one of supply-side constraints rather than demand-driven factors. Consider some of the factors pushing prices higher:

- *weather-related* factors: droughts and floods have played havoc with crop estimates and plantings; floods have forced Australian coal and iron ore producers to declare *force majeure* on long-term contracts
- *logistical* factors i.e. getting goods to the markets: take the recent snow storms in China, for example, which made the delivery of coal and food products virtually impossible and simultaneously increased the demand for coal to the extent that China declared a three-month moratorium on coal exports in order to satisfy local demand
- *extraneous factors* like power-shortages in SA, which pushed the gold and platinum group metals prices to record highs. It also did other coal users no favours. Eskom's clamour to secure 44m additional tonnes of coal (their annual usage of 125m tonnes) at a time of critical shortages in the spot market only made matters worse - one hesitates to think what that cost them!
- *demographic factors:* the advent of rapid urbanization, increase per capita incomes and other demographic

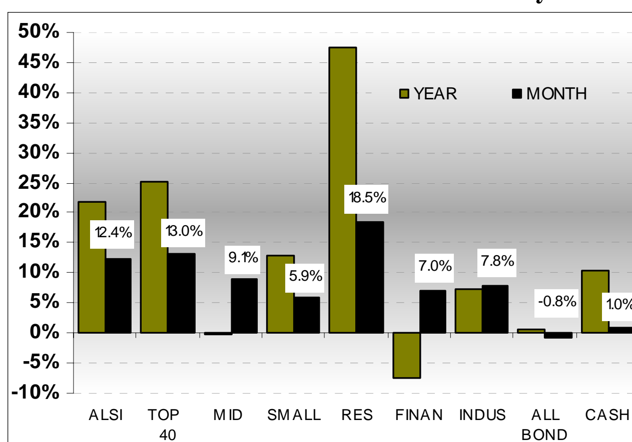
changes, particularly in large emerging markets like China and India have resulted in a large increase in the demand for basic foodstuffs.

There are a number of other factors affecting commodity prices, but at this stage the majority of them are not related to consumption as much as to supply problems. That simply means that an economic slowdown will be less effective in reducing prices, as will any increases in interest rates. We will continue to monitor global inflation but reiterate our concern that it may be one of *the* major factors in the investment environment in 2008 about which authorities and regulators can do little.

January in perspective – local markets

There were only two factors that drove SA equity markets in February: the weak rand and record metal and commodity prices. With the heavy weighting of resources in the All Share index, the basic materials index gain of 18.5% in February propelled the latter index 12.4% higher. The financial and industrial indices rose 7.0% and 7.8% respectively. The industrial metals index (ArcelorMittal and Hiveld) rose 31.4%, general mining (which includes Anglo, Billiton and Kumba) 21.5% and the platinum index 18.8%. Despite the weak rand, which declined 3.4%, the All Share index still rose 8.6% in dollar terms, which is a great monthly return when compared to those listed in Chart 1. And despite a record gold price and a weak rand, all the gold index could manage was a *decline* of 0.4% - refer again to my comments regarding gold in last month's *Intermezzo*.

Chart 2: Local market returns to 29 February 2008



"State of the nation"

For your information we have revised the Maestro website to include our three products as well as information that relates to them such as Introductions to each Fund, Fund Summaries and Quarterly Reports. I invite you to visit the site and let me have any comments you may have on it.

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	Feb	**9.4%**	**1.0%**	**16.8%**
Maestro equity benchmark *	Feb	10.4%	1.6%	13.9%
JSE All Share Index	Feb	12.4%	6.2%	21.9%
Maestro Long Short Equity Fund	Jan	**-8.7%**	**-8.7%**	N/A
JSE All Share Index	Jan	-5.6%	-5.6%	N/A
Central Park Global Balanced Fund ($)	Jan	**-4.9%**	**-4.9%**	**2.8%**
Benchmark**	Jan	-2.7%	-2.7%	5.0%

* 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

Chart of the month

The current SA equity market conditions are unique and are creating all sorts of expectations which are not necessarily realistic or sustainable. The "unusual" conditions are caused largely by rand weakness. Under "normal" conditions – if there are such things these days – one would expect the current weakness in the dollar to translate into rand *strength*. However, for reasons that are not exactly clear right now (apart from uncertainty surrounding the country in the light of the political changes and the Eskom debacle, etc) the rand has been incredibly weak. Add to this, the effects of very strong commodity prices, which to some extent are also a reflection of dollar weakness, and the net result is that the (rand) price of commodity and rand-hedge shares – read the basic materials sector – on the JSE have been catapulted into the stratosphere. The very heavy weighting resource (materials) shares have in the All Share index means that the latter index has risen dramatically, although the rest of the market, which is more indicative of the SA economy, has actually fared much worse. The combined returns for the first two months of 2008 illustrate this very clearly: the All share index has risen 6.2%. The basic materials index (the beneficiary of the weak rand and strong commodity prices) has risen an extraordinary 21.5%. In stark contrast, the mid and small cap index are both *down* 6.7%, and the financial and industrial indices have *declined* 6.7% and 6.1% respectively. So while investors see the market heading higher, many are left wondering why their portfolios are down by so much. (As a matter of interest, the equity portfolios of our clients are up between 1% and 2% so far this year). We must therefore guard against a "fool's

paradise" thinking that markets are rising and "all is well" when in fact *nothing could be further from the truth*. Global equity markets are in a bear market (I would suggest the SA equity market is too) and are currently in a state of deep distress. Evidence of this can be found in the year-to-date returns of the MSCI world index, which is down 8.4%. The German market is down 16.4%, the UK 9.2%, Japan 10.5% and the US markets 9.6% - all steep declines; and that excludes their steep declines in March so far.

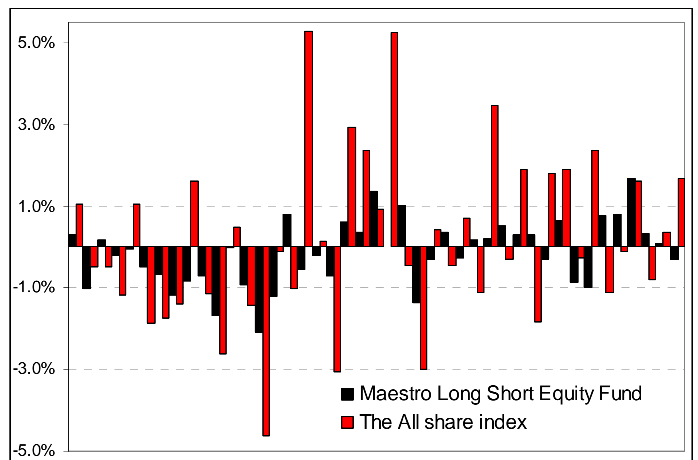
Chart 3 illustrates this state of affairs well; it bases the UK, US and SA equity markets (indices) to 100 at the beginning of October 2007. The direction of the SA equity is clear – it is heading in the opposite direction to other equity markets. Those of you who have been around a while will know that such a situation is *unsustainable*. Granted, the SA return reflects the weak rand – the indices are denoted in local currencies – but it is naïve to think that our market will continue higher while all others head lower. Either our market is headed lower or sideways, or global markets will recover or both will occur in some form or other. It will be interesting to see when this will happen and what the net result will be.

Chart 3: How long will it last? SA versus the rest

Source: Deutsche Securities

The Maestro Long Short Equity Fund: hidden attributes
Most of you will be aware of that Maestro established a hedge fund, the Maestro Long Short Equity Fund, in July last year, the returns of which are recorded regularly in *Intermezzo* – refer to Table 1. To be honest, its launch been a baptism of fire for us - it coincided with the peak in the recent bull market as well as the onset of volatility and trauma in the markets which we haven't seen for many years. We have posted a lot of information relating to the Fund on our website, such as an Introduction to the Fund as well as a document detailing the Investment Strategy we are applying in the Fund. I must immediately point out that *this Fund is not approved for sale to the retail public by the Financial Services Board (FSB)* - no hedge fund in SA is approved, for that matter. Maestro, along with many other hedge fund managers, has applied to the FSB for a specific (Category IIA) licence and we are awaiting the outcome of our application. We recently welcomed a three-person FSB team into our offices as part of their due diligence in response to our application. In my humble opinion the time together was constructive, informative and very helpful. But that is all background; I would like to highlight an aspect of the Fund that is not immediately obvious, namely *its low volatility relative to the market*.

Chart 4: Volatility of returns - Maestro vs. the market



A history of the Fund's returns can be found on the Fund Summary of our website; the Fund declined 8.7% in January and rose 2.8% in February. This compares to the All Share index return of -5.6% and 12.4% respectively. January's return was very disappointing. We compiled an explanatory document listing the events that led to January's return and you can obtain it by contacting either David or I. February's return was at least positive although it lagged the robust market returns. However, the Fund is unique and its return should not necessarily be compared directly to that of the market. But with the market being so volatile, an attribute of the Fund that is difficult to appreciate unless you follow it daily, is that **its daily movements are significantly less volatile than those of the market**. This aspect of any fund or portfolio is often not sufficiently appreciated by investors – hence my bringing it to your attention. Its wonderful achieving high returns, but one should always ask the question "with what risk were those returns achieved?" In most cases, the more the volatile the returns, the greater the implicit risk of the investment. The Maestro Long Short Equity Fund's daily returns during January and February are depicted in Chart 4 together with those of the All Share index. It is clear that the Fund's daily returns are far less volatile than those of the market – both on the way up and the way down. The range of the Fund's daily returns during the period is between -2.09% and 1.67% or an absolute range of 3.67%;

the market's range is between -5.21% and 4.61%, yielding an absolute range of 9.82%, which is more than two and a half times greater than those of the Fund. As a matter of interest the Maestro Equity Fund's range of returns during the same period is -3.35% and 3.61%, yielding an absolute range of 6.96%.

In times such as these, where huge market volatility is the order of the day, I find it comforting to know that the Long Short Equity Fund's daily volatility is a lot lower than the overall market, and it offers protection should the market fall sharply.

File 13: Items almost worth remembering

China remains an enigma to most Westerners, as do their markets. But do you think they know something we don't, or do we know something they don't? Read on and draw your own conclusions.

In the November 2007 edition of *Intermezzo* we drew your attention to Alibaba.com, the Chinese internet service provider that set new records for IPO's when it listed in Hong Kong last year. But despite the fact that the Shanghai market has lost about a third of its value since October (Hong Kong has lost a quarter) and the fact that the "bear" has gripped all global equity markets, along comes *China Railways Construction*, the former railway building unit of the People's Liberation Army. It is in the process of raising $5.4bn through a listing in Shanghai and Hong Kong. The Hong Kong leg of its listing alone was 81 times over-subscribed in the institutional placing and 291 times over-subscribed by retail investors, drawing a massive total of $237bn. Just think about the size of that number for a moment – it's about one and a half times the total amount of bank write downs in the current credit crisis, or about half the size (market cap) of Exxon Mobil. Or if you want a local comparison, that's R1 896bn or the combined size of the four largest companies on the JSE (Anglo, Billiton, Angloplats and Sasol) with about R20bn in change. And what's more, the price was set at the upper limit of its indicative price range, on a historic price earnings (PE) ratio of about 27 times.

Table 2: MSCI Emerging Market Feb returns (%)

EM countries/regions	Feb-08	YTD
Peru	18.8	13.5
Brazil	17.6	7.5
Taiwan	16.2	4.0
LatAm	**13.8**	**6.5**
China	11.4	-12.6
Argentina	11.3	2.7
Indonesia	10.9	8.8
Thailand	10.9	3.4
Czech Rep	10.5	-1.4
Morocco	10.2	25.0
Egypt	9.9	6.8
MSCI EM	**9.5**	**-4.3**
Russia	8.6	-8.9
Asia	**8.5**	**-7.2**
EMEA	**7.8**	**-6.9**
South Africa	7.4	-6.8
South Korea	6.9	-8.3
Israel	6.9	2.2
Turkey	6.4	-18.7
Poland	6.3	-8.5
Chile	5.9	3.8
Mexico	5.7	4.3
Hungary	3.1	-9.5
Jordan	0.7	2.6
Malaysia	0.1	-1.0
India	-0.6	-14.8
Philippines	-5.0	-12.5

Source: Merrill Lynch (end-prices at 28 February)

Issued by: Maestro Investment Consulting, Box 1289, Cape Town, 8000. Capstone 96 (Pty) Ltd *trading as* Maestro Investment Consulting is an Authorised Financial Services Provider operating under Licence number 739 granted by the Financial Services Board on 12 November 2004. The information and opinions in this document have been recorded and arrived at in good faith and from sources believed to be reliable, but no representation or warranty is made to their accuracy or correctness. Maestro accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use of this document or its contents. Please do not reproduce wholly or in part, distribute or publish this document without the consent of Maestro.