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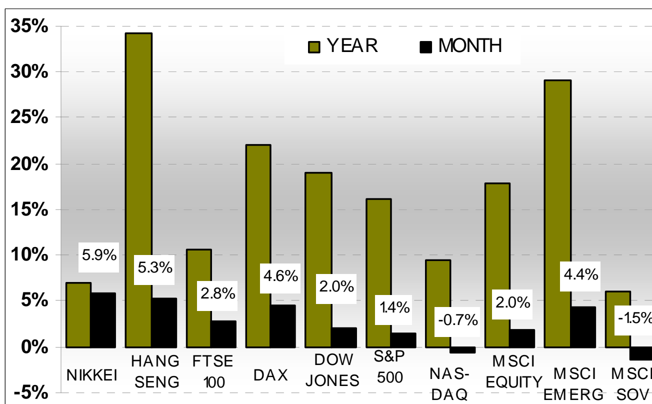
December in perspective – global markets
Welcome to 2007! What a year equity investors put behind them. Markets ended 2006 in a mood that was nothing short of euphoric. Once we have spent more time on recent returns later in this edition, you will understand why one can be forgiven for thinking that Nirvana has arrived. With the odd exception, most developed markets in Europe and America ended at or close to six-year highs. Japan and Hong Kong in particular posted strong gains in December. The MSCI World index ended 2.0% higher, bringing its gain for the year to 18.0%. Emerging markets provided much of the fuel for this growth; the MSCI Emerging market index ended the month and year 4.4% and 29.2% higher respectively. December is historically a strong month. However, ongoing positive sentiment, fuelled in part by strong corporate earnings growth and a belief that US rates have peaked, together with huge amounts of liquidity combined to take equity markets to record levels. M&A activity, which has been a strong force throughout the year, merely compounded the upward momentum.

Chart 1: Global market returns to 31 December 2006



December in perspective – local markets
Let's take a look at the SA equity market activity before reviewing the recent returns of all markets. The SA equity market joined the global party, all but ending 2006 at an all-time high. The rand was firm, gaining 0.8% against the dollar, which prevented the basic material index from making any headway; but the financial and industrial indices experienced no such problems, ending December 5.9% and 7.9% higher respectively. Mid and small cap shares also posted strong gains. The strong equity gains are in stark contrast to those of the cash and bond market; that much is evident from the comparison of annual gains from the bond, cash and equity markets in Chart 2.

A brief look into the rear view mirror
At this time of the year the media are full of data and facts about returns from various asset classes. At the risk of repeating these, the sheer quantum of recent returns leaves me with no alternative but to review them briefly, in order to provide a backdrop against which Maestro clients can forge their expectations for the coming year. In the letter that accompanies Maestro's monthly statements, I have on many occasions noted that the four year old bull market is "getting long in the tooth". Maestro has consequently adopted a cautious approach for some time now. Indeed, if anything Maestro has perhaps been too cautious in the past year. However, after considering the data below I am sure you will appreciate why we have adopted this stance. Of course, there are many reasons for the strong equity markets and I remain reasonably optimistic that 2007 will provide further positive returns. However, one needs to consider past returns in order to fully appreciate the implicit risk in the prevailing environment – and that's what this short discussion is all about.

Chart 2: Local market returns 31 December 2006

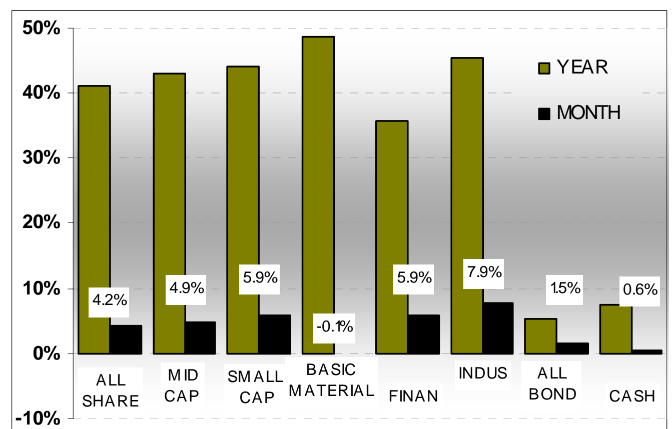


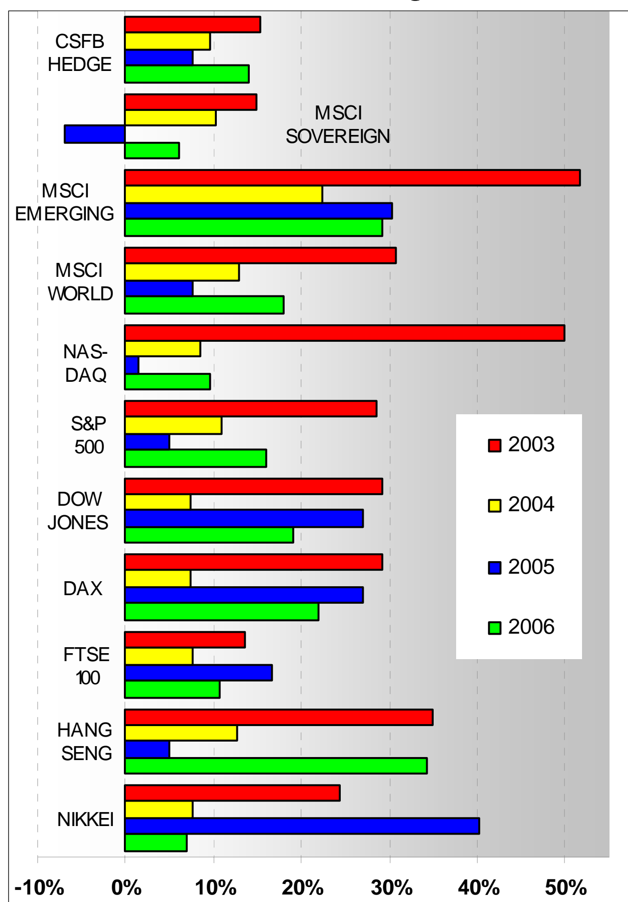
Chart 3 lists the annual returns from major developed markets over the past four years. The returns speak for themselves, but allow me to highlight a couple of aspects:

- With the exception of the bond market (MSCI Sovereign index in 2004), no major market of those reviewed here posted a negative return over the past four years.
- Although returns have been mixed, on most occasions returns have exceeded 10%, with gains in excess of 30% having occurred a couple of times
- Note how much greater the returns from the emerging markets have been than developed markets. More on this later.

What is not immediately evident from the chart, but is perhaps the most striking part of this analysis is not the quantum of the returns *per se*, but rather **the compound effect of four years of good investment returns**. Thus, $100 invested at the beginning of 2003 into the MSCI World index, a proxy for global equity markets, would now

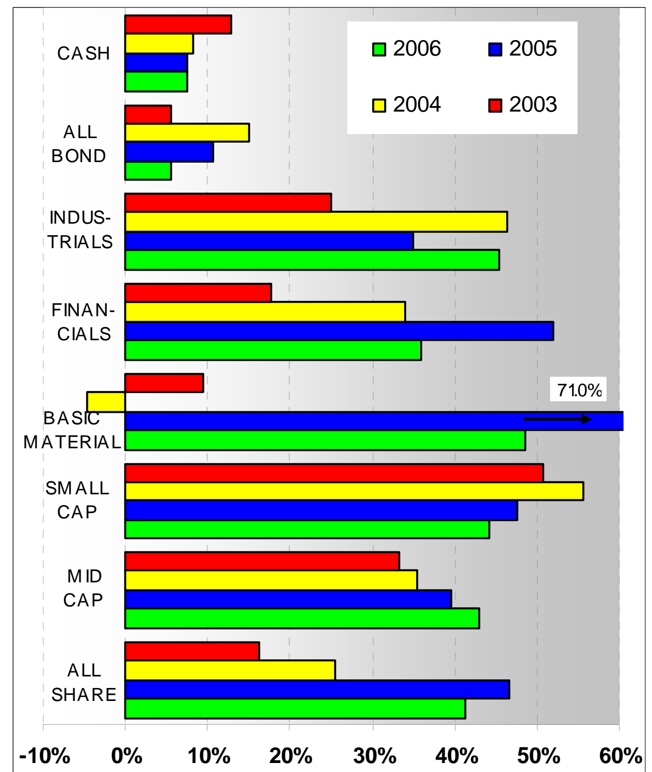
be worth $187. A similar exercise in the German equity market (the DAX) would have yielded a mount of $215 and a $100 investment in the MSCI Emerging market index would be worth a cool $312 – after only four years! These generous returns conjure up all kinds of thoughts (if only I had…, why hadn't we…, yes but at the time…., what about the risk, etc) but the point here is to remember that **nothing goes up forever** – not even equity markets. Markets go sideways and even down – not necessarily in that order either. A concern of mine is that many new entrants into the market, dare I say even some running around the corridors of big institutions, be they investment or hedge fund managers - have convinced themselves that the conditions experienced in the past four or five years represent the norm. If you fall into this category, 2007 may be a difficult and disappointing year for you. Please note that it is the *principle* I am emphasizing here, not my expectations of equity returns in 2007. My caution, and the principle, is applicable as much to equity markets as it is to commodity markets, emerging markets, the art market, property markets and the like. In general, investment returns over the past four years have been remarkable, but history provides sufficient proof that the good times do not last forever. Consequently when formulating expectations for the coming year we need to bear that latter in mind, irrespective of the expected economic conditions.

Chart 3: Annual returns of selected global markets (%)



This analysis is even more pertinent to the SA equity market, where returns have been spectacular – refer to Chart 4 in this regard. The compound *annual* returns of the All Share, Mid and Small cap indices over the past four years are 31.8%, 37.8% and 49.6% respectively. To return to the analogy of R100 invested in the beginning of 2003, the All share investment would now be worth R302, the mid cap one R360 and the small cap investment an astonishing R499 – all in a period of only four years. You now begin to understand some of the reasons behind the caution exercised by Maestro throughout last year and in May and June in particular, when markets were well and truly spooked. That period will be remembered by many investment professionals, particularly those operating in emerging markets, as the "2006 Stealth Crash" that most clients and investors never saw. Incidentally, since then most global equity markets are up more than 20% - and that's in a period of just six months.

Chart 4: Annual SA investment market returns (%)



When does "emerging" finally "emerge"?

An analysis of recent returns would be incomplete without a review of emerging market returns – please refer to Table 2 in this regard. It is easy to whip through the table but I invite you to consider *carefully* the returns of each market in each year. You will be amazed at the returns some markets have produced, consistently, over the period. Look at Indonesia for example, or Brazil, Argentina and Mexico, or Russia.

Regular readers will know that Maestro has been beating the emerging market drum for some time, and will continue to do so for a number of years to come. Developments within emerging markets have been a **major** feature of the investment landscape over the past few years. In fact their returns, and quite frankly the returns of many *developed* equity and bond markets are the result of the powerful changes taking place in the global economy as a result of the rise of a few giants, largely but not exclusively, the BRIC countries of Brazil, Russia, India and China. Consider the following:

- Total returns in emerging market debt have been positive for eight years in succession
- The most recent trough in emerging markets (using the MSCI index as a proxy) was in October 2002. Since that point the market capitalization of the MSCI Emerging market index has increased from $400bn to $2.3 trillion

- In 2006 emerging market returns exceeded developed market returns for the sixth year in a row
- A quick perusal of 2006 returns shows that the BRIC countries performed well, while the more "developed" emerging markets such as Korea and Taiwan, fared less well. The "frontier" markets such as Vietnam (+145%), Venezuela (+62%) and Morocco (+63%) did well, but there were some real train smashes in the Middle East, such as Saudi Arabia (-58%) and Dubai (-48%)
- Emerging currencies were generally firm in 2006, with the exception of countries with high and rising current account deficits, such as South Africa and Turkey.
- Although Table 2 lists returns for China, remember these represent the returns of the MSCI China index. There are a number of different stock exchanges in China, as well as shares that carry certain restrictions, all of which make analysis of Chinese equity returns rather difficult. There are 95 H-shares in Hong Kong, which are mainland Chinese companies listed in Hong Kong. Less than half of these companies have issued "A" shares, which are shares listed in domestic currency in Shanghai and Shenzhen. Capital raised in A-shares last year more than doubled to $25bn, while the A-share indices in Shanghai and Shenzhen rose 131% and 128% respectively. These same indices halved in value between 2001 and 2005. Are we seeing the start of a more stable and growing equity culture in China? Only time will tell, but as with most other things Chinese, ignore them at your peril.

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.

Table 1: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	Dec	**4.7%**	**25.6%**
Maestro equity benchmark *		6.0%	40.5%
JSE All Share Index		4.2%	41.2%
Central Park Global Balanced Fund ($)	Nov	**1.7%**	**11.4%**
Benchmark**		2.0%	11.1%

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

File 13:
Seeing that we omitted File 13 from last month's edition, I have taken the liberty of placing a couple of titbits into the file this month. *Firstly*, only two months ago I highlighted the world's largest IPO ever, namely the listing in Shanghai and Hong Kong of the Industrial and Commercial Bank of China (ICBC). Given the respective share price movements of the world's largest banks in the run-up to the end of 2006, ICBC displaced Bank of America to become the world's second largest bank behind Citigroup at $274bn. At the end of 2006 ICBC had a market cap of $251bn, 18 000 branches and 150m retail customers. Not bad for a bank that most of us had never even heard of six months ago!?

Secondly, did you see the results of a survey on global wealth conducted by … take a deep breath … the World Institute for Development Economics Research of the United Nations University? The survey makes for sobering reading: according to the survey the wealthiest 2% of adults own 50% of global assets while the poorest half of the world's population hold only 1% of the wealth. To belong to the top 1% of the world's wealthiest, you need just over $500 000, which only 37m have managed to accumulate. Adults with more than $2 200 (R15 400) were in the top half of the global wealth league, while those with more than $61 000 (R427 000) were in the top 10%. North America has 6% of the world's population, but holds 34% of its household wealth. The wealthiest 10% of the US population hold 70% of US wealth, in France the wealthiest 10% hold 61% of the wealth, in the UK 56%, Germany 44% and in Japan the top wealthiest 10% hold 39% of the wealth. And the final bit of trivia – if all the wealth was evenly distributed amongst the world's entire population, each person would have $20 500 or R144 000.

Table 2: Selected emerging market dollar returns (%)

	2003	2004	2005	2006
MSCI Emerging Markets	***51.6***	***22.4***	***30.3***	***29.2***
BRIC	84.2	13.6	39.8	52.9
China	81.8	-0.8	15.9	78.1
India	73.9	16.5	35.4	49.0
Indonesia	70.0	44.5	12.6	69.6
Korea	32.6	20.0	54.3	11.2
Pakistan	31.1	8.6	56.5	-1.7
Taiwan	40.0	6.5	3.3	16.3
Thailand	134.3	-4.0	4.8	6.8
Argentina	98.5	24.6	59.7	66.1
Brazil	102.9	30.5	50.0	40.5
Mexico	29.8	45.0	45.2	39.0
Czech Republic	54.2	76.6	43.4	29.6
Hungary	30.9	87.5	15.6	31.1
Poland	33.1	58.6	21.0	35.3
Russia	70.3	4.1	69.5	53.7
South Africa	39.9	40.7	24.0	17.3
Turkey	122.4	38.5	51.6	-9.2

Source: MSCI

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