INTERMEZZO

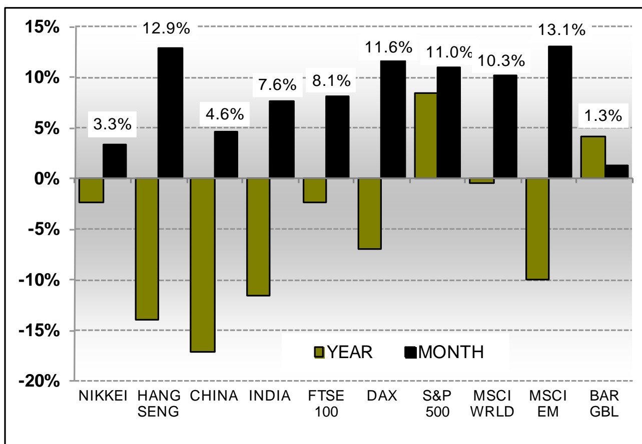
MAESTRO

11th Edition | November 2011

October in perspective – global markets

October bore testimony to another volatile performance by global equity markets. But unlike September, during which markets posted dramatic declines and set numerous records "to the downside" in the process, October set numerous records "*to the upside*" as markets zoomed up on the back of hope and expectation. In August and September the world watched policy makers playing silly games in the US and Europe and watched time eat into what little prospects remained of finding a sustainable solution. But on 3 October global equity markets turned around on the belief that European politicians would somehow manage to pull the elusive rabbit out of the hat. Simultaneously, assets such as US and German Treasures (bonds), which had earlier been regarded as "safe havens" were tossed aside in favour of riskier assets such as equities, high yield (junk) bonds and commodities.

Chart 1: Global market returns to 31 October 2011



The MSCI World index rose 10.3%, following September's 8.9% decline. The Hong Kong equity market rose 12.9%, Germany 11.6%, the US 11.0% and the UK 8.1%. The MSCI Emerging market index rose 13.1% - it declined 14.8% in September. Russia rose 16.6%, Brazil 11.4%, India 7.6% and China 4.6%. The SA equity market rose 11.3% in dollar terms. In terms of rises across company sizes (market capitalizations), the US large cap (S&P500) index rose 11.0%, while the mid and small cap indices rose 13.7% and 14.9% respectively. This was a very different experience from the SA market; the Top40 (large cap) index rose 10.3% but the SA mid and small cap indices rose only 4.8% and 1.9% respectively.

The global bond market flew into headwind in October as investors ditched bonds in favour of riskier assets such as equities and commodities. Towards the end of the month investors returned to bonds in some measure, mitigating their intra-month losses. The Barclays aggregate global index rose 1.3%. Bonds remain the top performing asset class abroad, having risen 7.6% for the year-to-date.

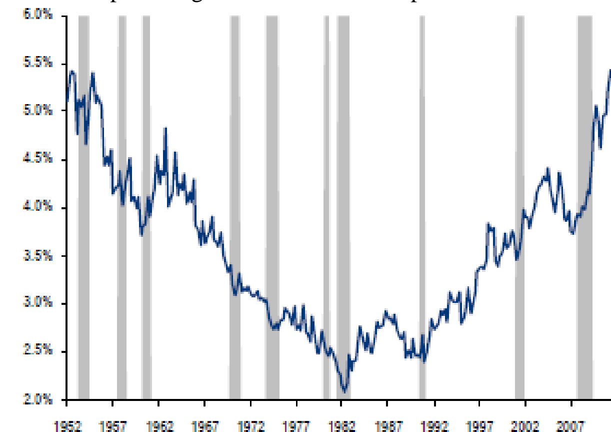
Commodity prices posted strong gains: gold, platinum, palladium and oil all rose about 6%, silver gained 12.5% and copper 10.7%. Iron ore prices were the biggest loser, declining between 20% and 30% on the month. How real and sustainable these losses are will soon become apparent. The CRB and S&P Goldman Sachs commodity indices rose 7.3% and 7.5% respectively. On the currency front the euro was the biggest winner, as investors took the view that progress was being made towards finding lasting solutions for the European debt and growth problems. The euro rose 4.0% against the dollar and the pound rose 3.6% against the greenback. Emerging market currencies were also firm; the rand rose 1.8%, which is a bit disappointing when one considers just how weak (-12.9%) it was in September. Other emerging market currencies were firmer (than the rand) against the dollar; the Aussie dollar, for example, rose 9.2% against the greenback.

Charts of the month

We have often noted that although the (Western) public (government) sector is in very poor health, struggling under excessive debt loads, the private sector is in very good health. Due to excessive uncertainty in the economic and policy realm, not to talk of the increasingly onerous regulatory environment, most corporates are withholding investment in new capacity and hoarding cash instead. In the short-term this boosts their balance sheets and keeps the cost of capital low. Chart 2 depicts the extent to which non-financial US companies have increased their cash holdings, particularly since the onset of the financial crisis in 2007.

Chart 2: Cash is king (shaded areas represent recession)

Cash as a percentage of non-financial corporate assets

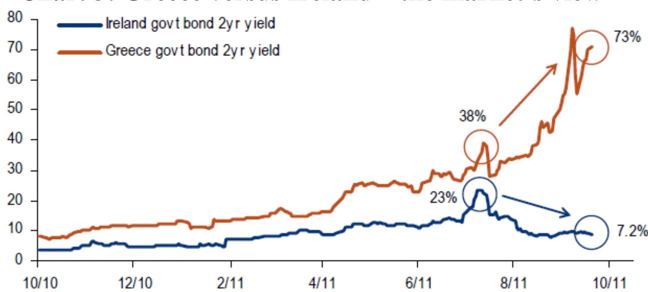


Source: Merrill Lynch

Another chart worth sharing is the contrast between Irish and Greek 2-year government bond yields. Merrill Lynch argues that a "3-R approach" is required for a resolution: recapitalization of the banks, restructuring of debt and regime change i.e. a new government. This has happened in Ireland, which is the only region which seems to be

successfully overcoming their debt-induced problems. Chart 3 depicts the respective yields. While yields (interest rates) on their two-year bonds peaked around 23% in July and have subsequently declined to around 7%, Greek yields rose to 38% at the same time, before soaring to 73%. You might be surprised to hear that one of the best performing assets during the past three months have been Irish bonds - they have risen 38% over the period!

Chart 3: Greece versus Ireland – the market's view



Source: Merrill Lynch

What's on our radar screen?
Here are a couple of items we are keeping a close eye on:

- *The South African economy*: SA retail sales rose 7.1% in the year to September, from 3.0% the previous month, while manufacturing production rose 5.6% from a contraction of 6.2% in August. SA's gross (gold and foreign exchange) reserves remain around $49.7bn. October saw the tabling of the Medium Term Budget Policy Statement (MTBPS), in which government reduced its 2011-2013 growth forecasts to 3.1%, 3.4% and 4.1% respectively. The national balance sheet remains reasonable, although there is room for improvement. Total debt to GDP equates to around 40%. More importantly foreign debt to GDP is projected to decline to 3.2% in 2012 (its rand value is R105bn), down from 4.1% in 2011.
- *The European economy*: Given that we are inundated daily with news about the European economy, there is little to add here. However, for the record, the new European Central Bank (ECB) president, Mario Draghi, cut interest rates by 0.25% to 1.25%, citing the onset of a "mild recession" as the primary justification for the cut.
- *The US economy*: Initial estimates for third quarter (Q3) economic growth came in at 2.5%, from the anaemic 1.3% in Q2. In general US economic data has been marginally better than expected. The consumer is still spending more than he or she earns, industrial production is still positive and the manufacturing and service sectors are still growing, albeit only just. The ISM manufacturing and non-manufacturing i.e. service indices were at 50.8 and 52.9 respectively in October. Anything above 50 indicates growth and below it, contraction.
- *Emerging markets*: The Chinese economy grew at 9.1% during the third quarter, from 9.5% in the second. September inflation slowed to 6.1% from 6.2% in August and annual retail sales rose 17.7%. China's foreign exchange reserves remain at $3.2 trillion. India raised its official interest rate by 0.25% to 8.5%, the 13th increase since the start of 2010. India's inflation declined marginally to 9.7% in September from 9.8% in August. The Reserve Bank of Australia (RBA) cut their rates by 0.25% to 4.25%; the RBA last cut rates in April 2009. Inflation in the September quarter was 3.5%, down from 3.6% in the June quarter. The Bank of Indonesia cut their rates by 0.25% to 6.5%, citing lower inflation pressures; inflation there is running at 4.6%. And finally Brazil cut its rates by 0.5% to 11.5% - the second cut in six weeks - in an effort to stimulate growth. Brazil is growing around 3% to 4% but is hamstrung by high inflation, which in September rose to 7.3% versus the official target rate of 4.5%.

October in perspective – local investment markets
The SA equity market also posted strong gains although they were driven largely by large caps and resource shares, both popular amongst global investors. The All share index climbed 9.3%, led by the basic materials index, up 10.9% (but down 5.4% in September). The financial and industrial indices rose 5.8% and 9.5% respectively. The year-to-date gains of these three indices are now 2.4%, 6.8% and 15.8% respectively. It's not every day that you see such a large divergence between resource (2.4%) and industrial (15.8%) returns, but then again these are hardly normal markets. The best performing sectors were personal goods (Richemont) which rose 26.8% and retailers 14.1%, while the decliners were led by fixed line telecoms, down 4.3% and forestry and paper, up 1.6%. The All bond index rose 2.8%.

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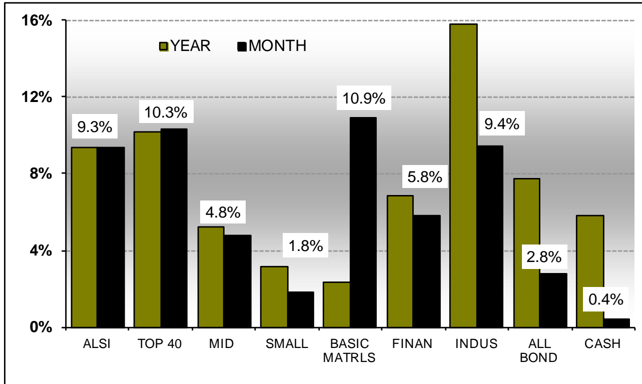
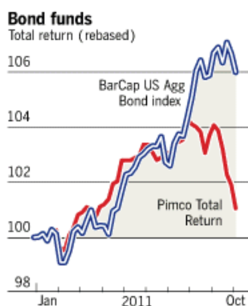
Chart 4: Local market returns to 31 October 2011



For everything there is a season

The purpose of the following section is not to gloat over the misfortune of others, but to bring to your attention the fact that some of the most respected names in the investment world have registered calamitous returns this year so far, proving firstly what a difficult period it has been in which to achieve respectable returns and secondly, that no matter who you are, the markets respect no one; even the best managers in the world, literally, can either fail or have to endure sustained periods of underperformance. The two highest profile casualties in this regard are Bill Gross and John Paulson. I won't go into the details here; suffice is to say that for both of these gentlemen 2011 is a year they would prefer to forget – to put it mildly!

Bill Gross's fame emanates from the fact that he manages the largest bond fund in the world and has, as one of the founders of the firm Pimco, established one of the most enviable records in the world for fixed income i.e. bonds and cash management. He now manages, amongst others, the Pimco Total Return Fund, which is no less than $250bn in size. Earlier in the year he took the view that US bonds were expensive and went on to sell the entire Fund's "long bonds". This proved to be an ill-timed decision. But he stuck to his view and subsequently went *short* of bonds i.e. through the use of derivatives he increased his negative view even further, which only compounded his earlier mistake. As a result of investors' mad rush into "safe havens" and through the Fed's action to lower the yield of long bonds, interest rates on US bonds declined (prices went up) to unprecedented levels, magnifying the error of Gross's views and pushing his Fund into the lowest 10% of its sector (refer to the inserted chart).



John Paulson rose to fame by betting against sub-prime loans in 2007, simultaneously securing for one of his funds the now legendary annual return of 580% when most other managers literally lost fortunes, and more. But through a sequence of disastrous investments, Paulson's Advantage Plus Fund is down nearly 50% so far this year. Now that *might* be tolerable for a "long-only" fund i.e. one which is precluded from selling short and from actively hedging its portfolio, it is a tough return to stomach from a hedge fund whose claim to fame is to hedge away the risks inherent in the markets in which it operates.

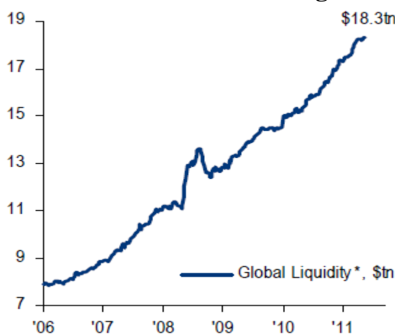
Many investment managers "get it wrong" – including ourselves, it must be said – but what has drawn additional attention to these managers is the extent of the convictions of their views and the high profiles which they adopted in the communication of their beliefs. "We are very excited about the outlook for our funds," Paulson told his investors in January this year, announcing that his fund was "80% long" i.e. the Fund's net exposure to the market represented 80% of its assets. Even from our humble viewpoint, that was a bold call to make. So it is not surprising to learn that as of mid-October, only one of Paulson's funds has generated a positive return, while the remaining funds have registered declines between 10% and 47%. There is a season for everything but how some of the mighty have fallen!

Another chart to chew on

We are all aware of the current global banking crisis. After having barely recovered from the 2008 crisis (and some didn't) banks are again faced with huge debt write-downs, much of the debt European in origin, and the relentless increase in regulation which, amongst others is prescribing that they raise or at least hold additional capital in reserve. The numbers are large, particularly on an aggregate basis, but these numbers are dwarfed by what some commentators call "the greatest hedge funds on the planet". I am of course, talking about the world's central banks. One would have thought that central bank intervention peaked in 2008 during

the Great Financial Crisis, with the collapse of Lehman Brothers and the near-collapse of so many other financial institutions. However, a quick glance at Chart 5 reveals that such a notion is far from the truth. In order to "liquefy" the world's economy, central banks have been pumping trillions of dollars into the global money system, to the extent that between the US Federal Reserve, the European Central Bank and the Banks of Japan and England alone, their balance sheets have grown to $18.3tn, way above the $10.4tn peak reached in 2008. (*Ed*: do you think taxpayers are aware of the humungous liabilities these central banks are laying down for future generations?)

Chart 5: Central bank foreign exchange reserves



Source: Merrill Lynch

For the record

Table 1 lists the latest returns of the mutual funds under Maestro's care. You can find more detail by visiting 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.

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

	Period ended	Month	Year to date	Year
Maestro Equity Fund	**Oct**	**6.4%**	**-3.3%**	**1.2%**
*Maestro equity benchmark **	*Oct*	*9.9%*	*7.0%*	*12.8%*
JSE All Share Index	*Oct*	*9.3%*	*3.5%*	*9.4%*
Retirement Funds				
Maestro Growth Fund	**Oct**	**5.6%**	**0.4%**	**4.1%**
Fund Benchmark	*Oct*	*6.8%*	*6.5%*	*9.9%*
Maestro Balanced Fund	**Oct**	**4.8%**	**1.7%**	**5.0%**
Fund Benchmark	*Oct*	*5.9%*	*6.6%*	*9.5%*
Maestro Cautious Fund	**Oct**	**3.2%**	**2.8%**	**4.9%**
Fund Benchmark	*Oct*	*3.8%*	*5.5%*	*7.6%*
Central Park Global Balanced Fund ($)	**Sept**	**-6.9%**	**-9.2%**	**-3.2%**
*Benchmark***	*Sept*	*-4.7%*	*-5.2%*	*-1.3%*
*Sector average ****	*Sept*	*-6.2%*	*-7.6%*	*-4.0%*

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Barclays Global Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
*** Lipper Global Mixed Asset Balanced sector ($)

Maestro publishes the returns of its equity portfolios every quarter in *Intermezzo*. These are the returns achieved on fully discretionary equity portfolios under our management and are shown after fees have been deducted. As our clients would know (we discussed this with them in separate correspondence) we had a disappointing March quarter, due in part to certain of our large holdings declining in January after posting sizeable gains during the previous quarter (our December 2010 quarterly returns were above average). In addition we were also not adequately positioned for the sharp (7.9%) decline in the rand in January, and many of the large index constituents, which were not part of our portfolio at the time, rose sharply, causing us to lag the major indices. Incidentally, Luke has just completed a brief attribution analysis on the Maestro Equity Fund and included it as an Appendix to the Fund's September Quarterly Report, which you can access by clicking here. Although our relative returns improved during the June and Septembers, the conditions in which to manage money remain tough and have not paid any respect to style, skill or distinctive competencies. I am very aware that we are not alone in struggling to deliver market-beating returns under the prevailing conditions. I sense the delivery of above-average returns at present has more to do with luck than skill; that is not a function of investment managers' ability but rather *a function of the prevailing dysfunctional markets*.

What is perhaps most disconcerting for us at the moment is that many investors are focussing on *returns* and not taking sufficient cognisance of the *risk* inherent in the markets or what managers such as ourselves are doing to mitigate these risks. For example, our offshore fund, Central Park Global Balanced Fund's estimated October return (5.5%) exceeded that of comparable funds i.e. the sector average and it's demanding benchmark. However, the measures we put in place to protect against possible declines in markets cost the Fund 5.0%. Had we not put those measures in place the

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October return would have a mouth-watering 10.5%, but we elected to retain the protection because we felt it appropriate in the prevailing high-risk, volatile environment. The point is this: investors see the 5.5% return and pass a value judgement on it, but they don't realise that, had the markets declined 5% or 10%, the Fund would have weathered the storm better than most due to the risk management measures we took.

Similarly, many of the shares in our local equity portfolios are going nowhere fast, simply because they are not widely followed or are not on global investors' radar screens. So while they are not necessarily generating great returns when the bulls come charging through the gate, as they did in October, the underlying companies are still generating good earnings and are increasing dividend payments; they are well managed with strong balance sheets and cash flows. In the midst of all the volatility, we are still prepared to hold them because we are of the view they will prove to be excellent long-term investments (many of them have already generated excellent returns for our clients over the past few years). Into this category we would place the likes of Abil, Aspen, Mr Price, Capitec and Cashbuild, all of which are amongst our larger holdings. Despite these frustrations, our returns stand as a matter of record and are shown in Table 2. The same returns are reflected in graphic form in Chart 6.

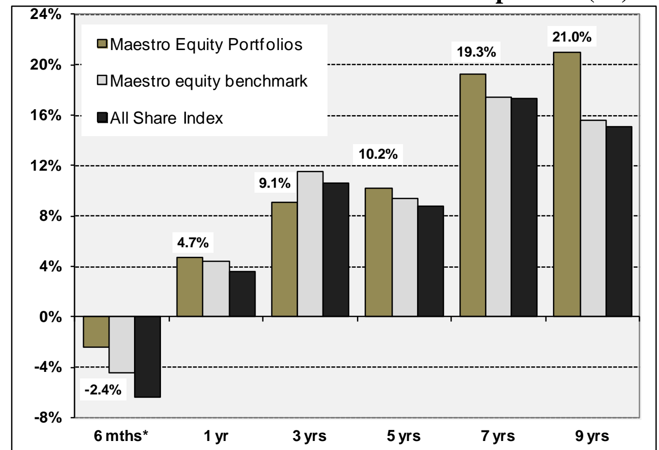
Table 2: Maestro annual returns to 30 Sept 2011 (%)

SA equity returns	6m *	1 yr	3 yrs	5 yrs	7 yrs	9 yrs
Maestro long-term equity portfolios	*-2.4*	*4.7*	*9.1*	*10.2*	*19.3*	*21.0*
Maestro equity benchmark	-4.4	4.4	11.5	9.4	17.4	15.6
JSE All Share Index	-6.4	3.6	10.6	8.8	17.3	15.1

* 6-month returns are un-annualized

The Maestro equity benchmark, one of the measures we compare ourselves against (the other being the All share index) is a combination of the Top40 and Findi30 indices, the effect of which is to reduce the heavy weighting in basic materials (resources) which is implicit in the All share index. We think this is a more appropriate benchmark against which to measure long-term equity returns in SA. However, with the basic material sector having performed poorly in recent times, you can see from a comparison between the two in Table 2 that the Maestro equity benchmark is proving to be a demanding benchmark. That is worth remembering when evaluating our returns. Finally, we are confident that Maestro's equity returns are less volatile than those of the two benchmarks, which is a critical consideration but which is not evident from the returns.

Chart 6: Maestro annual returns to 30 Sept 2011 (%)



* 6-month returns are un-annualized

A few quotes to chew on

Social unrest

Social unrest is not something that dominates an investment manager's radar screen but during the past two or three years, with political systems in many countries failing - more so this year with the dawning of the Arab Spring – social unrest is something that we are increasingly having to consider as part of the investment environment. With that in mind, we thought the following comment from the *Merrill Lynch's monthly Research Investment Committee Overview* was pertinent. "Unprecedented levels of peace time debt in the US, Europe and Japan necessitate fiscal austerity. Government sector retrenchment, together with perceptions of income inequality and poor governance, could lead to social unrest in the form of protests and riots (this has already started in some regions). Alternatively, a more radical political response in the form of repressive taxation or regulation could occur if politicians resist a smaller public sector. Another liquidity-led surge in food prices could also see social unrest spread to Emerging markets. ... Note that elections and political leadership changes will take place in 20 of the 45 countries within the MSCI Global index over the next 15 months, including the US, Spain, France and China." These comments were made in a section highlighting *possible* risks; Merrill Lynch was not suggesting they would necessarily occur.

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The consequences of kicking the can down the road

The world is by now tired of all the nonsense in the Eurozone and the glaring inability of politicians to get anything done. However, we believe investors will soon have the next instalment of the US political fiasco to look forward to. You will recall that the catalyst for the onset of the market mayhem in early August was the inability of US politicians to agree to measures to resolve the debt ceiling crisis and the subsequent downgrade of their credit by the Standard and Poors rating agency. We know where that mess got us. But if you recall correctly, the last minute agreement didn't achieve anything, other than to "kick the can down the road" – something all politicians have become very adept at doing. In effect, US policymakers agreed to establish a "super-committee" to resolve the issue. Having agreed to a deadline of 23 November, in the absence of an agreement to cut spending by $2.3tn (trillion) over the next ten years, certain cuts in government spending, equivalent to around $1.2tn, would automatic be triggered. So while the world's attention remains on Greece and the Eurozone, it is our sad duty to remind you that another, potentially more powerful time bomb is ticking on the other side of the Atlantic. We are not alone in our concern about the possible outcomes of the next chapter of the US political circus. *Merrill Lynch* has the following sober assessment of the situation: "With the election campaign under way we expect uncertainty to remain at high levels. We expect another debt downgrade in December when the deficit commission decides to fight rather than compromise. We think campaign rhetoric will focus on policy purity rather than practical compromise. We expect a big spike in uncertainty in front of the election itself. As we have noted before, with politicians digging in their heels, three time bombs will await post election – a major tax increase, a major cut in spending and the expiration of the debt ceiling. All of these highly contentious decisions will have to be handled by a lame duck Congress. In the TV show "MacGyver", the hero always managed to defuse the time bomb in time. Will Congress dismantle all three bombs in time? In a sense it doesn't matter, because the economy could suffer a heart attack while waiting."

File 13: Information almost worth remembering

The Silly Season approaches

If your experience is anything like ours, 2011 is careering to an end at an alarming rate. Christmas lights are up in shopping malls already and individuals and companies around the world are gearing up to send out greetings and gratitude. I am always fascinated by the logistics behind the crazy time of the year, and recently came across a press release from FedEx, the world's second largest package delivery company and, incidentally, one of Central Park Global Balanced Fund's larger equity holdings. FedEx expects to deliver 260m packages between the US holiday of Thanksgiving and Christmas. It plans to add 20 000 additional seasonal workers to cope with the expected 12% increase in parcels. Its busiest day is December 12, on which it expects to deliver 17m packages, more than double its average daily delivery.

A Bit of Africa

We have distributed *Intermezzo* to a number of new readers this year. It is very gratifying to welcome them all and indeed to see the number of recipients increase over time. I will have more to say about this next month, when as long-standing readers will know, I completely abuse my privilege as author, and write an extra-long edition, justified by the spurious belief that readers have the whole Silly Season to wade through it, and by the traditional update I need to share on both Maestro and other "special friends" we retain, such as the Music Therapy Community Clinic – more about that next month, too.

Regular readers will also know that I hate inefficiency. So the notion of having "wasted open space" on *Intermezzo* is simply intolerable ☺. Hence the "bit of Africa" for you this month – a selection of beautiful photographs, all courtesy of National Geographic, with Africa as a theme (other than the second last photo, which is of a deer in Japan). Enjoy.

Table 3: MSCI returns to 31 October 2011 (%)

	Oct'11	YTD
Russia	18.1	-12.0
Brazil	18.8	-17.1
Chile	18.1	-14.5
LatAm	17.1	-15.2
Australia	17.0	-6.4
Peru	15.3	-21.4
China	15.1	-15.1
Korea	15.1	-5.3
Mexico	13.8	-9.7
Poland	13.5	-18.6
AP ex-Japan	13.2	-10.7
MSCI EM	**13.1**	**-13.5**
Hungary	12.8	-24.6
Thailand	12.4	-4.7
Hong Kong	12.4	-13.2
Malaysia	12.4	-1.6
EM Asia	12.0	-12.2
EEMEA	11.6	-15.7
Singapore	10.5	-11.3
MSCI DM	**10.3**	**-4.9**
Philippines	10.0	-0.3
Egypt	8.5	-36.5
India	8.5	-21.5
South Africa	8.4	-15.5
Indonesia	8.3	6.9
Czech Republic	6.9	-3.3
Taiwan	6.8	-17.7
Colombia	6.3	-2.8
Pakistan	2.5	-5.0
New Zealand	1.4	5.2
Morocco	1.4	-8.5
Japan	-0.3	-12.9
Turkey	-2.7	-26.6

Source: Merrill Lynch

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