INTERMEZZO

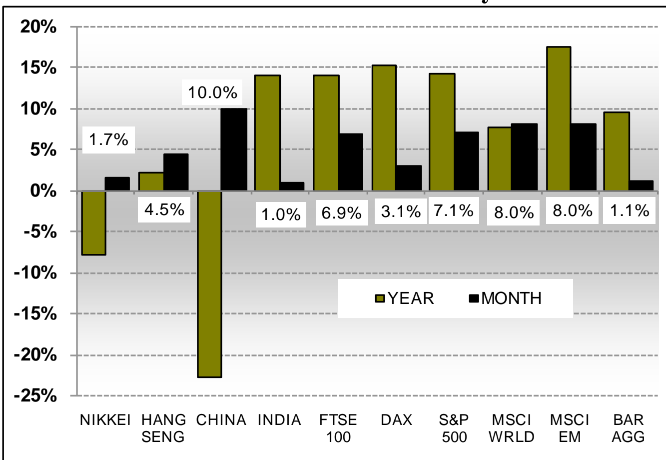
MAESTRO

Investment Letter | 10th Edition | August 2010

July in perspective – global markets

The market behaviour in July was noticeably different from May and June, when risk aversion and the "flight to safety" were the key themes driving markets. In contrast global investors seemed satisfied by policy measures announced in the past few months as well as the second quarter earnings season so far, which has been surprisingly resilient. The latter bears testimony to our belief that corporate balance sheets are in better shape than government ones; investors are therefore prepared to rate the former more highly than the latter. Given the change of attitude towards risk July's market movements are easier to understand: less risky assets i.e. "safety havens" declined (the gold price fell 6.0% despite the weak dollar, and the global bond market rose 1.1% although the US bond market was firmer). Riskier assets rose strongly; the MSCI World and Emerging market indices rose 8.0%, the euro posted an extraordinary rise of 6.4% and sterling rose 4.7%. Commodity prices rose sharply, helped by the weak dollar. Notable features during the month included the rise in certain equity markets: China rose 10.0% – its first gain in four months – Brazil 10.8%, Russia 10.5% and the US 7.1%. The unusual laggards this month included India, which rose only 1.0% (although it hardly declined in recent months and is one of the most expensive emerging markets at present) and the German market, which rose "only" 3.1%. Japanese equities continued to go nowhere, fast.

Chart 1: Global market returns to 31 July 2010



What's on our radar screen?

Here are a couple of items we are keeping a close eye on:

- *The SA economy:* the annual increase in retail sales rose from 2.9% in April to 4.6% in May, its highest annual increase since February 2008. The *retail* inflation rate, at 1.7% (down from April's 2.1%), is noticeably lower than the headline inflation rate of 4.2%. Speaking of which, the monthly increase in inflation was exactly 0.0%, better than expected. We still believe there is room to cut SA interest rates by 0.5%, although clearly the SA Reserve Bank (SARB) doesn't feel that way; they opted to keep rates at their prevailing levels at the July meeting. The firm level of the rand is becoming a key topic of debate within government circles. Even the SARB weighed in with comment in this regard, emphasizing that a lower rate exchange rate in itself is of little benefit if all it serves to do is to increase inflation. Surely there is no better time to scrap exchange controls in their entirety? For the record, Maestro's view has long been, and remains, that the rand is likely to remain firm for the foreseeable future.
- *The Chinese economy*: A raft of second quarter (Q2) data was released in China, the bulk of which showed that the Chinese economy was slowing. That came as a relief, given that China recently implemented measures to slow their economy. Investors had feared the authorities would implement severer policies if the economy showed no response. In the event, Q2 economic growth came in at 10.3% year-on-year, down from 11.9% in Q1. Annual retail sales growth fell slightly from 18.7% in May to 18.3% in June, while the annual inflation rate dipped to 2.9% from 3.1% in May. Industrial production slowed from 16.5% in May to 13.7% in June.
- *The US economy*: The provisional estimate for second quarter (Q2) growth in the US came in at 2.4%. First quarter growth was revised sharply higher, from 2.7% to 3.7%. Personal consumption rose at 1.6% while Q2 real final sales i.e. GDP excluding inventories, rose only 1.3% on an annualized basis. After trillions of dollars of stimulus and zero interest rates for nearly a year now, one has to wonder what exactly will get the US economy growing at a "normal" rate. Based on previous economic cycles, four quarters into a recovery the US economy is usually growing between 6.0% and 8.0%. It makes 2.4% look rather anaemic. And lest we need to remind you, there is the issue of jobs; on the basis of previous recoveries, jobs created at this stage into a recovery are normally about 721 000 above the previous peak. This time around more than 7.5m jobs have been lost; put differently the US labour market is still 5.4% below its December 2007 peak. Little wonder the issue of jobs tops the US political agenda.
- *The listing of ABC*: In another spectacular example of the difference between developed and developing markets, the world witnessed one of the largest IPOs (initial public offerings) in history, in the form of the $22.1bn listing in Shanghai and Hong Kong of the Agricultural Bank of China (ABC or AgBank). The sheer vastness of this entity is worth considering: it has 24 000 branches, assets worth more than the entire economic output of India and more customers than the entire population of the US!

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Charts of the month

We have commented on it a few times this year, but would like to draw your attention to it again; global retail investors are selling developed market (DM) investments in a dramatic fashion and investing the proceeds in Emerging markets (EM). Take a look at the year-to-date (YTD) column in Table 1. Despite $6.8bn flowing into the US market in the past four weeks, the net outflow of $15.6bn is still large, as is the outflow of $11.6bn from Europe. China and Russia have been net beneficiaries and surprisingly Brazil has seen net outflows. India, which has been one of the top performing markets for some now, has attracted little new money. The data cut-off was early August, and the respective year-to-date (MSCI) returns for the different markets were the US 1.0%, UK -2.4%, Europe -5.7%, Developed markets -1.4%, Brazil -4.0%, China -1.6%, India 4.8 %, Russia 2.2% and Emerging markets 2.2%.

Table 1: Net fund flows to EM and DM markets ($m)

	Past 4w	YTD
Total EM	**11,964**	**29,833**
Global EM Funds	8,139	21,817
Asia	3,299	7,337
EMEA	177	2,741
LatAm	349	-2,083
EM LO funds	4,017	11,710
EM ETF's	7,987	18,239
Brazil	313	-1,031
Russia	112	2,079
India	295	617
China*	953	2,809
Indonesia	81	248
Taiwan	372	211
Total DM	**5,274**	**-25,849**
US	6,813	-15,640
Japan	-1,209	637
Europe	49	-11,603
International	**-655**	**2,889**
Total Global	**16,583**	**6,852**

Total Global = EM + DM + International
Total EM = Global EM + Asia + EMEA + LatAm
* includes Greater China

Source: Merrill Lynch

The case for Mid and small caps

In Maestro's forthcoming *Market Commentary*, which will be published later in August, we plan to include two appendices, one of which will examine the case for investment into SA mid and small caps and the other will provide an in-depth analysis of the "typical" Maestro equity portfolio. With regard to the former, we are compiling the case for mid and small caps in part to clarify a common misunderstanding of what exactly mid and small companies are and why any serious long-term investor cannot afford **not** to consider them for his or her portfolio. We had the astonishing case recently when a multi-manager and institutional adviser took us to task about our interest in mid and small caps. He should really have known better and has clearly not looked at the data itself. We will provide more information on the case for investment in SA mid and small caps in our *Market Commentary*, but for now will leave you with the data (in Table 2) to wet your appetite.

Table 2: Compound growth rates by market cap (%)

Size does count ... let the numbers do the talking

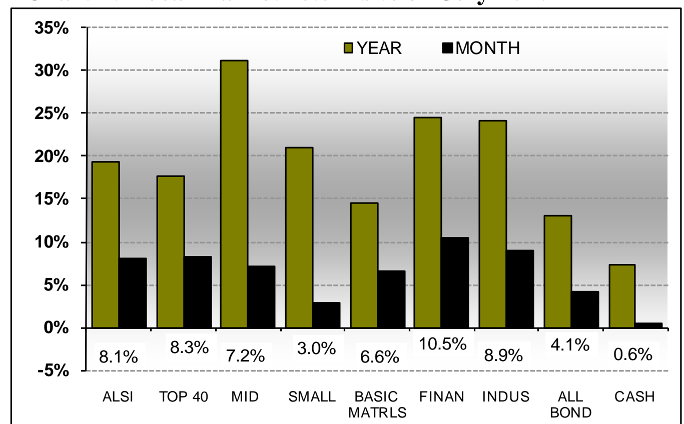
Periods to 30 June 2010	Large caps	Mid caps	Small caps
3 months*	-9.4	-0.7	-3.6
6 months*	-6.0	8.0	1.7
1 year	19.9	33.9	24.9
3 years	0.5	6.1	-2.7
5 years	15.5	21.2	17.6
7 years	20.3	25.6	27.6
10 years	15.6	22.4	23.2

*Un-annualised

July in perspective – local markets

For some time now within the Maestro office we have felt like we are running hard but going nowhere. That feeling was brought home to us during July; during the two prior months the All share index lost 8.1% but clawed back most of those gains to leave us close to where we started three months ago! Although we are grateful for the gains, it is no wonder we – and probably you, too – feel the way we do. The All share index was buoyed by a number of factors, not least of which was the return of some measure of appetite for risk on the part of global investors. July also proved to be a profoundly rewarding month for foreign investors into SA markets. In dollar terms the SA equity and bond market rose 13.4% and 9.1% respectively, thanks in part to the 5.0% gain in the rand against the dollar. With one month bond market returns of this magnitude in a world where yield is so scarce, it is not hard to understand why the rand is so firm.

Chart 2: Local market returns to 31 July 2010



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In rand terms the bond market rose 4.1% while the All share index rose 8.1%. Although the gold index lost 8.1%, bringing its annual return down to only 2.3%, the remaining indices posted healthy gains. The Financial sector led the charge, rising 10.5%, followed by industrials up 8.9% and basic materials up 6.6% despite the firm rand. For the first time in three months large caps (8.3%) outperformed their mid (7.2%) and small (3.0%) cap brethren. The best performing sector on the month was software and computer services, which rose 28.5% thanks to the R24bn offer for Dimension Data by NTT which pushed that share 31.7% higher on the month. The media sector rose 18.8% (thanks to the 19.7% rise in Naspers), while the worst performers were gold mining (-9.1%), coal mining (-5.9%) and fixed line telecoms (-1.9%),

A quote to chew on

We're 142 trading days into the year; 52 days (37%) have seen 1% or greater moves. And the S&P500 is now flat as a beaver's tail on the year. I call this the meat-grinder market. Dave Rosenberg (on 27 July), Chief Economist and Strategist at Gluskin Sheff and Associates.

For the record

Table 3 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 3: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Jul	**6.0%**	**2.2%**	**10.5%**
Maestro equity benchmark *	Jul	9.3%	5.1%	20.1%
JSE All Share Index	Jul	8.1%	3.7%	19.4%
Maestro Long Short Equity Fund	Jun	**-0.8%**	**-1.7%**	**10.1%**
JSE All Share Index	Jun	-3.2%	-4.1%	21.8%
JSE Financial and Indus 30 index	Jun	-3.0%	-1.7%	23.1%
Central Park Global Balanced Fund ($)	Jun	**-2.6%**	**-10.5%**	**-3.6%**
Benchmark**	Jun	-1.3%	-3.2%	7.7%
Sector average ***	Jun	0.3%	-5.3%	6.5%

* 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 ($)

Table 4 depicts our returns for the periods to end-June. Although it is not that clear from the Table, our *relative* turns, relative to the All share index that is, improved significantly during the June quarter. For reasons that we explained to our clients in their monthly letters at the time, we are aware that our relative returns during the December 2009 quarter were disappointing. The March quarter saw an improvement but we still lagged the index, while during the June quarter we improved further and performed better than the All share index.

Table 4: Maestro annual returns to 30 June 2010 (%)

SA equity returns	6m *	1 yr	2 yrs	3 yrs	5 yrs	7 yrs
Maestro long-term equity portfolios	*-2.4*	*18.6*	*-2.3*	*-0.9*	*17.4*	*23.8*
Maestro Equity Fund	*-3.5*	*12.7*	*-5.2*	*-2.0*	*N/A*	*N/A*
Maestro equity benchmark **	-3.8	21.5	0.1	0.9	15.4	21.0
JSE All Share Index	-4.1	21.8	-4.4	0.3	16.2	21.1

* 6-month returns are un-annualised
** 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index

It is perhaps appropriate at this stage to point out to all readers, as we do to our clients, that although in the longer-term we do strive to outperform the All share index, we fully accept that there will be times when we don't keep pace with the overall market. We are not "index-huggers"; we do not run our equity portfolios by hugging the index and only taking positions that differ marginally from the index. We invest in companies that we believe to be undervalued but that will generate long-term returns. It could be that they remain under-valued for some time but we have confidence that their value will eventually be recognized by the market. Alternatively they may have defensive qualities that only become evident when markets and economies move through a downward phase in their cycle. In addition we are continually constrained by Capital Gains Tax in our segregated portfolios, especially in portfolios that we have managed for more than three years. So the option of simply selling the investment and buying another one does not exist, which means we need to be even more certain that the companies into which we commit new and additional capital, will deliver respectable returns that are sustainable over the long-term.

Source: Unknown

Reflections on the 2010 World Cup Final

With the World Cup Final now a thing of the past, I'm sure we have all, in our own way, reflected on the spectacle of the tournament.

Source: Unknown

Some of you may read the regular column "Face Off" in the Business Day, which pits Khehla Shubane and RW Johnson against each other. In analysing the important lessons for South Africa recently, they had the following to say (I have used only selected comments of theirs):

Khehla: It has taught the country that South Africans can rally around a single issue. It is clear that with good leadership people can and want to be united. The country can get on top of many key problems it faces: crime reduction and managing big projects to stringent specifications can be done. ... The missing ingredient is a bold leadership capable of translating the lessons into everyday practice. ... Another lesson is that people in developing countries have yet to confront their prejudices that big international events can be hosted by them alone. People in developing countries are thought to be somehow not up to it. The World Cup in SA has shown this is false. To suit tastes in developed countries and to Fifa's eternal shame, a summer sport was forced to be held in winter, and despite the refusal to accept the reality that the world has two hemispheres, the tournament has exceeded all expectations.

Bill: The big lesson is that proper South African nationalism means putting our best foot forward and not caring about race. Nobody bothered about the skin colour of the architects, surveyors, engineers and contractors who built the stadiums or the Gautrain – we just used the best available. Second, the usually powerful pressure groups – taxi drivers, trade unions, security guards – were not allowed to dictate and were not deferred to. And finally, the police, immigration and other services made a serious effort to do their jobs properly, catching robbers, recovering good and, as you say, stopping hooligans and terrorists.

Khehla: True, disregarding the race of people who planned and managed the construction of infrastructure now in place is welcome and should constitute the first step towards implementing genuine non-racial policies – the basis of fighting apartheid. It would be an abomination if the government needed Fifa's goading to do this. A lesson for others is that vanity has never helped improve performance in the field of play. The shrieking criticism by the English media of everything related to preparations for the tournament in SA would have made you think that England would be the best team here. It was gratifying to see them sent packing with their tails between their legs after a performance no different from that of Bafana Bafana. To his credit, a contrite Franz Beckenbauer, the German soccer legend, has mustered sufficient humility to accept his scare mongering was based on ignorance.

Source: Unknown

Khehla: The ANC's penchant for disappointing seems boundless. Clearly the ability to curb crimes exists but citizens had to wait for the World Cup to be protected from rampant crime. Even as the man entrusted with ensuring the safety of communities was found guilty of corruption, there is no indication the ANC will abandon its policy of cadre deployment, which guaranteed that the man became the commissioner of police. But there is a glimmer of hope: for the duration of the tournament no gaffes were heard from Julius Malema. This was hopefully a result of a decision from the ANC hierarchy. And for a month, even the filth usually found around cities and towns received attention. Surely it is not difficult to implement all the positive measures that made SA such a wonderful place for everyone, citizens and visitors.

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Source: Unknown

Source: Unknown

File 13: Information almost worth remembering
Still on the subject of soccer (don't worry, we will get it out of our system in due course) did you see that while the world was watching the World Cup in SA, Spanish football club Barcelona was quietly seeking a €150m loan to help pay players' and staff wages. How ironic is that? Early in July the club announced that in the twelve months to June 2010 sales had increased to €445.5m while net income was only €9m. Yet another example, from sport this time as opposed to countries and governments, of living beyond one's means?!

Source: Unknown

And finally, how can we not end off the month of the World Cup and the wonderful celebration that it was, without paying due respect to one of the most famous forecasters in the world. Not very well liked in the Netherlands but an absolute hit in Spain, we salute Paul with a resounding "Olé" – forgive the "mixed metaphor" and our apologies to all the bulls that are being put out to pasture in Catalunya, now that bullfighting has been banned in that part of Spain.

Table 2: MSCI returns to 31 July 2010 (%)

	Jul'10	YTD	Q2'10
Poland	19.5	-3.8	-22.8
Turkey	16.0	13.0	-6.1
Argentina	15.9	11.5	-8.7
Czech	13.7	-5.4	-16.7
Brazil	13.7	-5.0	-16.0
Hungary	13.4	-12.0	-31.1
Colombia	13.2	28.2	2.9
EMEA	**12.6**	**2.2**	**-14.4**
South Africa	12.5	5.1	-10.2
Australia	12.2	-7.1	-19.6
Chile	12.0	13.7	1.5
LatAm	**11.8**	**-1.1**	**-12.7**
Russia	11.1	-1.1	-16.7
Pakistan	9.1	7.9	-7.9
MSCI DM	**8.0**	**-3.7**	**-13.3**
MSCI EM	**8.0**	**0.2**	**-9.1**
Peru	8.0	11.1	2.8
Singapore	7.9	4.8	-1.4
Korea	7.5	2.1	-7.6
AP ex Japan	**7.1**	**-1.8**	**-9.7**
Taiwan	6.8	-6.9	-9.4
Thailand	6.1	15.6	-3.3
Morocco	5.8	4.5	-7.5
Hong Kong	5.8	0.3	-7.2
Mexico	5.6	3.0	-9.5
Malaysia	5.4	13.7	-0.3
Egypt	5.3	-0.1	-14.2
Indonesia	5.3	19.6	3.3
EM Asia	**5.1**	**-0.1**	**-5.9**
China	4.3	-3.7	-6.2
Japan	3.5	-0.2	-10.1
Philippines	2.7	8.5	2.1
India	0.6	2.4	-2.9

Source Merrill Lynch

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