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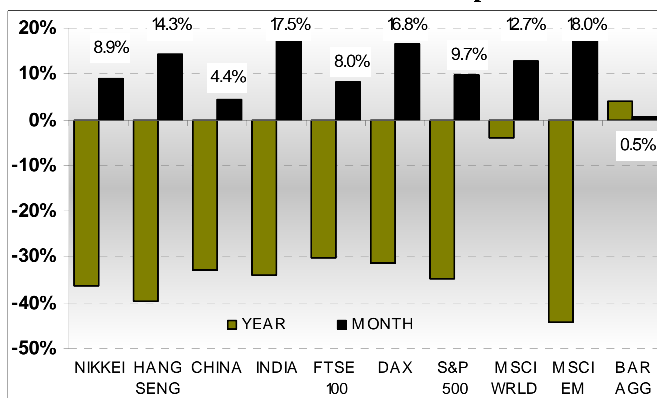
INTERMEZZO

Investment Letter | 9th Edition | May 2009

April in perspective – global markets

No one can accuse Mr Market of not being able to surprise! Despite the sharp rally that began on 9 March the market continued to gain momentum in April notwithstanding a significant deterioration in the fabric of the global economy. Seemingly impermeable to bad news, equity markets were driven by an increase in investor's risk appetite. Monthly gains were thus impressive, particularly in emerging markets – the MSCI Emerging market index rose 18.0% despite its 12.5% gain in March. Commodity prices, with the exception of gold, rose for the fourth consecutive month, emerging currencies were mostly firmer (the rand rose 12.2% against the dollar) and small caps seemed to be back in favour (the S&P Mid and Small cap indices rose 14.8% and 17.3% respectively). The MSCI World index rose 12.7%, after its 5.6% gain in March, with Germany up 16.8% (6.3% in March) and India 17.5% (9.2% in March). China rose "only" 4.4% but that needs to be seen in perspective: it rose 13.9% in March and is up 36.1% so far this year. With investor fears seemingly on the wane, the dollar lost a bit of ground against most other currencies (the pound recovered a bit during April) and the bond market moved marginally lower; the yield on the 10-year US Treasury ended the month above 3.0% - 3.12% to be exact.

Chart 1: Global market returns to 30 April 2009



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 global economy*: the International Monetary Fund (IMF) revised its estimates for global growth; whereas in January it expected the global economy to grow by 0.5% in 2009 and 3.0% in 2010, it now believes the economy will decline 1.3% in 2009 and grow by only 1.9% in 2010. The IMF sees developed economies declining 3.8% in 2009 and 0.0% in 2010. For the US the respective growth rates are -2.8% and 0.0%, the UK -4.1% and -0.4%, the eurozone -4.2% and -0.4% and Germany -5.6% and -1.0% (the German government recently forecast that their economy would decline 6.0% in 2009). As you will see from the data below, despite what equity markets would have us believe, there is little evidence "on the ground" that economic conditions are improving. On the contrary, it seems as though things are getting worse, although of course economic growth data is "old" i.e. it is a lagging indicator. History teaches us that markets look ahead; whether or not they are correct in their assessment that the environment is improving is another matter altogether.
- *The Spanish economy*: we don't often look at the Spanish economy, but it is currently deteriorating at such a rapid pace that an increasing amount of attention is being paid to it. In the early 2000s Spain grew at a rapid rate on the back of EU subsidies and a booming construction sector, especially residential construction. As the global crisis has gained traction, the sector has shed millions of jobs and building activity has declined dramatically. Spain's unemployment rate is now 17.4%, double the EU rate, with more than 4m people unemployed.
- *The Chinese economy:* an interesting development in recent days was the announcement by the Chinese government that it increased its holdings of gold. Such data is not released very often, but the authorities announced that, of the country's $2 trillion reserves, its holding of physical bullion had risen from 600 tonnes in 2003 to 1 054 tonnes at present. With respect to economic growth, first quarter growth was 6.1% versus 6.6% in the last quarter of 2008. The annual inflation rate in March was -1.2% i.e. deflation already exists in China, versus a rate of -1.6% in February. Retail sales rose 14.7% in March on an annual basis, up from 11.6% in February, providing some evidence that the government's stimulus package is boosting domestic demand.

Source: Ingram Pinn, FT.com

- *The UK economy*: the UK Budget was tabled in April. *Intermezzo* usually concentrates on the US economy when considering the global environment, but one should not underestimate the dire position that the UK finds itself in, as the following shows: the Chancellor of the Exchequer forecast that the UK economy will decline by 3.5% in 2009 and grow by 1.25% in 2010.

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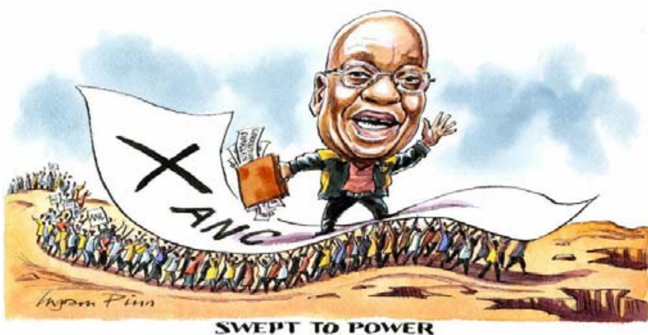
There are many, including the IMF, who believe these forecasts are too optimistic. The public borrowing requirement will be £175bn or 12% of total GDP; public sector net debt will double to 79% of GDP by 2013; and just for good measure the top marginal tax rate will rise from 40% to 50%.

- *The US economy*: the past month saw the first estimate of US economic growth during the first quarter. The consensus expectation was for a decline of 4.6% and the actual estimate was a decline of 6.1%. This follows the decline of 6.3% during the last quarter of 2008. Commercial construction declined by 44.2% in the quarter, and capital expenditure (capex) investment fell 33.8%, The residential building sector fell 3.8% and businesses cut inventories by $103.7bn, which took 2.8% away from the quarter's growth.
- *The SA economy:* annual retail sales declined 4.5% in February versus the 1.2% annual decline in January. Not surprisingly, the Reserve Bank cut its repo rate by 1.0% (to 8.5%) for the second consecutive month, notwithstanding the fact that (March) inflation remains at an elevated level of 8.5%. And in the midst of all the bad economic news, I am proud to report that the process of electing a new government proceeded without a hitch. Irrespective of one's view of the outcome, the manner in which the election proceeded, including the lead-up to the event, can only be viewed in a positive light. It provides further evidence of the extent to which the SA democratic process is maturing, and is a useful reminder of the 1994 miracle, when the peaceful transition to democracy took place.



Source: Ingram Pinn, FT.com

Why we believe in the investment process

All of us within the Maestro team are passionate about the act of *investment*; we believe in the power and benefits of long-term investment. That might seem a trite comment, but in the past eighteen months we have had ample reasons to challenge our beliefs and passion. The anecdote for any disbelief, though, is never far away, as we were reminded by the following, real-life example.

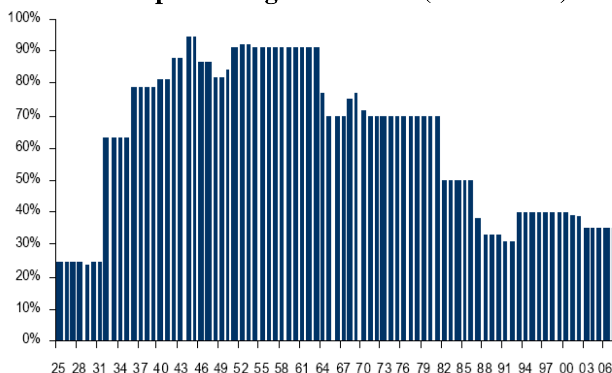
We have been privileged to manage certain assets (as a segregated portfolio) since May 2001, although our relationship with the client goes back to the early 1990s. This particular Fund totalled R3.5m when we first received the assets to manage in May and June of 2001. The Fund provides income for a number of beneficiaries, which is drawn down on a monthly or quarterly basis. From time to time there have been a few large ad-hoc withdrawals. At the end of March 2009, R3.9m had been drawn from the entity i.e. more than the full amount we initially received in 2001. Throughout the period, the Fund retained a well-diversified equity portfolio together with an offshore component of between 25% - 30% of the assets.

You would then be pleasantly surprised to hear that, notwithstanding the terrible markets over the past eighteen months, during which stage the Fund seldom retained more than 15% in cash, the value of the Fund at the end of March 2009 was … R3.4m! There is no rocket-science to it, no magic; *just the power of long-term investment.*

Chart of the month

We reported earlier that the top marginal tax rate in the UK is going to rise from 40% to 50%. With the masses of debt governments are currently issuing in their attempts to resolve the current economic crisis, not much attention is being paid to the vexing issue of who is going to pay for it all. Indeed, even in crisis times and when governments are involved, there is still no proverbial "free lunch." For example the tab to rescue the US financial system alone is now up to about $2.7 trillion (and rising), which equates to about 20% of US GDP. Someone is going to have to pay. Chart 2 below depicts the top marginal tax rate in the US – note how strongly it rose after the 1930s, and stayed very high for a long time. The message is clear – *governments are looking to the wealthy to foot this bill.*

Chart 2: Top US marginal tax rate (1925 - 2008)



Source: Merrill Lynch

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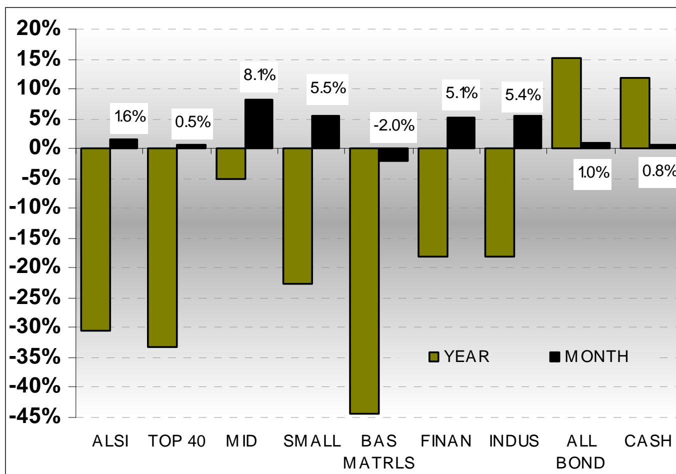
April in perspective – local markets

After seeing what happened on global equity markets in April you could be forgiven for expecting excellent returns on the SA market. Alas, the gains were nothing like offshore returns, thanks to the rampant rand, which firmed 12.2% against the dollar (after a 5.6% gain in March). Ironically that movement is very much part of the increase in risk appetite; emerging markets, of which SA is one, and emerging currencies are seen as "more risky" by global investors. So when they want to take on more risk, it is not surprising to see the rand firm – as well as most emerging markets; refer to Table 2 at the end of *Intermezzo* in this regard. The firm rand put the resource sector under pressure; it declined 2.0% on the month. Remember that, by and large, a firm rand is good for the country, particularly in the long-term. This was not lost on investors though, as we see from the returns of the financial and industrial indices, which rose 5.1% and 5.4% respectively. The mid and small cap sectors fared even better, rising 8.1% and 5.5%. The biggest casualty in April was the gold index, which fell 20.8% while the oil and gas sector declined 5.4%.

Chart 3: Local market returns to 30 April 2009



If I may return for a moment to the phenomenon of mid and small caps rising more than large caps during periods of rising risk appetite, it is worth highlighting that this is a relatively common event, so the SA market behaviour shouldn't necessarily be seen as abnormal. For example, the S&P500 (which is effectively a US large cap index) rose 9.7% in April (in itself an impressive gain) but the S&P Mid and S&P Small cap indices rose 14.8% and 17.3% respectively over the same period. If we extend the period to between the start of the current rally (9 March) and end-April, the S&P500's gain is 29.0% while the S&P Mid and S&P Small cap indices are up 38.8% and 44.1% respectively.

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	Apr	**4.5%**	**0.6%**	**-27.5%**
Maestro equity benchmark *	Apr	2.5%	-4.1%	-27.0%
JSE All Share Index	Apr	1.6%	-2.7%	-30.3%
Maestro Long Short Equity Fund	Mar	**-2.8%**	**-8.4%**	**-30.0%**
JSE All Share Index	Mar	-11.0%	-4.2%	-28.5%
JSE Financial and Indus 30 index	Mar	10.1%	-8.8%	-21.0%
Central Park Global Balanced Fund ($)	Mar	**3.2%**	**-1.1%**	**-15.1%**
Benchmark**	Mar	2.6%	-5.4%	-22.8%
Sector average ***	Mar	2.9%	-5.1%	-30.4%

* 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 ($)

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 this section called "The shape of things to come".

There is a lot happening in the investment environment at present; governments are becoming increasingly involved in the private sector whilst at the same time committing unprecedented amounts of money and resources across all levels of their respective economies, all funded with debt, in an effort to stabilize the current financial crisis. As we have come to learn by now, there are unique consequences for all of these actions, but there is so much happening that it is impossible to imagine what the consequences will be. But a picture is rapidly emerging of increased government intervention (many would call it interference) and increased regulation (many argue that much of it is unnecessary and

an over-reaction), which cannot possibly result in a more efficient, investor-friendly environment. The following is an example of the "new world" and highlights some aspects that worry us and bode ill for the future. The example is that of a US instance, but it would be naïve to believe this level of government involvement/interference will not eventually arrive on SA investors' doorstep.

Many of you have followed the demise of the US auto industry closely; we have commented frequently in previous editions of *Intermezzo* about GM in particular. As it happened Chrysler was the first to fold, with US President Obama announcing a short while ago that it was being put into bankruptcy. That much was expected. But what followed was not: Obama went on to label the "parties" (read Chrysler bondholders) that refused to accept a material reduction in the value of their Chrysler investment as "*greedy speculators*". He further singled out hedge funds as being amongst these entities. It was reported that a few banks, which held about 70% of Chrysler's outstanding debt, accepted 29c on the dollar i.e. a reduction of 71% in the value of their Chrysler debt, in an effort to try and save the company. It is worth remembering that hedge funds, unlike banks, have not received billions of dollars to "ease the pain" of the current crisis. In addition, these funds, whose clients (including retirement funds comprising the interests of US citizens) have entrusted the respective investment managers to look after their investments, have every right and reason to work as hard as possible to extract the best possible return for their clients. It is an investment managers' fiduciary responsibility to act in this way. So to call them "greedy speculators" is indicative of a serious misunderstanding of the role and obligations of investment managers. One would have thought the President would have known better. Besides, as I understand it many of these "greedy speculators" have a preferential, legally-enforceable right (lien), based on the bond covenants entered into at the time that Chrysler issued the debt (bonds), over specified Chrysler assets i.e. they hold preferential bonds whose value is secured by specific company assets (like buildings, perhaps). Once again, for anyone, let alone the US President, to paint them as ogres because they are exercising their legal rights and working hard to protect the interests of their clients, is of great concern. Can the President prescribe how investment managers should act, irrespective of those managers legal obligations and what legally-binding covenants might exist between the holders and issuers of debt? Is the President and by implication, the US government above the law? Surely these matters need to be decided in courts by means of due process?

Talking of which, the President also indicated that Chrysler's transition through the bankruptcy court would be a "quick in and out" – he even mentioned a period – "about two months." Well, firstly seeing is believing; secondly I imagine the legal process would have to run its course and it will eventually be up to the court to determine the length of the process, not a President trying to strong-arm creditors into accepting a bad deal. I wonder if it occurred to the President that it is these same "greedy speculators" he will have to persuade to buy oodles of "toxic assets" currently sitting on banks' balance sheets?

And finally, as for the deal that was being negotiated, but ultimately failed, it seemed that the unions would get a large portion, perhaps the majority of Chrysler, Fiat would obtain a large chunk and the US government the rest. But think about it. Have you ever seen a more unlikely bunch of bedfellows? Does anyone *really* believe that to be a sustainable and workable solution? The US government forcing bankruptcy onto a company in order to sell the best parts of it to an Italian company, letting the union run it and leaving the bad parts of the company for the "greedy" senior secured creditors to fight over the remaining crumbs? Welcome to the New World. And that's just Chrysler – what about GM in three weeks' time?

File 13 – things almost worth remembering

Last month we reported that the hero of the Arab world, 30-year old Muntazer al-Zeidi, the journalist who threw his shoe at former US President George Bush during a news conference, had been sentenced to three years imprisonment. On appeal of the sentence, Iraqi's highest court reduced the sentence to one year, on the grounds that he had no prior criminal record.

And now for something completely different; I wasn't sure whether to include this item under the section "The shape of things to come" but let me put it in "File 13" simply because it's a nice story to end off with. However, it is indicative of the swing from the West to the East, which remains a large focus for us at Maestro and indicative of what the future holds. For years now there has been a debate in the musical world about the "crisis in classical music." The vigorous debate amongst musicologists has the protagonists arguing that classical music is slowly slipping into the realm of irrelevance, particularly amongst today's youth, in the face of an ageing audience and competition for the ear from popular music and an "instant age" mentality. Others disagree; on the back of the digital revolution, they argue, classical music has also benefited and is more accessible than ever and being enjoyed by more young listeners than in any time in history. Not surprisingly this view is put forward by music producers, who continue to find and champion the causes of young classical musicians who amaze audiences with their prodigious talent and technical abilities. And there certainly are many young, "up-and-coming" musicians, who bear testimony to this view.

One such artist is Lang Lang, a 26-year old Chinese pianist who is well on the way to establishing himself as one of the most famous ever. He has just published his autobiography *Journey of a Thousand Miles*. His spectacular technique is a major draw card, but he attracts as much attention through his evangelical efforts to spread the popularity of classical music amongst young people and through the way in which he is making classical music more accessible to young people by means of technology. Lang Lang's story reads like many Chinese children. When he was nine, his father gave up his job and took his son to Beijing so he could study for a place in the prestigious conservatory there. The two lived off the R1 275 ($150) his mother sent from Shenyang every month in an apartment that was so cold his father would get into bed first to warm it up for his son. Life was miserable and he and his father argued bitterly over how much he practiced. After his father lost his temper one day and shouted hysterically that he should "kill himself rather than bring shame on the family," Lang Lang refused to play for four months. In 1997 at the age of 15 Lang Lang was awarded a scholarship to study further at the prestigious Curtis Institute in Philadelphia. There he was given his own apartment, which he shared with his father and a seven-foot Steinway piano. Lang Lang recalls "I woke up in the middle of the first night and went to touch the piano to make sure it was real. It was just like heaven. (The Curtis) is the smallest (music) school in the world; the whole school is like one class of the Beijing conservatory. In the conservatory you used to have five or six people fighting over a little, stupid upright piano. You needed to have a ticket to play."

Today there are more than 30m learning to play the piano in China, partly due to the popularity of Lang Lang. "Despite having some of the finest music schools in the world" Lang Lang says, "the real crisis in music education is in the US, not China."

Lang Lang playing at the Beijing 2008 Olympic Games opening ceremony

Table 2: MSCI Emerging Market April returns (%)

	Apr'09	YTD
Indo	30.5	31.9
Tur	28.3	11.6
Pol	26.3	-13.4
Hun	25.1	-11.0
MSCI EM Small Cap	**22.1**	**25.1**
Rus	21.8	28.4
Kor	21.4	19.6
Egy	21.3	4.8
India	19.5	17.6
Bra	18.9	33.1
Cze	18.1	-0.4
Taiw	17.4	27.2
Col	17.1	4.8
Thai	17.0	10.0
Asia	**16.5**	**17.9**
LatAm	**16.4**	**21.7**
HK	16.4	15.3
MSCI EM	**16.3**	**16.9**
Sing	16.2	5.5
Mal	15.9	11.5
EMEA	**15.4**	**10.0**
AP ex Jap	**15.0**	**14.2**
Mex	14.3	-1.7
Aust	11.2	7.5
S.Afr	11.2	5.5
MSCI DM	**10.9**	**-3.0**
China	10.9	12.3
Jap	9.6	-9.4
Arg	7.6	-8.6
Mor	7.3	-2.1
Chil	7.1	21.3
Phil	6.7	11.2
Pak	6.3	44.7
Isr	4.0	9.6
Per	0.7	7.0

Source Merrill Lynch

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