MAESTRO

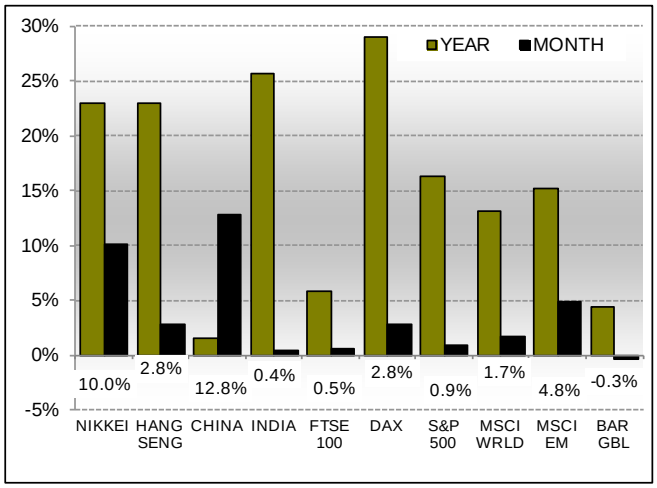
INTERMEZZO

Investment Letter | 13th Edition | January 2013

December in perspective – global markets

Welcome to 2013 dear readers. I hope all of you have had a restful time in the past few weeks and had the opportunity to relax and recharge your batteries? May I take this opportunity of wishing you a productive, successful and fulfilling 2013? May it be full of good health, safety, fun and family time. Another 12 months of fun, learning and careful navigation of all that the markets will put in our way, lies ahead of us. The Maestro team is looking forward to it and also look forward to being of service to all our clients.

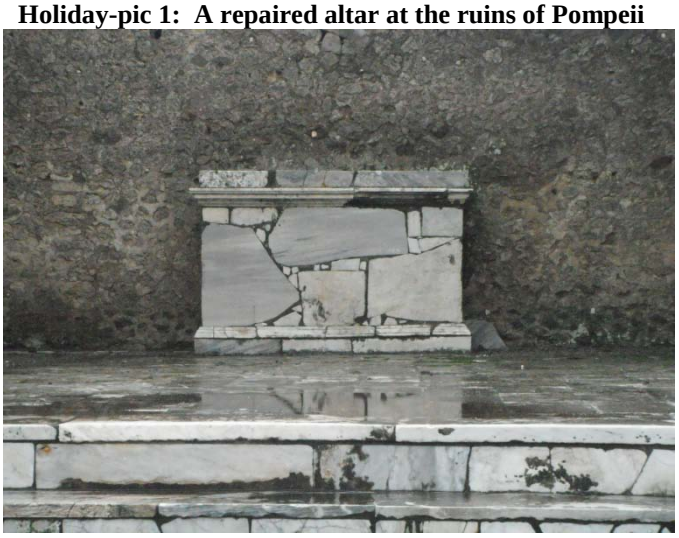
Chart 1: Global market returns to 31 December 2012



December had only one real item on its radar screen, although you would never say so if market returns are anything to go by. Of course that item was the negotiation, successful or otherwise, of the US fiscal cliff. Even though a Band Aid deal was stitched together at the 11th hour – literally – the market, rightly or wrongly, took a positive view of events and most indices ended the month higher. There seemed to be a general movement into equities – remember that global investors are very underweight on their equity exposure – and emerging markets moved up more strongly than their developed counterparts; the MSCI World index rose 1.8% while the MSCI Emerging market index rose 4.8%. This final year-end thrust also pushed the annual return of emerging markets (15.2%) above that of developed markets (13.2%), despite the fact that the latter had performed better than the former for most of the year. The Chinese market was a standout, rising 12.8% in December alone on signs that the Chinese economy was recovering nicely, although Brazil, up 6.5%, Russia 6.4% and South Africa 3.2% (the All share index rose 8.0% in dollar terms) all posted healthy gains. A driving factor was emerging market currency strength; the rand rose 4.7% against the dollar and the Brazilian real 3.0%. On the other hand the yen weakened sharply (4.8%) against the dollar, largely due to political developments in that country, which in turn lit a rocket under the Japanese equity market, which is very sensitive to export-related shares (a weak yen means better export proceeds); the Japanese equity market rose 10.1% in December alone. Although movements in the dollar were not a major feature affecting commodity prices, three features are worth highlighting: firstly, the weakness in precious metal prices – gold, platinum and silver prices declined 3.6%, 5.0% and 12.6% respectively. Secondly the price of iron ore, which rose between 23.4% and 25.4%, although it must be said that iron ore prices had been very weak of late, and the recent price increases only restored prices back to their April 2012 levels. Thirdly, the Baltic Dry index, which measures the price to transport dry commodities (coal, iron ore, etc) by ship, declined 35.6% in December.

The analysis of annual returns of equity indices, currencies and commodity prices is also an interesting and educative process, but for the sake of brevity we will keep this exercise for our Quarterly Reports which will be sent to clients later in the month.

Holiday-pic 1: A repaired altar at the ruins of Pompeii



What's on our radar screen?

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

- *The US economy*: At its latest FOMC meeting i.e. the meeting where the US Federal Reserve sets interest rates (or more correctly determines interest rates policy), the Fed reaffirmed its commitment to low interest rates but surprisingly tied the latter to three specific criteria. It stated that interest rates would remain between 0.0% and 0.25% as long as firstly, the US employment rate remains above 6.5%; secondly, inflation between 1 and 2 years ahead is projected to be no more than 0.5% above the Fed's 2% long-term target; thirdly, that long-term inflation expectations

continue to be "well-anchored". It is perhaps a brave move to commit the level of interest rates to the US labour market, but one thing is clear: as we have said all along, US interest rates are going to stay very low for a very, very long time. In our view, that extends to at least the end of 2015. With regard to the economy itself, the final third quarter US economic growth rate was revised up from the second estimate of 2.7% to 3.1%, largely due to an adjustment to inventories i.e. the build up of inventories rather than final demand drove the additional growth "found" by the stats "bean counters". One has to question the integrity of these numbers though: recall that the initial estimate of third quarter growth, some two months ago, was actually 1.0% i.e. the final growth rate is more than three times the initial estimate.

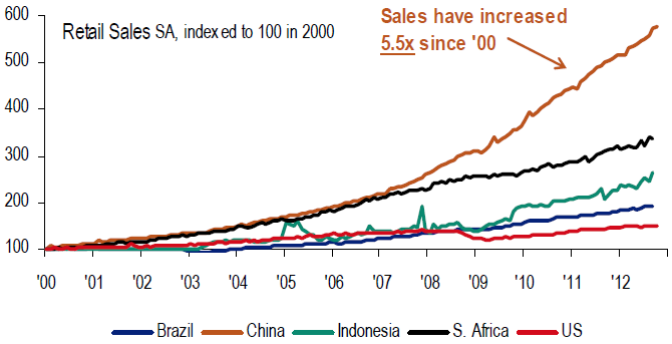
- *Emerging economies*: **Turkey**, until a few quarters ago one of the fastest growing emerging markets with annual growth rates in 2010 and 2011 in excess of 8.0%, registered a growth rate of only 1.6% during the third quarter of 2012. With regard to the **Chinese economy,** tangible evidence emerged from a number of sectors (including vehicle sales and manufacturing activity) that seemed to indicate the economy has bottomed and has at least begun to recover. Clearly, investors took note of the positive indications, if the 12.8% rise in the Shanghai Composite (equity) index is anything to go by.

Holiday-pic 2: Delights available at a Venetian fish market

Chart of the month – part 1

As you sure know by now, the retail sector was one of the standout performers on the local stock market during 2012. Throughout the year, and even during 2011, we found ourselves continually explaining to concerned clients and investors why we thought the sector, while admittedly expensive, is not about to collapse. One of our explanations is that the emerging market (EM) consumer is a long-term theme which is likely to last for many years and which has not only been identified by global investors, but is also appreciated by the latter, hence the elevated ratings that quality retail stocks enjoy, not just in South Africa but in many other emerging markets too. Chart 2 places these comments in perspective; it depicts US and EM retail sales based to 100 in 2000. While the increase in South African retail sales is evident in the chart, so too is the drop in US sales following the Great Financial Crisis in 2008, from which that consumer has barely recovered nearly five years later. For more comment on the retail sector, see the section "Investment basics 101" later in this edition.

Chart 2: Why the world loves the EM consumer



Source: Merrill Lynch

Some quotes to chew on

Hard work ahead for bond investors

We have maintained a slightly underweight allocation to bonds within our offshore fund, Central Park Global Balanced Fund, largely because it will be so difficult for bonds to achieve a return anywhere near that of equities, given the prevailing low level of interest rates. The following comment from *Michael Hartnett, Merrill Lynch's Chief Investment Strategist*, places our view into perspective: "What's more, the math for bonds isn't great. For 10-year US Treasuries to match the long-run return of equities (roughly 10% per annum), the yield would need to fall from 1.8% to 0.8%. And for US Investment Grade credit to deliver 10% total return in 2013, spreads would need to tighten from 155bp to an all-time low of 79bp, and riskless rates would also need to fall to record lows".

Common sense from a rare breed of politician

In a refreshingly frank interview with the Financial Times, *German chancellor Angela Merkel* stated the following when asked about Europe's current problems; "If Europe today accounts for just over 7% of the world's population, produces around 25% of global GDP and has to finance 50% of global social spending, then it's obvious that it will have

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to work very hard to maintain its prosperity and way of life. All of us have to stop spending more than we earn every year". If only all politicians were prepared to stare the problem so directly in the face and were so honest! We were given insight into her firm belief in the need to ensure that the Eurozone becomes more competitive; "When the Berlin Wall fell in 1989, it had a huge impact on my life. It marked the triumph of freedom over dictatorship. We witnessed in the German Democratic Republic (East Germany) and in the entire socialist system that an economy which was no longer competitive was denying people prosperity and ultimately leading to great instability." Powerful words indeed, and a relevant message for all countries in these times.

Holiday-pic 3: A mime outside the Colosseum in Rome

Globalization revisited

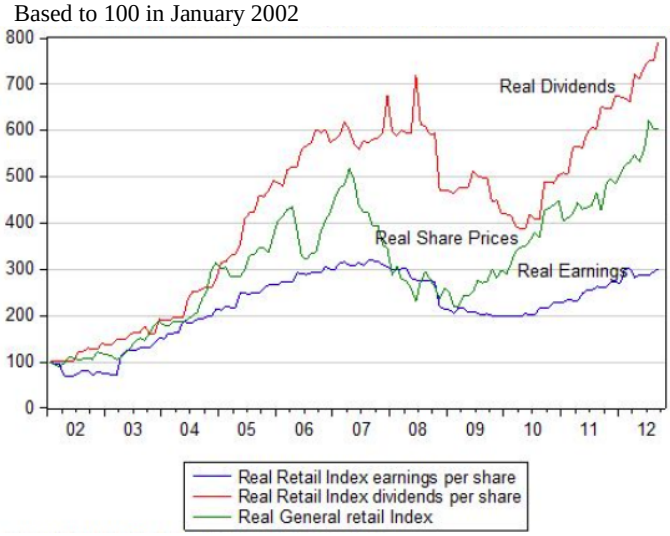
One of the underlying themes we have followed within our investment strategy has been globalization. While this is not a new phenomenon, it is an aspect of the global economy that merits periodic revisitation, given that it is so dynamic. We recently came across the following facts in an excellent article on Globalization by Deutsche Bank; the unique character of the German economy in particular, struck us as very relevant. The phenomenon must also go some way to explaining the structural loss of jobs from the West to the East, the quantum of which is still hard to quantify but the effects are rather evident. "One consequence of rising trade imbalances is rising foreign exchange (forex) reserves. Worldwide forex reserves have risen to about $10.5tn as of 2011, an annual growth rate of 15.9% since 1999. Rising global trade is reflecting an increasing international division of labour and a stronger fragmentation of the production processes, but also a shift of production from developed market (DM) countries to emerging market (EM) countries. This leads to growing industrial production in EM, but also in declining industrial production in DM. In the US, the industrial share of GDP declined from 28% in 1980 to 16% in 2010, in the UK from 34% to 16% and in France from 24% to 13%. In contrast to most other developed countries, Germany was able to keep the industrial share of GDP nearly stable over the last decade (from 25% in 2000 to 24% in 2010).

Investment basics 101: the importance of dividends

We touched on one of the reasons why the retail sector has been one of the top performing sectors on the SA equity market for some time. Another reason for its excellent performance has been the cash generative nature of its earnings, which has in turn led to one of the most powerful drivers of share prices, namely the payment of consistently rising dividends. Brian Kantor, noted economist and Investec Securities strategist, wrote a piece on this topic a few months ago, but which is still very relevant today. So, with grateful acknowledgement to Prof Kantor, herewith a section of his report, which places the outperformance of retail shares into perspective.

Chart 3: JSE retail index, earnings and dividends

Based to 100 in January 2002



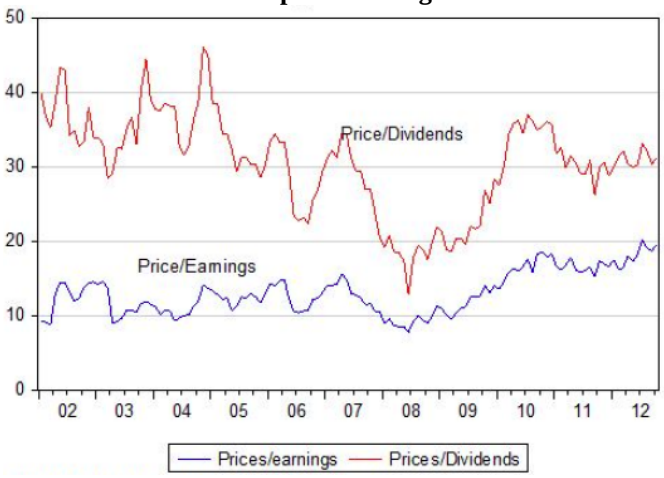
Source: Investec Securities

"The valuations of retail companies have clearly improved significantly faster than those of real sales. They have also outpaced real retail earnings per share, leading to elevated ratios of share prices to earnings of the retail counters, as has been well documented. However what has not been as well recognised is the extraordinary growth in real dividends distributed by the retail companies. Dividends per retail

index share have grown much more rapidly than earnings per share. Dividends in fact have not only grown faster than earnings – 2.6 times as rapidly since 2002 – they have also outpaced the increase in the retail index as we show (in Chart 3).

Thus, while the price to earnings multiple (PE ratio) attached to the general retailers in SA has increased significantly since 2002 (from 9.3 in early 2002 to the current 19.6 times) the price to dividend ratio has in fact fallen since 2002, from 40 times for a rand of dividends in January 2002 to a mere 31 times today.

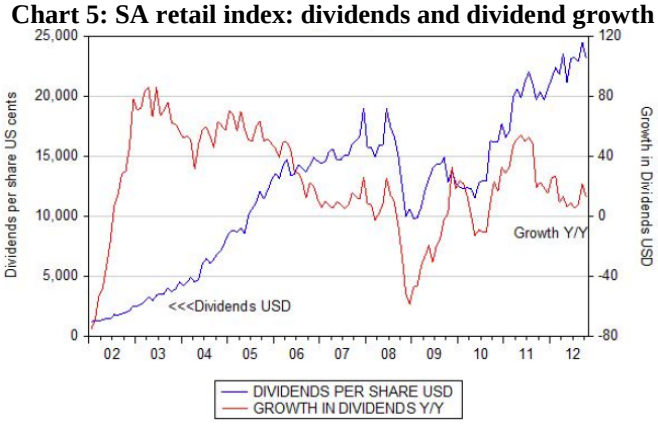
Chart 4: SA retail index price earnings and dividend ratios



Source: Investec Securities

Retail companies listed on the JSE have benefitted from strong growth in sales and stronger growth in bottom line earnings as operating margins have improved. But they have also been able to generate strong growth in free cash flow – that is cash generated after increases in investments in working and fixed capital. The strength of their balance sheets, or perhaps an inability to find sufficient opportunities to deploy cash inside their businesses, has encouraged the retailers to pay out cash to their shareholders in the form of share buybacks and a reduction in earnings cover. The ratio of earnings to dividends per share has declined dramatically over the years, a decline that appears to be accelerating. These dividends per retail share (in US dollars) have grown at an average compound rate of about 27.1% per annum since 2003 and have clearly had great appeal for foreign investors who have come to hold an increasing proportion of the shares in issue while SA fund managers have (regrettably) reduced their stakes. The index in US dollars (excluding dividends) has increased at an average compound rate of 24.9% per annum over the same period.

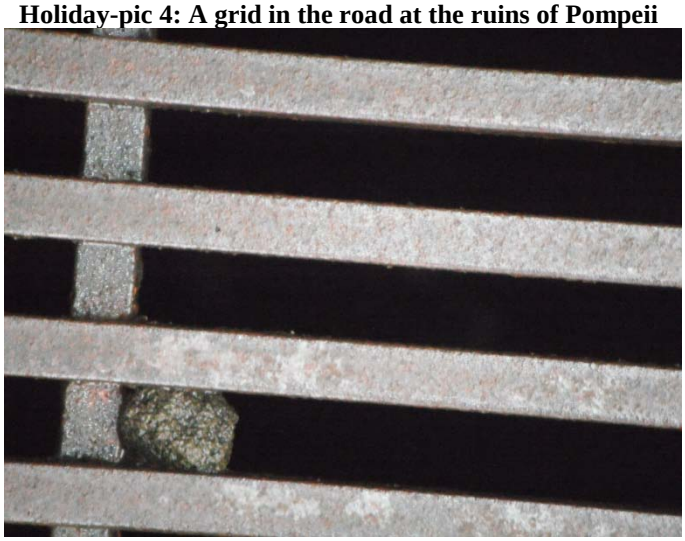
Chart 5: SA retail index: dividends and dividend growth



Source: Investec Securities

Dividend yield and growth in dividends that SA retailers have been able to generate have had particular appeal in a world of very low interest rates. The exceptional returns provided by SA retailers in recent years are therefore not at all surprising in the circumstances. Their valuations – seen as a dividend rather than an earnings plays – make every sense".

Holiday-pic 4: A grid in the road at the ruins of Pompeii



For the record

Table 1 below lists the latest returns of the mutual and retirement funds under Maestro's care. You can find more detail on our website at www.maestroinvestment.co.za. Returns include income and are presented after fees have been charged. Fund Summaries for each respective fund listed in the table are available on our website.

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Table 1: The returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity				
Prescient Fund	**Dec**	**3.8%**	**25.5%**	**25.5%**
JSE All Share Index	*Dec*	*3.2%*	*26.7%*	*26.7%*
Retirement Funds				
Maestro Growth Fund	**Dec**	**2.1%**	**20.0%**	**20.0%**
Fund Benchmark	*Dec*	*2.0%*	*21.0%*	*21.0%*
Maestro Balanced Fund	**Dec**	**1.9%**	**18.3%**	**18.3%**
Fund Benchmark	*Dec*	*1.7%*	*18.8%*	*18.8%*
Maestro Cautious Fund	**Dec**	**2.2%**	**16.0%**	**16.0%**
Fund Benchmark	*Dec*	*1.8%*	*14.8%*	*14.8%*
Central Park Global				
Balanced Fund ($)	**Nov**	**0.5%**	**7.8%**	**5.9%**
*Benchmark**	*Nov*	*0.6%*	*6.8%*	*6.8%*
*Sector average **	*Nov*	*0.5%*	*5.4%*	*5.5%*

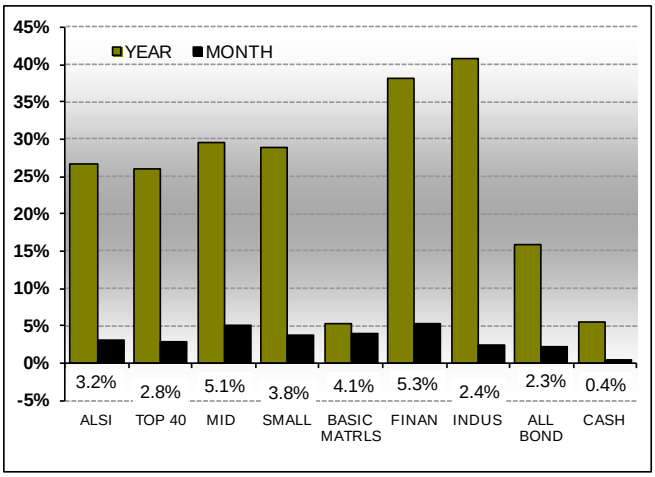
* 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
** Lipper Global Mixed Asset Balanced sector ($)

December in perspective – local investment markets

If we were rather surprised by the returns of global markets in December, we were even more pleasantly surprised by the returns of local markets. Given the reasons for the strong global markets, namely that investors took a positive view on the hopeful resolution to the US fiscal cliff which in turn would be very positive for the global economy, the SA market was always going to rise and the rand firm. And that's exactly what happened. Perhaps it is an appropriate time to remind readers of our long-held view that if you want to understand what drives the level of the rand dollar exchange rate, you need to look abroad and take the view of an overseas investor. Thus, in the minds of global investors, a resolution to one of the major constraints on the global economy (the fiscal cliff) is far more important than an ANC elective conference and its outcome. So, given the positive view (whether investors are right in their view will be evident in the months to come) investors took on the fiscal cliff situation, the rand rose 4.7% against the dollar in December, taking its decline against the greenback for all of 2012 to only 4.8%. The positive sentiment also helped the basic materials to a 4.1% monthly gain, which would of course been far greater had the rand not gained so much. Financial and industrial shares held their own, rising 5.4% and 2.4% respectively. The 3.6% decline in the gold price and the firm rand helped push the gold index down 4.2%, at the same time driving the gold index down 18.5% for the year as a whole.

Although we will do more analysis on the annual returns in the Quarterly Reports, I can simply not resist drawing your attention to the phenomenal returns of the financial and industrial indices for 2012. The 40.8% return of the industrial index can be compared to the 5.4% annual return of the basic material index, vindicating yet again our long-held belief that long-term South African equity portfolios should have a strong bias towards industrial shares. The All share posted a 26.7% return for 2012 – a far cry from the 18.5% decline of the All gold index, into which many fearful investors headed in the naive hope it would protect them from a "deteriorating" political situation in South Africa. For the record, Maestro holds no gold shares in any of the portfolios under its management and has not done so since our inception in 2000.

Chart 6: Local market returns to 31 December 2012



December brought to an end another extremely rewarding year for SA equity investors. I don't think anyone – certainly not the Maestro team – ever imagined it would prove to be such a profitable year for SA equity investors, provided of course, you were invested in the right areas of the market.

Holiday-pic 5: More delights from the Venetian market

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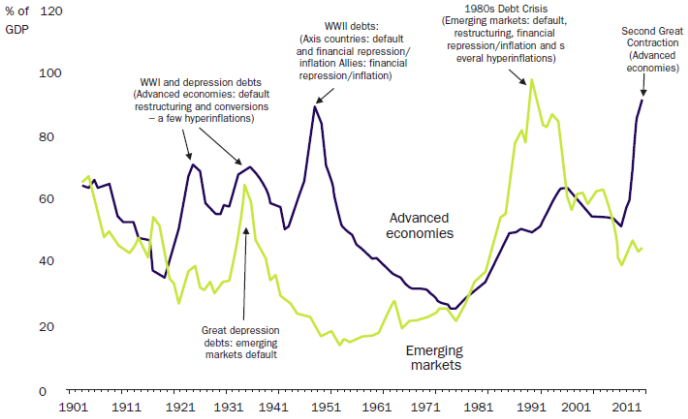
Holiday-pic 6: Investment manager of an SA gold fund
(alternatively a Pompeii resident who perished in the tragedy)

Chart of the month – part 2

One of the issues that has been – indeed continues to be - on the forefront of our minds throughout the year is the issue of debt levels – government debt levels to be specific. We have focussed on the difference in levels of indebtedness between developed and emerging markets, which is why we find the following chart so interesting.

Chart 7: Debt levels in developed and emerging markets



Source: Sarasin House Report Q4 2012

(Apologies for the small chart. Can I suggest that you enlarge it so that you can see all the detail – it makes for very interesting reading?) Chart 7 shows the level of debt in central governments, split between developed and emerging economies. Two things are immediately apparent: firstly the reversal of the trend in the nineties when emerging market indebtedness began to decline sharply and since 2008 when the level of indebtedness in developed economies soared to unprecedented levels, the net result being that public debt levels in developed markets are now significantly larger than those in emerging markets. Secondly, the sheer level of debt levels in developed countries – they are higher than they have ever been at any stage in the past century, higher even than the levels that prevailed in the aftermath of World War II. Add to that the fact that many of the austerity measures implemented in many developed economies have yet to really take effect, and the US fiscal cliff debacle, and we have the makings of a *really* interesting year in investment markets!

"State of the Nation"

Just a quick reminder the Maestro team moved premises in mid-December. Please note that all our contact details, including our telephone number of 021 674 9220, will remain the same. Our postal address remains Box 1289, Cape Town, 8000 but our physical address is now **3rd floor, Letterstedt House, Newlands on Main, Main Road, Newlands**. A map to the new offices has been posted on our website which can be accessed by clicking here.

So what's with the pics?

Some of you may know that I have been privileged to be enjoying a wonderful holiday travelling around Europe with my family. So, at the risk of being selfish, I have included some photos of Europe – I kid you not – as seen through the eyes of my children, who took all the photos in this edition of *Intermezzo*. Enjoy ☺.

Holiday-pic 7: A section of the Palazzo Vecchio ceiling, Florence

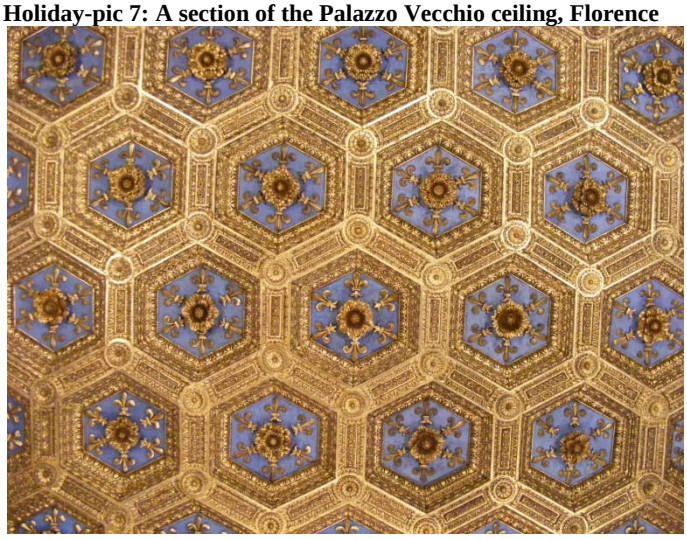


Table 2: MSCI returns to 31 December 2012 (%)

	YTD	MTD
ACWI	13.4	2.1
DM	13.2	1.7
Asia Pacific	11.0	4.0
Australia	16.4	2.8
Hong Kong	24.4	0.9
Japan	5.8	5.2
New Zealand	23.0	1.9
Singapore	26.4	2.7
GEM	15.1	4.8
EM Asia	18.1	3.5
China	19.0	4.8
India	23.9	0.0
Indonesia	2.4	1.6
Korea	20.2	5.1
Malaysia	10.8	3.8
Philippines	43.9	2.8
Taiwan	13.4	0.9
Thailand	30.9	6.1
EMEA	17.7	7.8
Czech	-3.1	4.7
Egypt	44.5	8.2
Hungary	18.7	-3.1
Morocco	-16.5	-3.6
Poland	32.1	8.5
Russia	9.6	6.2
South Africa	14.8	9.9
Turkey	60.5	6.9
LATAM	5.4	6.1
Brazil	-3.5	7.0
Chile	5.6	4.1
Colombia	31.6	7.6
Mexico	27.1	4.1
Peru	15.5	6.0

Source: Merrill Lynch

Holiday-pic 8: Sugar crystals on a much-needed cappuccino