INTERMEZZO

MAESTRO
Investment Consulting

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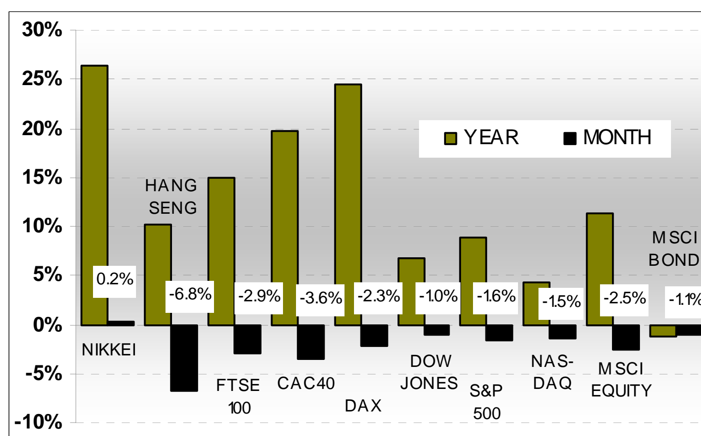
October in perspective – global markets
True to its reputation, October proved to be another wild ride - and not a particularly rewarding one either. With the exception of Japan, all major developed markets posted declines on the month (so too did all the major indices in the SA equity market for that matter). What is not apparent from Chart 1 is the increased volatility: daily movements in excess of 1% were commonplace. On more than one occasion daily price changes of more than 2% occurred in some markets. Monthly returns would have been far worse had it not been for the dramatic rise in equity markets during the last two days of the month. Ongoing merger and acquisition (M&A) activity supported markets in general and in the UK in particular. For some time now Maestro has been warning against the complacency prevalent in equity markets – this month reality seemed to set in. Questions about global inflation and growth re-emerged to plague investor sentiment, and the effects on markets were dramatic. Emerging markets were particularly weak, with India down 11.2% in dollar terms and South Africa 10.3%. Global bond markets didn't fare much better either, registering their second consecutive monthly decline.

Chart 1: Global market returns to 31 October 2005



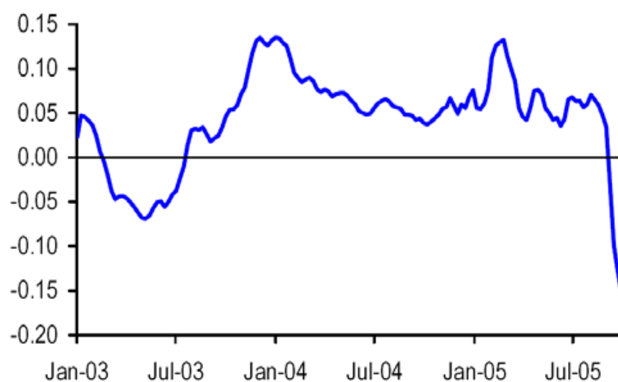
What's going on out there?
In retrospect, I thought the September edition of *Intermezzo* had been overly bearish. In the October edition my warnings continued, this time about the conflicting messages from global bond and equity markets – but then it all came together in October. Many of the concerns raised in the past few months now seem to be weighing on investors' minds. We have to now ask whether the change in sentiment is temporary, or whether it is likely to not only stay for longer but also prove to be an indication of what to expect in the coming months.

Unfortunately, I think the latter is more likely i.e. I continue to believe that we may well have seen the best of equity markets for 2005 and that the coming months will represent trying times for investors. The inherent risk in the markets has risen - we have to take cognisance of that. I will not repeat the contents of the two previous *Intermezzo* editions here, but would encourage you to revisit them in order to familiarise yourself with my concerns about the future state of the global economy and hence also the markets. A couple of developments occurred recently in the ongoing story being weaved by the markets, which are worth highlighting.

On the positive side, the Chinese economy continues to grow at breakneck speed: GDP rose 9.4% in the September quarter, bringing to nine the number of consecutive quarters of growth in excess of 9%. Fixed asset investment grew by 26.1% despite the government campaign to rein in lending in sectors such as steel and real estate. Inflation remains under control – it rose only 1.3% in the year to August.

US third quarter GDP growth was 3.8%, marginally better than expected. However there are unsettling signs that the consumer is starting to take strain. At this stage the effects of Katrina and Rita are still distorting the data, but it is hard to believe that the effects of higher energy prices are not beginning to take their toll. Chart 2, which represents a proprietary Merrill Lynch Consumer Index, shows just how dramatic the change in sentiment has been.

Chart 2: the Merrill Lynch Consumer Index



Source: Merrill Lynch

Moreover, although it is not yet over, the third quarter reporting season is littered with warnings from companies of a slowdown in consumer demand, alternatively pressure from higher energy prices, both of which represent headwinds for future corporate earnings. Remember that the base off which these earnings are being measured is high, making growth from here on that much more difficult. Matters have not been made easier by some high profile corporate failings in the US and rumours of more to come, and of course the world in getting increasingly "edgy" over

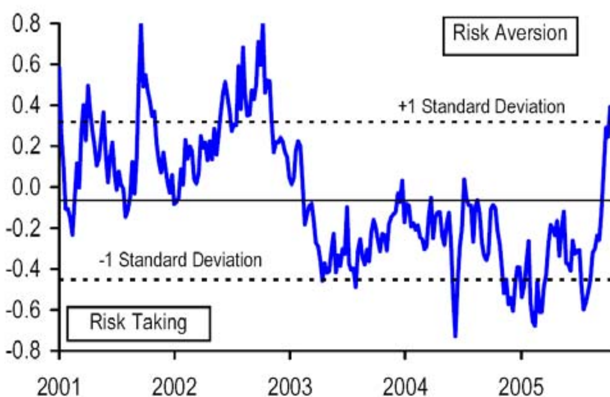
the threat posed by avian flu. As if that were not sufficient, the US Federal Reserve has made it clear that it plans to continue raising interest rates, and even the ECB has muttered a bit about the possibility of raising rates. None of these factors inspire confidence in the markets, although I would note that in general valuations levels are approaching fairly attractive levels. For example, no less than 40% of the MSCI Emerging Market index constituents are trading at less than 10 times 2006 earnings. That is hardly expensive, although of course valuations may yet become even more attractive before their real value becomes apparent.

Added confirmation of the increased nervousness in the markets came from the hedge fund community when a large, reputable hedge fund issued a warning that October was shaping up to be the worst month in its history. It warned that its fund was down some 3.5% in the first three weeks of October, which although not calamitous, is an indication of how difficult it is "in the trenches". As I said earlier, it is not just the weakness of the markets that has troubled managers – it is the alarming increase in volatility that has made it so difficult to generate returns, both in South Africa and abroad. Perhaps it is significant then that total assets in the hedge fund industry have risen to $1 100bn, with net inflows into the industry totalling $9.4bn during the third quarter. As with conventional investment managers, hedge funds dedicated to emerging markets have shown the greatest returns in the past year (despite the poor October returns) and are attracting an increasing portion of inflows.

Chart of the month

I have alluded to the rising risk levels inherent in the markets. Nowhere is this more poignantly illustrated than in another Merrill Lynch proprietary index – their Financial Stress index. Once again it is the recent dramatic rise in the index that is most alarming, particularly when viewed against the two-year old period of risk tolerance that preceded the recent rise.

Chart 3: The Merrill Lynch Financial Stress index

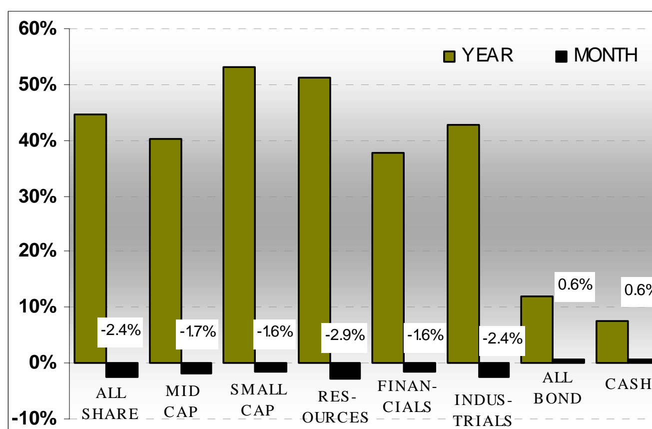


Source: Merrill Lynch

October in perspective – local markets

Similar to global markets, the local equity market endured a topsy-turvy month, ending up in the red. Unprecedented volatility was the order of the day, with the local market taking its lead from offshore markets. The weaker rand, down 5.0% on the month, couldn't save the resource sector, neither could it prevent the gold index, which had surged 31% in September, from declining 4.0%. Of interest though was the 2.9% rise in the platinum index. The oil and gas sector (read Sasol) declined 12.7%. Though still negative, the mid and small cap indices posted relatively better returns than their larger brethren and the market in general.

Chart 4: Local market returns to 31 October 2005



For the record

The latest returns of the collective schemes (unit trusts) that Maestro manages are listed in Table 1, below. If you wish to find out more detail on the Funds, including the latest Maestro Equity Fund Summary, please visit our website at www.maestroinvestment.co.za. Table 2 lists the returns Maestro achieved on the segregated portfolios under its management for the periods to the end of September. We are now able to list four-year returns for the first time and these are included in Table 2. Perhaps the most gratifying aspect of the returns, apart from their high absolute levels, for both Maestro and its clients, is their consistency in terms of being comfortably in the top quarter over every period, when compared to the universe of South African general equity unit trusts.

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

	Month	Return	Year to date
Maestro Equity Fund	October	**-1.8%**	Not applicable
Maestro equity benchmark *		-2.4%	27.0%
JSE All Share Index		-2.4%	32.6%
Central Park Global Balanced Fund ($)	Sept	**2.8%**	0.1%
Benchmark**		1.1%	2.4%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, and 20% each in MSCI Sovereign Index, CFSB Hedge Index and 3-month US Treasury Bills

File 13: Information you needn't retain

October saw the largest ever initial public offering (IPO) in Asia outside of Japan and the largest listing of a bank worldwide since 1980. It came in the form of the China Construction Bank (CCB), which raised $8bn in the process of their listing on the Hong Kong market. The CCB is the first of four big Chinese state banks that plans to list. But get this – demand was ten times the amount on offer i.e. $80bn, with retail investors in Hong Kong, where the primary listing took place, applying for $17bn alone, some 42 times more than what was on offer. It is interesting to note that China spurned the traditional US markets for their listing, in favour of Hong Kong. One wonders if the strict – some would argue excessive – regulatory environment in the US is now acting more as a deterrent than an attraction.

Table 2: Maestro returns to 30 September 2005 (%)

SA equity returns	6 months	1 Year	2 Years	3 years	4 years
Maestro average	***27.0***	***56.6***	***48.3***	***36.3***	***30.5***
Maestro equity benchmark **	25.7	47.3	44.5	26.7	21.3
JSE All Share Index	28.6	47.2	41.4	25.1	23.9
Median general equity unit trust *	24.6	48.4	42.9	27.5	N/A
Rank in general equity category ***	8/52	3/48	7/43	3/43	N/A

* Hugo Lamprechts Unit Trust Survey, Sept 2005, NAV – NAV
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
*** Assuming Maestro had participated in the unit trust survey

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