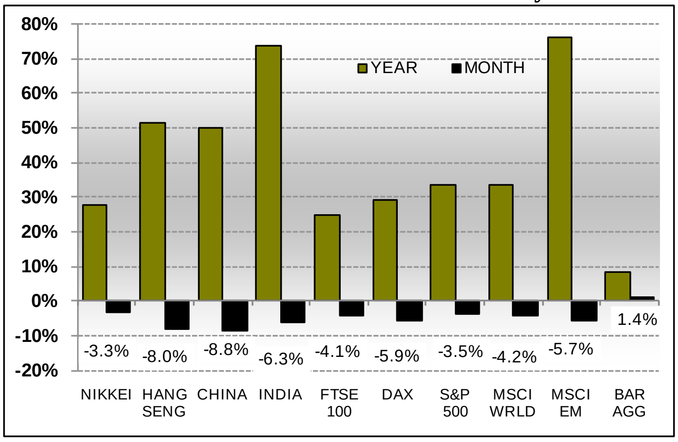
MAESTRO INTERMEZZO

Investment Letter | 10th Edition | February 2010

January in perspective – global markets

The year started off with a bang, as is so often the case in January, but the icy winds of reality soon set in and markets turned lower. Concern about the state of Greece's finances (and other European countries with similar problems) and a general fear about the immediate future of the global economy sent the euro down sharply, the dollar higher, global equity markets lower and commodity prices lower, too. The declines were exacerbated by the elevated levels of markets following 2009's dramatic recovery that had been fuelled by unprecedented levels of liquidity and low rates. The MSCI World and Emerging market indices declined 4.2% and 5.7% respectively. Hong Kong ended 8.0% lower, China 8.8%, India 6.3%, Germany 5.9%, and the US 3.5%. The bond market offered a little support, rising 1.4%, but investors there fear the massive issue of new bonds in 2010 and beyond and find the low rates rather unappealing. The gold price declined 2.3% and oil 8.3% on fears about emerging market growth. Interestingly, both platinum (3.5%) and palladium (6.6%) ended the month firmer. As a matter of interest, the base off which the annual returns to end-January are being measured moved lower -end-January 2009 was a lot lower than end-December 2008 (remember that markets troughed in mid-March) which means that the *annual* returns to January 2010 rose significantly despite across-the-board losses during the month.

Chart 1: Global market returns to 31 January 2010

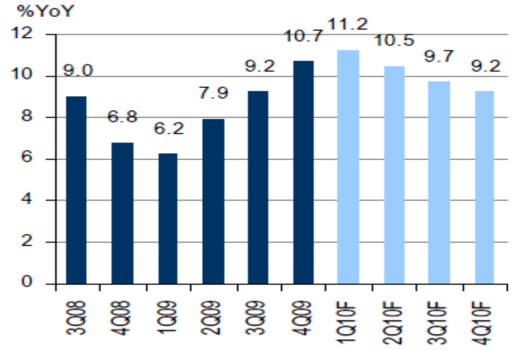


What's on our radar screen?

Herewith a couple of items that were either of significance or which we are still keeping a close eye on:

- *The German economy* fell 5.0% in the last quarter of 2009, no less than five times the worst previous contraction (in 1975) since the Great Wars. Consumer spending rose 0.4% but the latter was boosted by the government's subsidies to the auto sector.
- *The US economy* grew 5.7% in the last quarter of 2009; it grew 2.2% during the third quarter. A large part of this growth was due to a replenishment of inventories although consumer spending rose 2.0% and capital spending 13.3%.
- *The Chinese economy grew at 10.7%* in the last quarter of 2009. For the year as a whole it grew 8.7%. The annual inflation rate in December rose to 1.9%, driven largely by food prices. Urban fixed asset investment (FAI) for the year grew 30.5%. In December it grew by "only" 20.0% (annualised) which is down from the peak of 39.0% in May. Retail sales grew at an annual rate of 17.5%, which was higher than expected. The main driver (no pun intended) behind the strong retail sales continues to be vehicle sales, which rose 90.6% in the year to December. Passenger car sales grew 88.7% while commercial vehicle sales grew 97.7%.

Chart 2: Quarterly year-on-year Chinese GDP growth

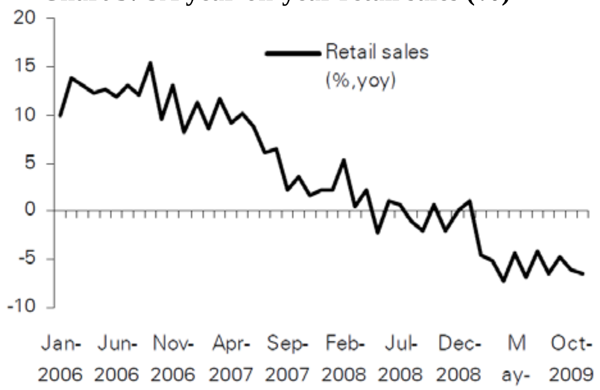


Source: Merrill Lynch

- *The SA Monetary Policy Committee (MPC) of the Reserve Bank (SARB) kept interest rates on hold* as expected. The intriguing aspect of the comment that accompanied their decision was their concern about the effects of Eskom's planned electricity tariff hike. For those who may not know, Eskom has applied to the national regulator for a 35% increase in the electricity tariff for *each* of the next three years. The MPC based their action on a belief that the tariff will rise 25% this year (the regulator has yet to make a final decision) but more importantly they noted that *there was room to reduce interest rates* but they had not done so due to the pending electricity tariff increase. By inference then, SA is being held ransom by Eskom, who has single-handedly ensured that rates are higher than what they would otherwise have been has Eskom not been so badly managed. That's quite a hard pill to swallow for the average consumer who is working hard to pay off his mortgage bond and will soon face exorbitant electricity price increases. The MPC also quietly shifted the focus of monetary policy (the level of interest rates) back onto government; if government wants lower rates, they must deny Eskom the tariff increase. There are few in SA though that don't believe Eskom will be granted a high tariff increase, which means that SA interest rates will remain high and may even have reached their trough this cycle despite the fact that, even by the MPC's own admission, there is room to cut rates further.

- The SARB's MPC also tabled their SA GDP forecasts. They see *the SA economy growing at 2.0% in 2010 and 3.0% in 2011.* Separately, SA retail sales during November declined 6.6% year-on-year. The only sub-sector (of six sectors surveyed) to post an annual *increase* was the pharmaceutical sector.

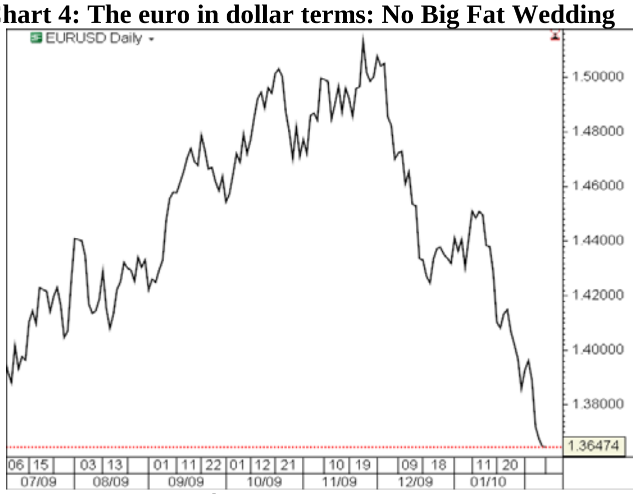
Chart 3: SA year-on-year retail sales (%)



Source: Deutsche Securities

- A factor behind the strength in the platinum and palladium prices in January was *the launch of the first US Exchange Traded Funds (ETFs) for each of these metals*. Similar to the gold ETF, these ETFs will physically buy the underlying metals which will then be held in vaults in Switzerland. It will be interesting to see how much money flows into these new funds. According to the World Gold Council inflows into the gold ETF during 2009 alone saw the Fund increase its physical holdings by 573 tonnes, bring the total amount of gold held to record 1 762 tonnes. One of Maestro's reservations about the gold price is what will happen when these investors (into the gold ETF) want to redeem their investment? The ETF will have no option but to sell the gold, irrespective of the prevailing market conditions. We will keep you posted about the progress on the platinum and palladium ETFs.
- *Greece:* What can we say about Greece that hasn't been said already? Not much, other than to note that it has been the focus of global investors ever since Dubai rocked the world in November by effectively declaring a debt moratorium. In a nutshell, global investors are concerned that Greece's debt is too high and that the government has lost control of its spending. In "economic speak" its deficit is too high and investors fear it has neither the political will nor ability to rein in its spending. There are two complicating factors: firstly nobody seems to know what Greece's actual deficit is – not even themselves, which shows what disarray their finances are in. Even when Greece declared what they believe their deficit to be - Prime Minister Papandreou recently announced that the 2009 public sector deficit would be around 13%, more than double what had previously been feared - no one believed them. Even the European Commission went on record as saying they have no faith in Greece's data – eina! The second complication is that Greece, for better or for worse, is now part of the European Union (EU), which means it shares the same currency as other countries who are in better shape and whose fiscal house is in order, such as Germany and France. In the "old days" the Greek drachma would simply have collapsed, but it can no longer do so because it doesn't exist. But the euro does; hence the enormous pressure on it as the Greek situation weighs on it.

Chart 4: The euro in dollar terms: No Big Fat Wedding

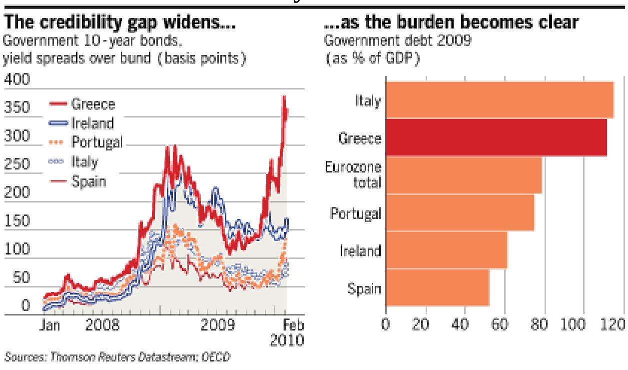


Source: Saxo Bank

But it gets worse; it is well known that Greece is not the only EU member whose economy is troubled by high debt (deficits) and uncontrollable spending. Spain, with an unemployment rate well above 20%, Portugal, Ireland and Italy all belong in the EU "sick bay". Portugal's budget deficit is 9.3% of GDP and Spain's 11.4%; of course that excludes the external debt that the respective countries owe (see Chart 5). To date only Ireland has taken the measures – pretty drastic ones at that – to rein in spending and reduce its deficits. The irony is that while investors have fled to the dollar for safety, many US states – California is a prime example – are in a similar state to Greece, if not worse. The US deficit on its own, for example, was 9.9% last year. Yet another example of just how irrational markets can be at times.

For the record, Greece's economy constitutes only 2.5% of the whole of the EU. Its current account deficit peaked close to 15% in 2007 and government debt as a percentage of GDP sits at 110%. In response to the crisis Greece has tabled a plan to reduce its deficit from 12.7% currently to 3.0% by 2012 but few believe this is even remotely possible.

Chart 5: The EU sick bay – the so-called PIIGS



Source: Financial Times

All that glitters is not gold

There were times last year when the gold bulls got very excited, particularly when the gold price reached an all-time record of $1 226 in December. But with a little time and some concrete information comes the opportunity to review the factors driving the price, specifically with a view to establishing how sustainable the price is. It has now been established that investors bought three times more gold than buyers of jewellery for the first time in three decades. Investment demand for gold more than doubled to 1 820 tonnes (much of it into the gold ETF referred to above) while jewellery purchases declined 23% to 1 687 tonnes, a 21-year low. Hardly, at least in my opinion, the stuff of which sustainable bull markets are made. We know from previous behaviour that demand for jewellery is price sensitive, which means that investors and their sentiment are becoming an increasing influence in determining the level and direction of the gold price. The fact is, the latter is more difficult to predict and besides, what happens when sentiment or macro-economic conditions change for the worse? Surely more than a fair share of those1 820 tonnes will return to the market.

With respect to the supply of gold, in 2008 we alerted you to the fact that, after being the world's top producer of gold for more than a century, South Africa was relegated to second position in 2007 by, well ... China, of course. But thanks to a 5% decline in production last year, SA now occupies third position, having been overtaken by Australia last year.

Chart of the month

Before we get to this month's Chart I draw your attention to Table 5 at the end of this Report, which depicts returns for the decade. I am sure you will find it very informative.

Table 1, below, lists inflows into mutual funds across the world. The 2009 inflows are those you should concentrate on; note the huge dichotomy between inflows into emerging markets ($64.3bn) and the outflows from developed markets (-$45.1bn). No wonder we saw the disparity of returns were did between these two categories of markets in 2009.

Table 1: Net fund flows into EM and DM ($m)

	YTD	2009
Total EM	**4,724**	**64,278**
Global EM Funds	3,227	34,471
Asia	642	19,107
EMEA	446	2,012
LatAm	408	8,687
Brazil	159	5,148
Russia	302	2,019
India	188	2,843
China*	-345	7,550
Taiwan	-11	127
Total DM	**-5,964**	**-45,093**
US	-6,717	-42,084
Japan	768	-5,278
Europe	12	204
International	**1,016**	**18,403**
Total Global	**-225**	**45,938**

Total Global = EM + DM + International
Total EM = Global EM + Asia + EMEA + LatAm
* includes Greater China

Source: Merrill Lynch

A few quotes to chew on

Responding to questions about China's relationship with the rest of the world and how the west should accommodate Chinese power, Madam Fu Ying, the outgoing Chinese ambassador to the UK responded as follows: *"You have your standard (in the west) and you use that standard to measure China, and every time you find that China does not fit that standard. But China is never going to, is it? China has a long history of its own, the only continuous culture in 5 000 years. But it also has about 200 years of a very sad history, with foreign occupations. That hurt China. That's why the Chinese remember the suffering more than the victories. China has a strong sense of crisis … Premier Wen Jiabao said China will never be a hegemon. If one day China becomes one, the world will stand up against China. That is very deep in our hearts. Every diplomat knows that. The west should calm down and see China for what it is, not keep speculating and putting their own colour into this painting. A Chinese painting is water colour: fresh, very light. If you pour oil on it, you don't see the painting anymore."*

One notable omission from the BRIC bandwagon in terms of economic performance has been Russian – the "R" in BRIC. People are increasingly questioning whether we should not rather talk of the BIC countries? At a recent investment conference in Russia, a pension fund manager summed it up nicely: *"Russia defaulted in '91, restructured in '95, defaulted in '98, took assets away from Yukos, from*

Shell and then BP. If you complain, you get expelled from the country and then if you continue to complain you may die in London from polonium poisoning, or die in pre-trial detention in Russia. Now tell me: why should I invest in Russia?"

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

Table 2: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	Jan	**-4.6%**	**-4.6%**	**23.7%**
Maestro equity benchmark *	Jan	-2.5%	-2.5%	34.8%
JSE All Share Index	Jan	-3.5%	-3.5%	33.2%
Maestro Long Short Equity Fund	Dec	**4.4%**	**13.7%**	**13.7%**
JSE All Share Index	Dec	3.0%	32.2%	32.2%
JSE Financial and Indus 30 index	Dec	2.9%	29.3%	29.3%
Central Park Global Balanced Fund ($)	Dec	**-1.5%**	**12.1%**	**12.1%**
Benchmark**	Dec	0.6%	15.9%	15.9%
Sector average ***	Dec	0.3%	23.3%	23.3%

* 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 ($)

As is our habit we list in Table 3 the returns achieved on the equity portfolios under our management. It is clear that we have struggled a bit in the past year to beat the All share index returns. There are a few reasons for this, the largest of which is simply that market conditions have been such that company differentiation has played very little role in the returns over the past year or two. In other words, the value of "stock picking" as a strategy has declined during this period with the market being driven more by fear – the so-called "risk trade" – and global factors than specific local economic developments. Another reason for our "average" returns has been the fact that we have been too conservative; by that I mean we continue to invest in companies we believe will produce great returns in the long-run; companies that are characterized by reasonable valuation levels, excellent management, strong balance sheets and earnings prospects, and preferably where management have material stakes in the business. But these are not necessarily the companies that have produced the best returns in the past two years. Rather, it has been those which declined the most in the market downturn to mid-March 2009 and which are the most highly geared i.e. the companies that have a lot of debt and the weakest balance sheets. We have taken cognizance of the prevailing and recent market conditions, but believe we will return to a more "normal" market wherein the selection criteria we hold dear and rate highly in our investment decision making will again be appreciated by the market in general.

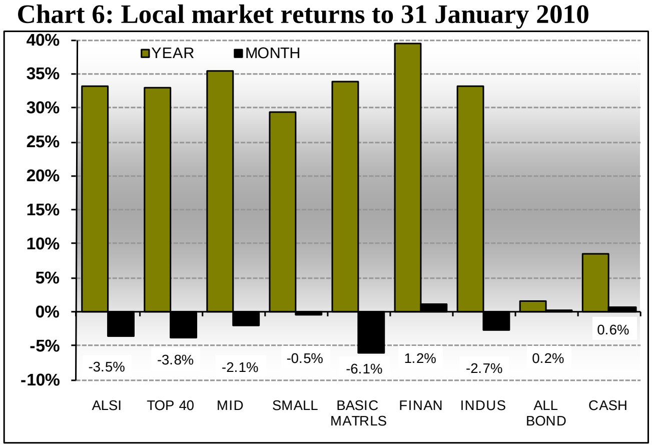
Table 3: Maestro annual returns to 31 Dec 2009 (%)

SA equity returns	6m *	1 yr	2 yrs	3 yrs	5 yrs	7 yrs
Maestro long-term equity portfolios	*21.4*	*30.2*	*-2.4*	*6.5*	*19.5*	*24.3*
Maestro Equity Fund	*16.8*	*25.3*	*-3.9*	*4.2*	*N/A*	*N/A*
Maestro equity benchmark **	26.3	30.7	1.6	5.9	18.5	20.4
JSE All Share Index	26.9	32.1	0.7	6.5	20.2	20.3

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

January in perspective – local markets
The negative sentiment in the international arena weighed on the local market, resulting in them mirroring their offshore counterparts. The All share index fell 3.5% while the All bond index rose 0.2%. The basic material index led the decline, ending 6.1% lower although financials actually posted a rise of 1.2%. Industrials fell 2.7% and mid and small caps ended down 2.1% and 0.5% respectively. The gold index declined 8.3% despite the rand falling 2.4% against the dollar. Within the JSE sectors the bank index rose 4.3% while the fixed line telecoms index (Telkom) fell 11.4% and media (mainly Naspers) 9.6%. Given the weak rand the All share index declined 5.8% in dollar terms which was not out of line with other emerging market dollar returns – refer to Table 4 at the end of this report.

Chart 6: Local market returns to 31 January 2010



Why we love this job – Part 4
Let me begin this section with an apology: I'm sorry if I sound like a stuck record, "riding my hobby horse" month after month with evangelical fervour. It's just that I feel so strongly about it – if fact all of us in the Maestro team feel strongly about it - I would hate you to ever turn around one

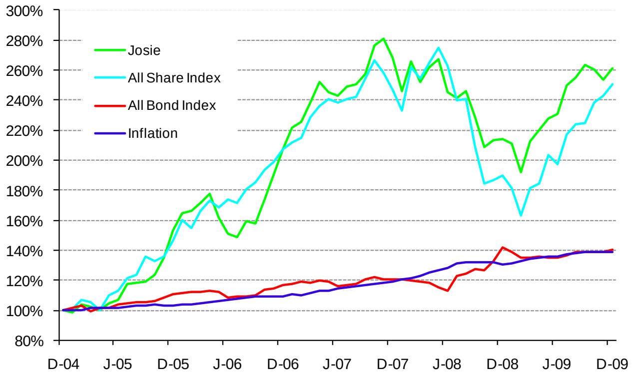
day and say "why didn't you ever tell me?" Few of us that are approaching, or are over, the "50-year old" mark had the benefit of wise words like these; and we at Maestro would hate to repeat that travesty. So we continue to preach about the merits of long-term investment to all who will listen. The essence of this sermon is **the power of long-term investment**. It matters *less* whether you invest in Fund "X" or Fund "Y" (although it would be nice if you consider the Maestro Equity Fund as the vehicle); it matters *more* that you invest; and that you start early. And you need to retain your money in the market – for a long time … which brings me to the subject of this month's "Why we love this job".

I write as a father, firstly, and then as an investment manager. I am frequently asked by other parents how to best teach their children about investing and the markets. Let me share my own experience with you. I do so very tentatively and humbly, knowing that there are many other ways of achieving the same goal. This may not work for every parent and family, but it has worked for us – at least so far. And a whisper to slightly older readers: before you switch off and skip to the end of this section, do you have grandchildren? Why not reach out to them with the same message? What a wonderful journey to embark on with them – and it comes with lots of fun thrown in as well as some spectacular long-term benefits. Here we go then:

A few years ago I decided that on my children's respective birthdays I would "invest" R500 into a "portfolio" for them. In addition, at Christmas time I would "invest" an additional R500 for them. I use inverted commas because at this stage I invest in a "paper portfolio" only although the day will come when I will physically invest the funds for them – at this stage the brokerage is too expensive on such a small sum of money. The portfolio will remain invested for them until they turn 21, at which stage they are free to do with it as they please. My hope is that they will retain the portfolio in its then-prevailing form, but let's see what happens.

The fun part is this: I give them a selection of shares in which to invest - I screen them first and oversee the process to ensure that, over time, a properly diversified portfolio is put in place. Each month they sit with me and update the portfolio on a spreadsheet we compiled together and compare its monthly performance against the returns of cash, the All bond index and the All share index. The spreadsheet contains a comparative graph which we compiled together from which it is easy to see "who is winning the race". Chart 7 is lifted straight from Josie's spreadsheet – excuse the weird colours, but that's what she chose (and she changes them every year – eek!) To retain their interest, I promised them that they can get all the dividends that are paid out of the portfolio and spend it as they wish. However, from the age of 13, the dividends must be reinvested into the portfolio.

Chart 7: Example from my children's spreadsheet



And that's it. It sounds simple, which it is, but we have had a lot of fun and learnt a lot together month by month. Some of the lessons, which we do well to remind ourselves of as adults, are as follows:

- Markets go up and down.
- There is life after a negative return in the market.
- Over time the dividend payouts get bigger and bigger
- Your money grows over time, despite suffering the odd negative monthly return.
- It's fun when you outperform the All share index
- Over time your portfolio grows much faster than inflation.
- And, so far at least, the share market has done a lot better than the bond market.

It is so refreshing to see how children learn, relate to and comment on these important lessons. And they relate to the portfolio in different ways as they grow older. As the value of the portfolio rises and they get a bit older, they suddenly realize the value of, say, R10 000 and then start to take the exercise a bit more seriously. There are months when boredom and indifference creeps in, but the rules are clear: if no interest is shown in the portfolio it reverts "back to dad". And the cash from the dividends does not flow to them unless their portfolios are updated. It is amazing how this focuses their minds.

Here are some little anecdotes from our experience so far:

- True to form, the first share my daughter selected from those I offered was … MTN. I mean, what else would a 6-year old little blonde relate to?! That was in March 2004 when the price of MTN was R25.00. Today it is R110.80 and that excludes the dividends she has received since buying the share.
- Then she selected (from my pre-selection) Mr Price. You know, girls, shopping, etc? That was in December 2004 when Mr Price's share price was R10.00. Today it is R36.42. And of course she's enjoyed the dividend flow since then, too.

- But part from the actual shares, both her and my son's portfolios are growing in size. To save embarrassing them and in the interest of client confidentiality of course, I won't disclose their actual size, other than to say they are already "meaningful".
- Most importantly, last year my daughter received R293 in dividends and my son R282 - not bad when you consider that we began by investing only R1 000 a year less than six years ago.

And that, dear friends, is why we love this job! Despite not beating the All share index *every* year and despite having endured the worst financial crisis in their (and my) lifetime, the money has grown significantly and is generating a rising income stream. The moral of this story? *The benefits of long-term investment cannot be underestimated, especially when you start early. The earlier, the better.*

Okay, I hear you say, "I don't have the knowledge to select shares." Fair enough, but you can invest R500 in the Maestro Equity Fund for your children or grandchildren and the sky is the limit when thinking up ways to make it interesting for them along the way, sticking to the "rules of the game".

Is it really worth it? I think so. Firstly it will teach them the power of investment and secondly it could help them provide for their retirement one day – and that's an incredible head start for your children. You think I'm joking? Hear me out: starting with R10 000, which is close to the current value of the portfolios, continuing with an annual investment of R1 000 as we have been doing until now and assuming a total return of 10% per annum, the value of the portfolio will have grown to R36 159 by the time they turn 21. Not a bad 21st gift I suggest (which of course cost far, far less than that!). But let's say the market delivers 15% per annum and not 10% between now and my son's 21st i.e. in eight years time. The value of his portfolio would have risen to R37 231, not too much of a difference I agree. But hear me out: if I can convince him to continue investing R1 000 into his portfolio after his 21st birthday and to retain the existing portfolio i.e. not withdraw any funds until he turns 40, and then leave it to grow until he is 65 i.e. retirement age, then a 15% annual total return would increase his portfolio to R3.1m – not bad for an investment of less than R40 000. And my last snippet on this topic: if the total return of the portfolio over that time proves to be 17.5%, which is what the SA equity market has delivered over the past 40 years, the value of his humble portfolio which we started together when he was only 6 would have grown to R27.2m – and that's enough for both him and I to retire on! As they say in the US, "Go figure …"

File 13 – things almost worth remembering

This edition of *Intermezzo* is getting long and I am very conscious of taking up more of your valuable time. Much has been said within the debate surrounding bankers' bonuses; we have our own view but this is not the place to share it. Suffice is to say that we regard it as "the ugly face of capitalism" and are rather ashamed to even be (incorrectly) regarded by some as operating in the same profession (of financial services). A number of facts inform our views. Let me share only one with you: to put the estimated $20bn bonus pool Goldman Sachs is planning to pay to its employees this year alone in perspective, let me remind you that it is way above the total NASA's 2009 Budget of $17.8bn and more than forty (40!) times the emergency fund that the United Nations struggled to collect for the victims of the Haitian earthquake. And that is just *one year's* bonus pool for Goldman Sachs – how did we ever arrive at a situation like this?

Table 4: MSCI returns to January (%)

	Jan'10	2009
Egypt	7.3	32.8
Morocco	4.3	-8.3
Chile	3.1	81.4
Russia	2.4	100.3
Turkey	2.3	92.0
Colombia	2.2	76.5
Czech	2.0	19.6
Indonesia	2.0	120.8
Japan	1.9	4.4
Pakistan	1.4	78.1
Hungary	0.7	73.9
Israel	0.3	51.3
EMEA	**-0.7**	**63.5**
Malaysia	-0.9	47.8
Poland	-1.1	37.3
Argentina	-3.2	61.1
MSCI DM	**-4.2**	**27.0**
Korea	-4.9	69.4
India	-5.3	100.5
Thailand	-5.3	70.0
South Africa	-5.4	53.4
MSCI EM	**-5.6**	**74.5**
Philippines	-5.9	60.2
Singapore	-6.0	67.3
Mexico	-6.2	53.1
AP ex Japan	**-6.4**	**68.4**
Taiwan	-6.5	75.1
Hong Kong	-6.6	55.2
Australia	-7.0	68.8
China	-8.6	58.8
LatAm	**-8.9**	**98.1**
Peru	-10.1	69.3
Brazil	-11.0	121.3

Source Merrill Lynch

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20 years to the day ...

All but a few living in South Africa today cannot but get a lump in their throat when they think back to the event we witnessed, exactly 20 years ago, which fulfilled the dreams and prayers of millions, gave birth to hope, put the past behind us (at least to some extent) and irrevocably changed the course of South Africa. Of course I refer to 11 February 1990, when the man no one had seen in public since 1964, strode out into the glorious South African sunshine and into a new life of freedom.

There is so much to write and share about this moment, and the man, that it is easier to let the pictures do the talking.

Table 5: Annualised monthly total returns by asset class and decade (%)

Decade	S&P 500	Small Cap	Govt Bonds	Corp Bonds	Cash	Copper	Real Estate	US CPI
1930's	-0.1	1.4	4.9	6.9	0.6	-3.6	-1.2	-2.0
1940's	9.2	20.7	3.2	2.7	0.4	4.1	8.1	5.4
1950's	19.4	16.9	-0.1	1.0	1.9	6.0	3.0	2.2
1960's	7.8	15.5	1.4	1.7	3.9	4.7	1.8	2.5
1970's	5.9	11.5	5.5	6.2	6.3	7.1	8.0	7.4
1980's	17.5	15.8	12.6	13.0	8.9	0.4	6.6	5.1
1990's	18.2	15.1	8.8	8.4	4.9	-2.8	2.5	2.9
2000's	-1.0	5.2	7.7	7.5	2.8	13.7	4.3	2.6

Source: Bloomberg; Ibbotson; BofAML Investment Strategy

Notes: Real Estate based on Case Shiller annual data 1930-1999, monthly data thereafter (updated as of October 2009); CPI data as of November 2009; Corporate bonds are high grade

Source Merrill Lynch