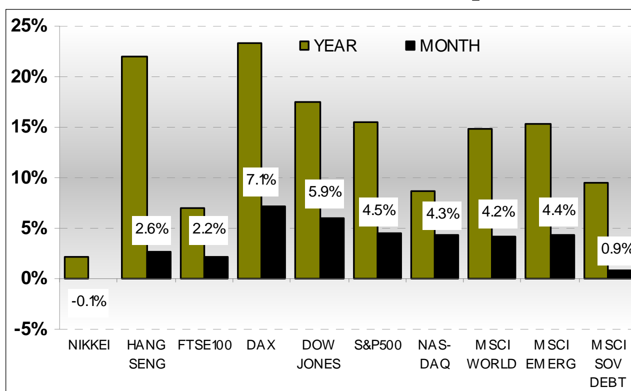
INTERMEZZO
MAESTRO
Investment Consulting
Investment Letter | 7th Edition | May 2007

April in perspective – global markets
The resilience of global markets was again tested during April, and again they withstood everything placed in their way, bouncing back with vengeance. April proved to be a very strong market on global equity markets, despite the fact that so far this year returns have been very positive. Even the perpetual laggard, the US equity market, rose strongly to register its largest monthly gain since December 2003. The German market rose 7.1%, India was up 6.4% and the MSCI World and Emerging indices both ended the month more than 4% higher. Japan however, lagged badly and is now up only 2.2% over the past year. General dollar weakness was another feature of the month; the greenback declined to above 1.3666 euros, the highest ever since the euro was formed.

Chart 1: Global market returns to 30 April 2007

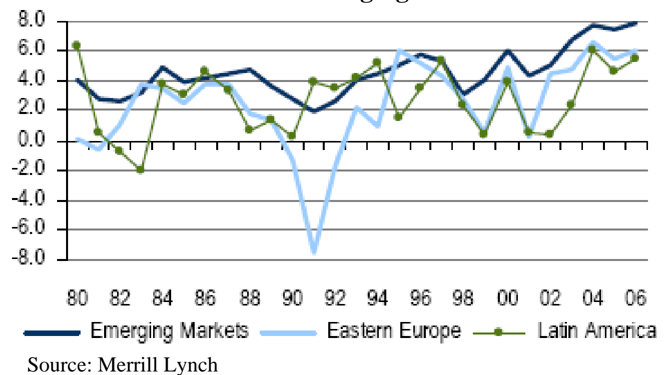


When the US economy sneezes … so what?
I thought that headline would grab your attention. For those who have been around long enough to remember the days before computers (OK, at least PCs) if there was one adage that was very true, it was that "if the US sneezed, the rest of the world caught a cold". But times, they are a-changing. In what is becoming an increasingly important theme, one which Maestro has been developing for some time, there is increasing evidence to suggest that the US economy is not as influential as it used to be. More specifically, there is sufficient momentum and development in other parts of the world to compensate for the current and expected weakness in the US economy. This theme is being referred to as "de-coupling" and the recent economic evidence provides ample proof of this developing feature of the 2007 investment landscape.

Before reviewing some of this evidence, lets us examine what is meant by the "**de-coupling theme**". We have been very positive on emerging markets, including South Africa, for a number of years now. We have listed our reasons in prior editions of *Intermezzo* as well as the Quarterly Reports sent to Maestro clients, so I will not repeat them here.

Suffice is to say that we believe, as do a seemingly larger number of investors as time progresses, that the economic growth and opportunities in the rest of the world, specifically emerging markets and Asia, are sufficient to offset the current weakness in the US economy. We do not believe the US consumer, who incidentally last experienced a decline in spending for a single quarter way back in 1991, is unimportant. It's just that he is not as important as before. And yes, the world will be worse off as a result of a weak US economy. But the global economy will still grow, at about 5.0% this year, what's more; the growth would just have been higher had the US continued to grow strongly.

Chart 2: Boom time for emerging markets



Source: Merrill Lynch

Merrill Lynch recently put forward four reasons why they felt even more confident about the decoupling theme than before. *Firstly*, the rest of the world has discovered **new export markets**. Between 2004 and 2006 the global economy experienced the strongest growth in over three decades, yet during this period the US economy "only" managed average growth of 3.5%. Europe grew at its fastest pace in four years, Japan the fastest pace in a decade. But the real star was emerging markets. Not only Asia, but parts of Latin America, the Middle East, Eastern Europe and even Africa all contributed to the party. Refer to Chart 2 in this regard; note how strong emerging market growth has been – since the early eighties. Thus, US demand is being replaced by consumption and investment in other parts of the world, which incidentally is likely to continue for some time. Chart 3 shows China and the rest of Asia's declining reliance on exports to the US.

Secondly, the exciting growth in China, India and other rapidly growing parts of Asia has **increased domestic demand** in these countries. Higher asset prices and greater employment has increased the propensity of Asian consumers to spend and to invest. With regard to the latter, each week one million new accounts are opened on the Chinese bourses, adding $26bn to the market in the past month. Did you know that there are over $2.1 trillion sitting in savings accounts in China earning just about no interest?

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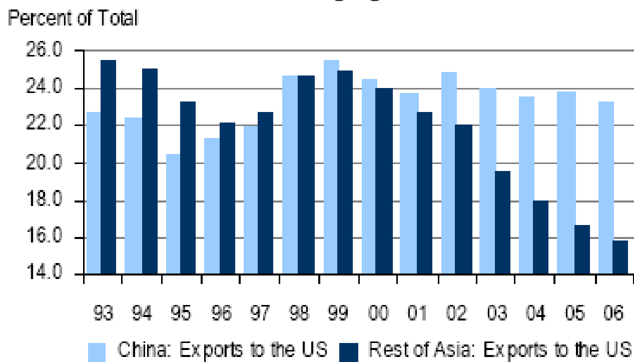
Is it no wonder the Chinese stock exchange is heading into the stratosphere? More about this later.

Chart 3: Boom time for emerging markets



Source: Merrill Lynch

Thirdly, a range of **new products and services** are now being exported from Asia. For example, software and business services now constitute 9% of India's economy, a sizeable proportion for a large, domestically-focussed economy. In Hong Kong exports of services, which grew 15.9% in 2004-06, amount to 38% of GDP; in Singapore they account for 45% of GDP and grew 17.6% over the same period. Labour forms an increasingly large component of exports as well. Workers' remittances in the Philippines now amount to 11% of GDP, having grown at an annualised rate of 15% since 2001. Remittances also play an important role in Pakistan and India.

Table 1: Contribution to every 100c of global growth

Global	100
Emerging markets	77
Developed markets	23
BRIC	49
China	32
India	11
US	9
Japan	3
EU	7

Source: Merrill Lynch

Finally, the macro economic policies are very supportive of further sustainable growth in Asia and in certain other emerging markets. Many of these countries run large trade surpluses, in stark contrast to the US and many other developed economies, and have large reserves. As far as interest rates are concerned, one of the larger risks to the global economy at present is the fact that higher rates are needed in many of these countries, specifically China and India. But the very point here is that there is *too much growth*, not too little, even as the US economy grows more slowly. Merrill Lynch put it so succinctly: the question should not be "can the world and emerging markets cope with a US slowdown". The *real* question is "can the US and Europe cope with an emerging market slowdown?" Table 1 provides a remarkable picture of the changing relevance of global economies. It is estimated that of every 100 cents of global growth, emerging markets contribute 77 cents. Even more startling is the fact that the US is forecast to contribute only 9 cents. China will contribute more than three times that amount, or 32 cents. India will contribute 11 cents, the Eurozone no more than 7 cents.

The US *is* sneezing, but where does that leave us?

This time of year sees the release of the first estimates of economic growth. The Eurozone is in fine shape, with inflation running at reasonable levels (1.8% in April), business confidence at 6-year highs and unemployment at the lowest (7.3%) since 1993, when data was first compiled on the combined Eurozone. To confirm the essence of the discussion above regarding the effect of the slowing US economy on the rest of the world and China in particular, one need look no further than the hard facts: US economic growth during the first quarter of 2007 was 1.3%. In contrast, China notched up growth of 11.1%. I rest my case.

Watch closely now … storm clouds on the horizon?

I won't spend much time on this topic but it must be kept on the radar screens because of its importance and of the large repercussions it will have "if things get nasty". I have previously drawn your attention to the strong Chinese equity markets in 2007, when the local index (let's use the largest domestic market's index, the Shanghai A index, as a proxy) rose 130.6%. The index rose 27.6% in December alone. The gains slowed in January (+4.0%) and the market fell 9% on February 27, causing widespread declines across global equity markets. But Chinese equity markets recovered and still registered a gain (+3.3%) for February. Yet it is the subsequent movements that I would draw your attention to.

The Chinese equity market rose 10.6% in March and 18.1% during April, bringing its year-to-date and annual returns to 40.3% and 161.3% respectively. Experienced investors will only draw one conclusion from these kinds of movements – and that's why we need to keep this topic on our radar screens. With global equity markets just about all at record highs, and a local economy growing at 11.1%, way above what the Chinese authorities are comfortable with – in April they again tightened bank's reserve requirements – the effects of a sharp fall in Chinese equities cannot be ignored. Irrespective of the wonderful "China story" and all the growth and opportunities it represents, no market can continue to rise at this rate. Digging into the detail reveals true bubble-like mania, which is all the more reason for concern: local companies are trading on an historic PE ratio of 42 times, and 30 times 2007 earnings. The MSCI China index, which tracks Chinese companies listed abroad, has an underlying forward (2007) PE ratio of 16 times, which illustrates the premium local investors are paying for their equities. With exchange controls in full force, South African

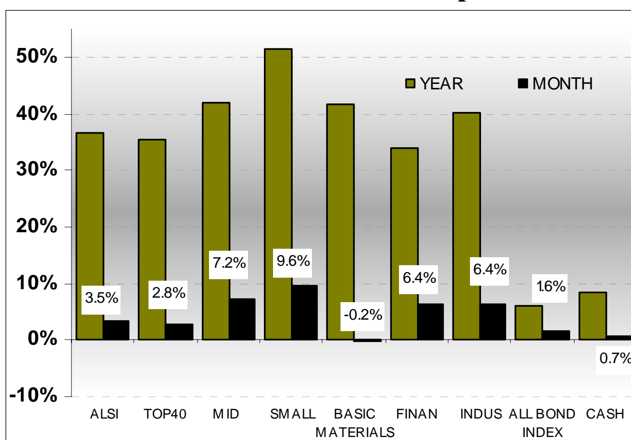
equity investors will understand the "hothouse effect" that must be playing a role in driving Chinese prices ever higher. To make matters worse 9 out of the 183 Chinese equity mutual funds underperformed the index in the first quarter of 2007. Fund managers blame the behaviour of retail investors for their poor relative performance. They claim that, due to volatility of flows, they have to hold large cash balances, which only exacerbates the poor relative returns.

We don't claim to be experts in Chinese equities – but if you have seen a couple of bull and bear markets you will take note of the risk that an ever-rising Chinese market represents to not only the level of other markets around the world, but also the global financial system at large.

April in perspective – local markets

In keeping with global markets the SA equity market rose strongly during April, as shown in Chart 4. Despite the firm rand – it gained 3.2% against the dollar and 1.3% and 1.0% against the pound and euro respectively – the All Share index rose 3.5%. The basic materials index declined 0.2%, pulled lower by the rand's strength, while the financial and industrial indices each gained 6.4%. The real "stars of the show" were the mid and small caps, which gained 7.2% and 9.6% respectively bringing their year-to-date returns to 22.1% and 28.7% - and we are only one third of the way through the year! Good corporate earnings, relief that interest rates were not increased during the month, the firm rand, ongoing positive consumer confidence and reasonable valuation levels all contributed to the positive month.

Chart 4: Local market returns to 30 April 2007



For the record

Table 2 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 2: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	Apr	**4.3%**	**15.8%**
Maestro equity benchmark *		4.6%	12.4%
JSE All Share Index		3.5%	14.2%
Central Park Global Balanced Fund ($)	Mar	**1.2%**	**2.5%**
Benchmark**		1.0%	2.0%

* 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

Table 3 lists the compound annual returns for the periods ended 31 March 2007 on the equity portfolios under Maestro's care. The numbers speak for themselves but the *size* of returns over the longer periods bear testimony to what a rewarding period this has been for investors in SA's equity market. I would hasten to add, for the benefit of readers outside of South Africa, that the dollar returns are even greater.

Table 3: Maestro annual returns to 31 March 2007 (%)

SA equity returns	6 mths*	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
Maestro average – ***short-term, actively traded portfolios***	***31.1***	***29.5***	***47.5***	***49.8***	***53.0***	***60.3***
Maestro average – ***long-term portfolios***	***31.8***	***41.4***	***50.4***	***47.1***	***48.7***	***42.7***
Maestro equity benchmark **	22.2	34.8	43.0	39.6	41.8	23.2
JSE All Share Index	23.4	37.7	47.1	40.4	41.3	23.7

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

Why invest? Why not sit with your cash in the bank?

During the course of my experience at Maestro, and indeed on many occasions in my twenty years in the profession I have had cause to argue at times, with great difficulty, and persuade, sometimes without success, potential and even existing clients why they should invest in the equity market and not sit with large cash balances in their bank account, "waiting for the market to move lower" (assuming of course that they don't need the capital in the short or medium term, and that their risk profile and circumstances were suitable for equity market investment).

I recently did a simple calculation that I would like to share with you, just to view the returns listed in Table 3 in another light and to reiterate my point to anyone sitting with large cash balances about the power of conservative, long-term investment. One tends to focus on absolute data when assessing returns, as one rightly should, but I found the exercise a useful example of, more than anything else, the power of long-term investment. To state the obvious, all of us at Maestro are firm believers in the power of and benefits from long-term investment, which is why we go about our

business with such enthusiasm and passion. We have seen the difference it makes to peoples' lives. Let me share the exercise with you, which is the **actual** experience of one of Maestro's first clients.

The client placed R3.5m into Maestro's care in May 2001. At the time, 25.7% of the portfolio was invested offshore via asset swaps, which three years later were invested into Central Park Global Balanced Fund, the offshore unit trust that Maestro's manages. As at the end of April 2007, the Fund still had 16.8% invested offshore. Remember though, that the rand has been very firm over the past five years – the five-year compound annual return to 31 March 2007 on the Fund's offshore investments was -0.1% (but 9.1% in dollar terms) - so in essence only between 75% and 85% of the Fund has performed "reasonably" over the whole period i.e. the returns would have been larger had the Fund not invested offshore. The Fund provides a monthly income of R15 000 to a related party and is also used to provide for other regular expenses in line with the objectives set at the time of its establishment. Since May 2001, no less than R2.5m has been paid out of the Fund – remember it was only R3.5m in size at the outset. No additional contributions have been received and a quarter of the Fund (its offshore component) has not risen much due to the firm rand. Given that the local portion of the Fund was just about all invested in the SA equity market, what do you think this Fund's market value was at the end of April 2007? R2m? Perhaps R4m? Wrong in both cases – the Fund had a market value of R5.4m at the end of April; testimony to how strong local equity market returns have been in the past few years and also a wonderful example of the benefits of long-term investment.

State of the nation – Part 2

No, you are not seeing double – there was a "state of the nation" update in the April edition of *Intermezzo*. I am happy to announce that the Maestro team has expanded yet again, with the arrival on 16 April of **Otto Dreyer**. Otto's role will be similar to that of David's, namely to assist me with a number of client relationships and continue building Maestro's range of services and depth of experience and capacity. Otto will be the champion of the Maestro Equity Fund and will assist with our business development activities. Both he and David also have specific investment research responsibilities. I "pursued" Otto for some time before he finally "saw the light". We started chatting in November last year, but he had to go on an MBA exchange program to Chicago for three months before deciding that the sunshine and beautiful country that is South Africa was the place he wanted to settle down and call home! Anyone who has experienced Chicago in winter will know what I am talking about! Jokes aside, Otto is from Harrismith but was schooled at Grey College, Bloemfontein (as an old-Grey myself from Port Elizabeth I had to forego deep inter-school rivalries) where he was a prefect and a member of the 1st water polo and swimming teams. During that time he was awarded provincial colours for water polo. He went on to do a post-matric at Michaelhouse in KwaZulu Natal and simultaneously started B. Com degrees in information systems and finance, which he subsequently finished, part-time, through Bond University in 2004. He worked as a Business Analyst at Investec Bank for three years prior to heading to Cape Town to complete his MBA at UCT last year.

With Otto and David on board and with Tracy and Sue's continued help the Maestro team has been raised to a new level. We are very excited about the future and the manner in which we can help clients, both old and new, manage their investments.

File 13: Interesting information, but worth forgetting

For the benefit of new readers "File 13" is a section wherein interesting facts or knowledge are highlighted which, once assimilated, can be relegated to File 13 i.e. the mental dust bin. They are less relevant – at least to some readers - and are listed purely for interest purposes and often just for a good laugh.

Many of Maestro's clients and *Intermezzo* readers have an intimate knowledge of the property market. They will be interested to know that HSBC recently sold their UK head office in London for $2.2bn. Home to 8 000 workers, the 1.1m square feet of property was sold on a yield of 3.8%.

Having mentioned some details about the Chinese equity market above, you may be interested to know that the market capitalization has increased from $43bn to $1 180bn over the last ten years. Another interesting fact is that there are today more individual shareholders in China than there are members of the Communist Party.

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