INTERMEZZO

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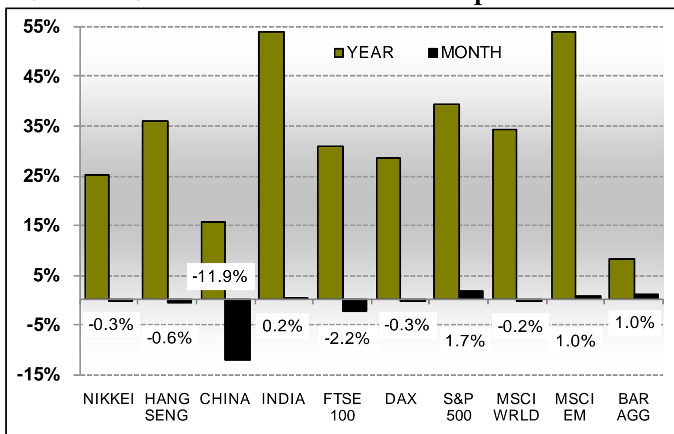
Investment Letter | 10th Edition | May 2010

April in perspective – global markets

April may not have generated much by way of returns, but it certainly generated a lot of excitement. Throughout the month global investors played the guessing game as far as Greece was concerned; the outcome with respect to that country's rescue package is hugely significant as it will, rightly or wrongly, be seen as a precursor of what to expect if and when the budgie hits the fan in larger European countries like Spain. It may be a bit over-dramatic, but it is fair to say that the future of the Eurozone is under scrutiny as the region grapples with country-specific differences (in this case the quality of members' respective balance sheets) within a regime (the EU) that, at its birth, made immanent political sense but less economic sense. The downgrade of Greece's bond status to junk and the subsequent downgrade in Portuguese and Spanish debt only served to elevate these concerns. Were it not for a month-end rally the euro would have reflected more than a 1.7% decline against the dollar. The month also saw what will surely go down as the most disruptive and expensive cloud in history; how ironic is it that, following its own implosion in 2008, Iceland, with a humble 300 000 inhabitants, sent a cloud of volcanic ash over its European creditors, bringing the global airline industry to a virtual standstill for nearly a week. The costs are still being counted but may well exceed what investors lost when Iceland's banks folded at the beginning of the credit crisis. And finally, the developing story of what is likely to be the worst ecological disaster in history, as BP's Horizon oil rig spews oil into the Mexican Gulf, seemingly uncontrollable after 15 days. The oil comes from *one* rig – there are currently over 4 000 rigs operating in the Gulf.

Chart 1: Global market returns to 30 April 2010



Back to the market returns for April: The Chinese equity market declined 11.9% and India (0.2%) and Russia (0.02%) managed only small gains. The US equity market held up relatively well, ending April 1.7% higher. The global bond market was more profitable, ending up 1.0% as investors again "fled to safety". The dollar was also a safe haven, ending stronger against most currencies.

What's on our radar screen?

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

- *The SA economy*: Annual retail sales to February declined 1.5%. This is a very disappointing number and points to a monthly *decline* in sales after two strong months in December and January. We retain our view that there may well be another rate cut at the Reserve Bank's July 22 Monetary Policy Committee (MPC) meeting. Annual growth in private sector credit extension (PSCE) in March was -0.7% - refer to Chart 2 for a historic perspective of retail sales and PSCE. And while Greece struggles to secure finance for a looming short-term bond rollover and its longer-term debt crisis, the World Bank approved a \$3.75bn loan to SA's power utility, Eskom, despite many objections to the fact that the bulk of the loan will go towards the building of the Medupi coal-fired (i.e. environment unfriendly) power station. For the record, the UK, the Netherlands and the US (the largest polluter on the planet) abstained from voting.

Chart 2: SA retail sales and PSCE (annual % change)

Source: Deutsche Securities

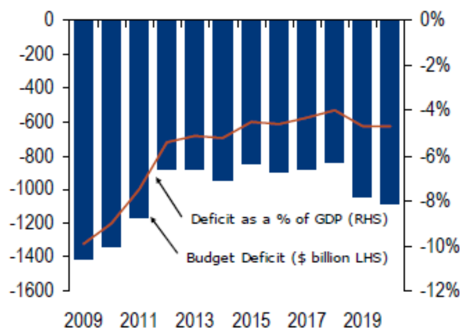
- *The Indian economy*: The Minister of Finance forecast the 2010/11 expected growth rate for the Indian economy between 8.25% and 8.75%. Inflation is rising strongly in India which led to the central bank raising rates by 0.25% to 3.75%. The reserve requirement ratio for banks was also raised from 5.75% to 6.0%.
- *The Chinese economy*: Economic growth in China during the first quarter of 2010 was 11.9%, a bit better than expected. Annual inflation to March rose to 2.4% while annual retail sales were 18.0%, down from February's 22.1% rise. The authorities remain concerned by runaway property prices as well as the huge increase in bank lending in recent months. In an effort to rein in these excesses the central bank again raised the reserve requirement ratio for banks to 17% and announced significant additional measures to curb property speculation.

- *And" Down Under":* The Reserve Bank of Australia (RBA) increased their interest rate twice since last month and for the sixth time since October, the May 4 increase taking the benchmark lending rate up 0.25% to 4.5%. House prices rose 20.0% in the quarter to March compared to the similar period in 2009.

Chart of the month

The "Lost Decade" continues to be a Big Picture theme of ours. It encapsulates our concern that the US economy is heading for, or already in, a position where they are over-whelmed by the process of recovery from a position characterized by excessive levels of private and public debt, declining growth, deflation and general introspection – not dissimilar to the Japanese experience since the late 1980s. Key to this concern is rising debt levels, particularly on the part of government (fiscus), reflected in the surging budget deficit. Chart 3 shows that, after hitting 10% of GDP in 2009, the 2010 US Budget deficit is forecast to be around $1.3 trillion or about 9% of GDP.

Chart 3: The US Budget Deficit: Big, bigger, ...



Source: Merrill Lynch

It is forecast to decline further as the once-off stimulus packages used to prime the consumer and get the economy going again come to an end. But even after taking this into account, the deficit remains large, particularly in absolute terms. It all looks manageable at the moment, but what happens when interest rates, which are effectively 0% in the US, begin to rise? We are currently experiencing the fallout from investors fretting about Greece's ability to honour their debt. With apologies to my Greek friends, that country is hardly a major player on the world stage; what happens when investors begin to fret about the US in this regard? See what Federal Reserve Governor Ben Bernanke had to say about this in the quote below.

A few quotes to chew on

Unfortunately we cannot grow our way out of this problem. No credible forecast suggests that future rates of growth of the US economy will be sufficient to close these deficits without significant changes to our fiscal policies. Fed Governor Ben Bernanke.

After the announcement of the EU and IMF rescue package to Greece and after a three-day, 3.5% decline on equity markets at the beginning of May, ex-Merrill Lynch Chief Economist and now Gluskin Sheff Chief Economist and Strategist, Dave Rosenberg, had the following to say; *As an aside, why is it that via the IMF, American and Canadian taxpayers are funding a Greek bailout? And, the EU part of the rescue means that – get this – countries like Portugal, Spain, Italy and Ireland are* de facto *coming to Greece's aid as well. Talk about the blind leading the blind! You can't make this stuff up.*

In a recent research article entitled Sovereign Musings, Deutsche Bank listed their recent thoughts on the sovereign debt crisis. They began the report with the following: *The first thing to say is that although a Western World Sovereign crisis has been our most likely end game, given that four successive private sector bubbles have been rolled onto Government balance sheets, the timing of the recent escalation has been much quicker than we would have imagined. All these current issues (and more) would have likely developed over time but the problems have spiraled due to an EU framework which understandably finds it difficult to make proactive and aggressive decisions. There are just too many countries, all answerable to their electorate, involved in making incredibly difficult and expensive choices.* Jim Reid, Strategist, Deutsche Bank.

For a number of reasons Maestro is not particularly enamoured by gold shares. To be frank we don't like them at all and neither do most of our clients. So we found the following comment most informative: *During the past decade the three "majors" (AngloGold, Harmony and Goldfields) generated R69bn in cash flows from operations. They invested R81bn in new capital expenditure ... and a further R31bn in other investments (acquisitions and gold price hedging structures). This leaves an enormous shortfall of R43bn. This was funded by issuing shares to the tune of R35bn and increasing debt by R20bn.* Anonymous, from Sanlam Investment Management.

April in perspective – local markets

The SA equity market followed the broad trend of global equity markets. There was little return to speak to during the month, but the market held up well under the circumstances, despite what we perceived to be a return of a small bit of risk aversion (see how quickly the rand declined on the day the SEC charged Goldman Sachs, before recovering again). Some notable features included the 9.3% return from the All gold index and the fact that the small and mid cap indices outperformed the large cap index, with monthly returns of 3.3%, 1.9% and -0.4% respectively. This experience was true in the US markets as well, with the monthly returns of the S&P small, mid and large cap indices being 5.8%, 4.2% and 1.7% respectively. The rand was stable over the month,

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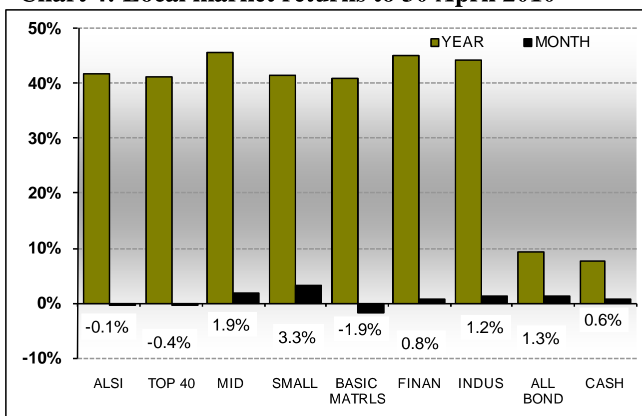
ending down 0.2% against the dollar at R7.36, although it breached R7.50 at one stage when the Goldman Sachs "event" first hit the headlines. Despite the flat All share index, there was quite a bit of divergence in sector returns; apart from the 9.3% rise in the All gold index, the fixed line telecoms sector rose 8.6%, and beverages (SAB) 8.1%. The coal sector was down 10.7% and general mining 5.0%. The All bond index rose 1.3%, bringing its year-to-date returns to 5.8%.

Chart 4: Local market returns to 30 April 2010



The Final countdown

At the time of publishing this *Intermezzo* there are just 32 days to go before the kick-off in the 2010 FIFA World Cup Final. Following on from last month's *Photonomics* pictures of some of the stadiums, I include a few more this month, particularly for the benefit of our overseas readers. And let me repeat, don't be too perturbed by the "old" pictures – all the stadiums are complete and "ready to kick-off".

Photonomics 1: Nelson Mandela Bay stadium, Port Elizabeth

Source: Google Earth

Source: www.fifa.com

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. Returns include income and are presented after fees have been charged.

Table 1: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Apr	**1.0%**	**3.3%**	**28.7%**
Maestro equity benchmark *	Apr	0.2%	4.8%	43.1%
JSE All Share Index	Apr	-0.1%	5.0%	41.8%
Maestro Long Short Equity Fund	Mar	**4.8%**	**2.3%**	**23.8%**
JSE All Share Index	Mar	7.9%	4.5%	44.1%
JSE Financial and Indus 30 index	Mar	6.3%	5.7%	49.9%
Central Park Global Balanced Fund ($)	Mar	**2.7%**	**-0.9%**	**12.4%**
Benchmark**	Mar	2.8%	2.1%	25.0%
Sector average ***	Mar	3.6%	0.5%	30.6%

* 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 2 depicts our returns for the periods to end-March. A few comments on them would be appropriate. Firstly, one needs to bear in mind that the past year or so – more like two and a half years actually, since the bursting of the sub-prime bubble in October 2007 – the investment environment could hardly be described as normal. We are not using this as an excuse, one just needs to take cognizance of it and bear it in mind when assessing any return that covers this period. Unusual pressures have been brought to bear on all markets during this period, such as zero interest rates,

unprecedented government interference, huge uncertainty and systemic damage, to mention but a few, that have all, in their own way, distorted the market. As for the Maestro team, we have tried as best as possible to stick to the "recipe" we know which is based on stock selection under an umbrella of conservatism and caution. Most of the assets under our care are subject to tax (CGT in particular) and we do not have the luxury of actively trading the portfolios (not that active trading would necessarily have increased the returns). In addition the returns shown are simply the untaxed gains in the equity portfolios; they do not reflect the total return to clients who in many cases have additional assets under our management that are not included in the returns below. Because each client is unique it is impossible to provide one "aggregate return" for a "typical Maestro client". Some equity portfolios require us to be more conservative while others require a higher-than-usual income component, so the returns in the Table below represent only a snapshot of but one section of the service and solution we offer.

As a function of our conservatism and caution, our equity portfolios have marginally lagged the market and similar "general equity" mandates. The past few years have seen a huge rise in the risk implicit in the market; we reacted to that by raising cash levels for our clients and concentrating on high quality equity investments. This strategy worked at the "total return" point of view, but the equity component, reflected in the Table below and which forms but one part lagged the market returns. Many of the views we adopted in the underlying investments will take a few years to bear fruit; we are dead against chasing returns just for the sake of being at the "top of the charts". We all know where that movie ends. We are also not about to place our clients' assets at greater risk just because we are lagging the All share index and benchmark over the past few years. The longer-term returns, shown in the 5 and 7-year periods, below, bear testimony to the fact that our approach is sensible and works for our clients. They also say nothing about the underlying risk profile of those portfolios, which, at least in our opinion, are lower than the market and with which our clients are comfortable.

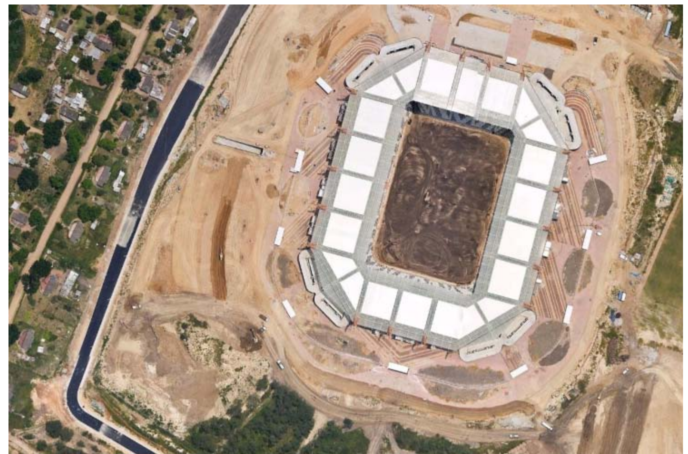
Table 2: Maestro annual returns to 31 March 2010 (%)

SA equity returns	6m *	1 yr	2 yrs	3 yrs	5 yrs	7 yrs
Maestro long-term equity portfolios	*9.8*	*41.2*	*0.9*	*3.4*	*20.1*	*27.3*
Maestro Equity Fund	*4.5*	*33.1*	*-1.63*	*1.4*	*N/A*	*N/A*
Maestro equity benchmark **	15.8	46.3	4.5	4.9	18.8	24.6
JSE All Share Index	16.5	44.0	1.5	4.6	19.9	24.2

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

If I may, I would like to borrow a thought from Allan Gray, whom we hold in high regard. Commenting on their recent underperformance in their Orbis Africa Fund, he had this to say: "In seeking the best relative value on South African equities, the Fund's composition may differ significantly from that of the Benchmark. This can lead to periods of short-term underperformance such as for the 2009 calendar year, but we remain confident that it will translate into long-term outperformance." We identify fully with this philosophy and thinks it accurately represents the manner in which Maestro approaches its clients assets in general and their equity investments in particular.

Photonomics 2: Mbombela stadium, Nelspruit



Source: Google Earth

Source: www.fifa.com

The State of the Nation – internal affairs

David celebrated his third year with our team during March. We joke internally that since David joined, the equity markets have only been beset by crises and downturns. But somehow he has survived; he has certainly learnt a great deal and taught us a lot in the process. Within our team, David's responsibilities include heading up our Retirement Fund activities, where he has been involved in constructing the four different solutions we offer to retirement fund members, and developing Maestro's role as an Asset

Consultant to Funds. He is also shepherding our increasing presence into the Garden Route – David was born and bred in the Wilderness, which remains his spiritual home (Vic Bay, to be exact). David is an active member of the investment team and looks after many client portfolios and relationships. On a personal note, I should add that David blew us all away early in May by the surprise announcement of his engagement! Way to go, David! ☺

Photonomics 3: The Eyjafjallajokull volcano, Iceland

Note: the small white dot in front of the ash is an aeroplane.

As you are aware, on their anniversary I provide team members an opportunity to write a no-holds-barred, unedited piece of *Intermezzo*. Here, then, is David's contribution:

The most important lesson I've learnt at Maestro is that it's 'time in the market,' not necessarily timing it. Seeds need time to grow. Sure, your returns are certainly a function of "where you got in" but investments should be long term in nature (speculation can be short term, if that's what you're after). The other important thing that I fully subscribe to is diversification. Regardless of whether you're a "property guy" or a stock market believer – there's a very valid place in a portfolio for both. I've ensured from a young age that I participate in both asset classes, because at the end of the day it's not really about which one does better on a yearly basis, but the security of knowing that you don't have all your eggs in one basket.

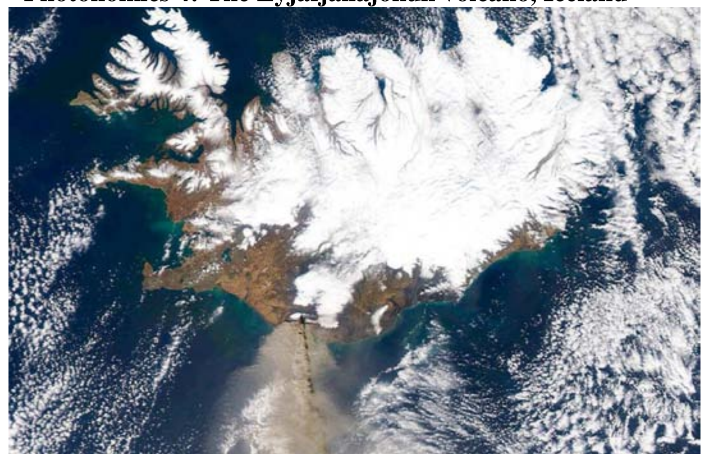
One of my earliest and most vivid memories was the day my father took me to the Johannesburg Stock Exchange. I was 10 years old and we were en route to Durban to watch the then famous "Gunston 500" surfing event. A lot has changed since then. We no longer have the open outcry system, due to dematerialization of scrip, nor do we allow tobacco companies to sponsor sporting events. But two decades on I'm still fortunate enough to be combining and enjoying two very diverse passions in my life, both of which featured so prominently in that one trip…

I'd been fascinated with stock markets from a very young age; how they worked, the unpredictability and excitement of how prices moved up (and down) on a daily basis, what drives these daily movements and ultimately what the major catalysts are for long term trends. We rely on investments in order to generate wealth, and the longer the seed has to grow, the better the harvest.

It sounds so simple and obvious, but I think few people grasp this concept at a young age. I was perhaps exposed to it earlier than most because I grew up in a household that was fairly alternative in its way of thinking. It wasn't completely dissimilar to other homes, but it was a home in which lateral thinking, entrepreneurship and "pushing the envelope" were always encouraged, alongside an emphasis on enjoying life and living out doors.

This love of the outdoors meant that I surfed from a young age. I was fortunate enough to be "paid" for my surfing efforts from a clothing sponsorship while still at school. My surfing endeavours meant that I enjoyed a certain degree of financial independence in my youth, and it was when I had money to invest that I learned one of the most important lessons in investment management (that I only fully comprehended years later) … that its time in the market, not necessarily timing it.…

Photonomics 4: The Eyjafjallajokull volcano, Iceland



There is often a debate about property vs. stocks and which one generates the best returns for private, individual investors. For some reason you also find that a distinct line is drawn between the two camps, and people find themselves in one or the other. My father was, and still is, very much in the property camp. I grew up listening to dinner-table conversations about property investments. This was around the same time that I was starting to receive money from surfing sponsorship. I was in grade 10 and always searching for opportunities to make extra cash to fund my surfing trips, which took me as far afield as Bali, Tahiti and

Hawaii at the age of 19. These dinner-table discussions triggered an interest in property, which I still pursue today, but at the time I had to rule that out as an investment option because I had no reliable income stream. Instead I followed the advice of a new acquaintance, who would prove to have a big influence on the direction of my professional life. He was a retired stockbroker from Johannesburg, who worked for Simpson Mckie, which was later bought out by HSBC.

He introduced me to the market, and this marked my entrance into the exciting world of investment markets. Under his guidance, I made my ***very first investment in a company called M Cell, which today is known as MTN.*** *I purchased 5000 M Cell shares (around 1993) for about 300 cents and a few years later I sold those 5000 shares for about 1200 cents. At the time I felt elated, and more than a little proud of myself, but what I didn't know then was that in 2009 they would peak at 16000cents (a return of 2222%). My initial investment of R15 000 would have been worth R850 000. One can't help but think about it from time to time (especially when preparing client portfolios and I see some of their "in costs" around R10 or R12 – I sometimes wonder if those aren't the shares I sold) but you live and learn, and the lesson learned here was, once again,* ***"time in the market" with the caveat that it needs to be a quality company or portfolio!***

I'm continually interested in what drives stock prices, cycles, interest rates and more recently how crises are dealt with by government. My arrival at Maestro (1March 2007) was ominously close to the peak of the market. Sure, it went higher, but the amount of volatility that crept into the market over the proceeding 12 months was exceptional and unprecedented. I have a number of older friends who have had long and successful careers in financial services, more specifically portfolio management, and a large majority seem to have similar stories about when they first started out in this field.

I feel very fortunate to be working at Maestro, surrounded by good people who not only love what they do and believe in what they do, but are also good at what they do. It's a continual learning curve for me, which I really enjoy. With regards to work, people often say; "you have to love what you do" and although this is very true, I think what's equally important is the need to believe in what you're doing or selling or providing. Without that belief, in my opinion, you're destined for mediocrity and a lack of personal fulfilment. I'm fortunate to still be fascinated and fulfilled by the things that once motivated and fascinated me as a 10-year old boy. Today, a large number of our clients are significant property developers and we invest a percentage of their wealth into the equity markets. I have constant contact with them and I get to watch the markets all day long (alongside other work!) In some shape or form, I feel at home being surrounded by the clients we have and working as an investment analyst/manager. I'm not a professional surfer, but I live 5 minutes' walk from a great little surfing break in the corner of Camps Bay. I've come a long way since my childhood trip to the Johannesburg Stock Exchange and now I'm excited to see what the next two decades has in store….

File 13: Information almost worth remembering

South Africa is getting ready to welcome visitors to the Soccer World Cup – and there really is a palpable atmosphere of expectation throughout the country – it is worth taking a look at another major global event, the International Exposition, currently underway in Shanghai. You may recall that I have in the past referred to my home grown "law of large numbers". Well, here is another example of it: a most optimistic forecast for the number of visitors to the Soccer World Cup is about 500 000. The Soccer Final will stretch over one month; so far, in the first six days of the Shanghai Expo, no less than 643 000 visitors have bought tickets. At this stage, 70m (yes, that's million i.e. just short of one and a half times the entire population of SA) visitors are expected to attend the 6-month long Expo. It is estimated that 95% of the visitors to the Expo will come from China. $59bn was spent on preparing the 200-odd pavilions that comprise the Expo, more than twice what was spent on the 2008 Beijing Olympic Games. 72 000 volunteers work inside the Expo and another 100 000 work in service centres around the city. 1.97m volunteers will work as volunteers around the city during the whole Expo.

You can find out more about the Expo by visiting their site at http://en.expo2010.cn/. It is worth doing so, if only to see pictures of the spectacular designs of some of the pavilions.

Alberto Giacometti. *Walking Man 1*, 1960. Bronze. 183 x 26 x 95.5cm

And finally *Intermezzo* readers would know that we harbour a keen interest in art and thus couldn't but help notice the record that was set in New York on 4 May at a Christie's auction. If anyone had doubts about the robustness of art as an asset class and how the global credit crisis had affected it, consider the following. The previous world record for any artwork was established when a sculpture, Walking Man 1, by Alberto Giacometti, was bought for $104m in February this year at a Sotheby's auction.

But on 4 May, Pablo Picasso's Nude, Green Leaves and Bust was sold for $106.5m, setting a new record for the most ever paid for a work of art. The work was painted in one day in 1932 and depicts one of Pablo Picasso's muses.

You can find out a bit more about this fascinating work by clicking here or by visiting Christie's site and seeing the full story behind the auction and artwork. Enjoy!

Pablo Picasso. *Nude, Green Leaves and Bust*. 1932. Oil on canvas. 162 x 130cm

Table 3: MSCI returns to 30 April 2010 (%)

	Apr'10	YTD
Egypt	8.5	19.9
Turkey	6.5	10.5
Indonesia	6.0	16.6
Korea	5.6	8.6
Singapore	5.1	3.6
Morocco	4.8	11.8
Philippines	4.7	8.4
Malaysia	4.2	12.8
Chile	2.8	2.8
Taiwan	2.5	-1.4
India	1.8	6.7
Pakistan	1.2	8.8
AP ex Japan	**1.2**	**2.7**
MSCI EM	**1.0**	**3.1**
South Africa	0.6	4.7
Czech	0.3	0.1
Colombia	0.2	10.3
Peru	0.2	0.3
Mexico	-0.1	7.6
MSCI DM	**-0.2**	**2.6**
Japan	-0.2	7.1
EMEA	**-0.4**	**5.5**
Hungary	-0.5	12.0
Australia	-0.6	2.4
China	-0.6	-2.2
Poland	-0.6	3.6
Russia	-0.8	5.9
LatAm	**-0.8**	**0.5**
Argentina	-1.0	4.3
Brazil	-1.3	-1.8
Hong Kong	-2.9	-0.8
Thailand	-3.9	8.2
Israel	-7.6	1.5

Source Merrill Lynch

Photonomics 5: BP's Horizon oil rig

This picture was taken just prior to the rig sinking. Note the hole in the heliport – gives one an indication of how hot the fire was.

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