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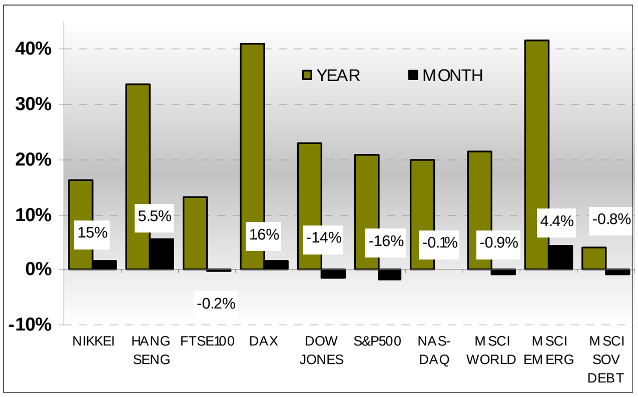
June in perspective – global markets

Global markets displayed a significant degree of volatility during June, with few developed markets posting positive returns. The Japanese and Hong Kong markets posted gains but other developed markets registered declines, resulting in the MSCI World index losing 1.9% in June. In contrast emerging markets posted solid gains – Russia rose 6.6% assisted by a stronger oil price. The MSCI Emerging market index ended up 4.4%. The dollar weakened against most currencies and the oil price rose 5.9%. Precious metals ended the month slightly lower. Although they ended off their lowest levels, global bond markets had a torrid month, plagued by ongoing woes in the US sub-prime market.

Chart 1: Global market returns to 30 June 2007



US sub-prime woes rear their ugly head – again.

Not for the first time, the ghost of the US sub-prime market reared its ugly head. While the effect was the same as last time – the sharp decline in credit (bond) markets having a noticeable impact on global equity markets – the source of the "wobbles" was different this time. To re-cap, the sub-prime market refers to the practice by banks of extending credit to those who cannot, or who can least, afford it. As the US economy has slowed and the effect of higher interest rates gained traction, so borrowers, who should really not have received finance in the first place, have started defaulting on their loans. The rapid deterioration in the US housing market, which experienced bubble-like conditions until about a year ago, has not helped matters, as the market value of many houses involved in the sub-prime market is way below the price that was paid for them. So, borrowers cannot afford to maintain their mortgages, they cannot afford to repay them, and the underlying security is "not worth the paper it is written on" so to speak.

Enter the credit market, which until about a year ago had enjoyed favourable conditions. Assisted by huge inflows into credit markets and inventive means to "repackage" and distribute such loans, the latter gave rise to a proliferation of new products, including collateralised debt obligations or CDOs, many of which were backed by sub-prime mortgages. Many of these products were taken up by hedge funds active in the credit market arena.

Coming back to the source of the credit market wobbles of June, Bear Sterns went public on the fact that two of their hedge funds, refuted to involve billion of dollars, had posted significant declines. One of the funds (the one with less leverage, at "only 5.8 times!), was called the High Grade Structured Credit Strategies Enhanced Leverage Fund (*Ed*: if that didn't scare away investors, nothing ever would!). It had access to over $9bn of credit, extended by some of the largest names in the investment banking business. Bear Sterns initially announced that the Fund had declined 7% in April but later increased the estimate to 23%. They also announced that they would commit $3.2bn in loans to the less-geared of the two funds, but had intention of stepping in to resuscitate the more leveraged one. That was enough to spur the investment banks into action: Merrill Lynch set about seizing $850m of the Fund's assets with a view to selling them. Deutsche Bank seized $350m and JP Morgan followed suite. It was reported that when Merrill Lynch auctioned the better (of a bad bunch, that is) quality bonds, they attracted fire-sale type prices; the majority of the bonds apparently attracted *no* bids at all!

Three days later Caliber Global Investment, a $908m hedge fund, announced that it was closing, following significant losses in the US sub-prime market. Earlier in the week, Queen's Walk Investment, a hedge fund run by London-based Cheyne Capital Management, disclosed a $91m loss, partly due to the slump in the US sub-prime market.

Without going into more detail, you will understand that June was not a pleasant month in the credit market and why equity and credit (bond) markets have become a bit more nervous. I don't think we have heard the last of the sub-prime woes, so watch this space…

Chart of the month

I don't claim to be an expert in credit instruments and I certainly don't follow specialised areas of that market very closely. However, in many of the articles I have read about the sub-prime market, the chart below has been referred to a number of times: it depicts an index of a tranche of low-quality, BBB-rated bonds, where AAA represents the best quality. From the chart it is clear that the initial trauma started in February, although we saw another down-leg in this ongoing saga in May and June. I understand that similar indices have fallen more than 60% so far this year. The index in Chart 2 is down "only" 45% so far this year!

Chart 2: ABX index of a tranche of low-quality bonds

Source: markit.com

A cheeky comparison to illustrate a value

In a not-so-subtle attempt to focus on Maestro's hedge fund that was established at the beginning of July, I want to use a cheeky comparison to illustrate a value that is very dear to Maestro. The value is simply this: ***we honour our clients***. Implicit in this value are many consequences for Maestro, not least in the way we manage their assets and in the way we respect their trust in us. That may sound all well and good, but it is difficult to illustrate this value without using hard data. Consequently I would like to compare a recent *global* hedge fund that we reviewed to the **Maestro Long Short Equity Fund**.

In order to place the comparison in perspective, please understand that my actions are in no way meant to slander the hedge fund in question – let's refer to it as the ABC Fund. I am in no way implying that the vendors are being dishonourable in the manner in which they have put their fund together. The fact that I have selected the ABC Fund is coincidental; it just happened to be the most recent fund we looked at. We considered investing in it via Central Park Global Balanced Fund, as we found many of its features attractive. In the end, however, we decided against investing in it. But most, if not all, of it's salient features are fairly standard; you will find similar structures and terms in most hedge funds open for investment today.

Now back to Maestro's value of *honouring the client*. One of the implications of this subtle but important value is that clients need to understand that **we work in their best interests at all times**. We do not rip them off with high, undisclosed fees; we do not take soft commissions or backhands and at all times we seek to align their interests with ours. Maestro does not sell products - rather, we provide a service - but there are times when products are the best means to an efficient investment vehicle. For that reason we have established three of our own products. Even in their construction though, we seek to be as reasonable as possible and show, through our actions, that we honour our clients. Maestro itself has made significant investments into each of the products. We will therefore also experience the benefit of working in the client's best interests.

Enough talk; let's look at the numbers. The ABC Fund is in the process of raising its first assets. The vendors have already received commitments of R350m so I have used this size for comparative purposes. Although we do not for a moment expect the Maestro Long Short Equity Fund to reach this size any time soon (it would be nice of course!) I have used the same size in order to make the comparison more meaningful. Table 1 lists some of the fees in *percentage* terms, thereby providing a simple comparison.

Table 1: Fees - at first glance

	ABC Fund	**Maestro Long Short Equity Fund**
Establishment costs	R2.8m	Maestro bore all the establishment costs. The Fund thus bears none of these costs
Initial (upfront) fees	5.0%	0.0% (Nil)
Annual investment management fee	2.0%	2.0%
Annual performance fee	20.0% of increase in NAV in excess of LIBOR (about 7.0%)	12.0% of increase in NAV, of which 3% goes to charity and only 9% to Maestro
Annual custody fee	0.2%	0.18% excluding a meaningful first year concession

On the basis of Table 1 the fees attached to the Maestro Long Short Equity Fund are clearly lower. So on the face of it we seem to be living up to our value. However, as is so often the case, when you dig a bit deeper other fees start to emerge, which at the end of the day start adding up rather quickly. And when you have finally read all the fine print, it becomes apparent just how much money an organization that works in your interests can actually save you.

Consider Table 2, which now lists **all** the fees, this time in *rand* terms, still based on a Fund size of R350m. The table excludes performance fees (listed in Table 1), the cost of borrowings on any leverage, and trading or brokerage costs. The latter are a function of how actively the assets are traded and are thus difficult to estimate. As an aside, Maestro would humbly submit that its trading fees are comparatively low due to the low turnover in the portfolios under our management. In fairness ABC's Fund has some unique features, and thus costs, that Maestro's Fund will not incur, such as shipping and insurance, but look at the data and draw your own conclusions.

Table 2: Fees - after reading the fine print

Fees payable by the Fund to:	ABC Fund	Maestro Long Short Equity Fund
Investment advisor	R7m	R7m
Administrator	R700 000	R580 000 (excl first year concession)
Custodian	R350 000	R35 000
Auditors	R210 000	Maximum of R25 000
Transaction charges	R54 600	Nil
Shipping	R1.19m	Nil
Insurance	R868 000	Nil
Directors fees	R1.12m	Nil
Directors insurance	R175 000	Nil
Advisory board	R595 000	Nil
Listing fees	R100 800	Nil
Independent valuer	R210 000	Nil
Directors travel	R350 000	Nil
Risk advisors	R70 000	Nil
Annual total expense ratio (TER)	**3.7%**	**2.2%**

For the record

Table 3 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. I have included an annual return in the table for the first time i.e. the most recent return over the past twelve months. Returns include income and are presented after fees have been charged.

Table 3: Returns of funds under Maestro's care

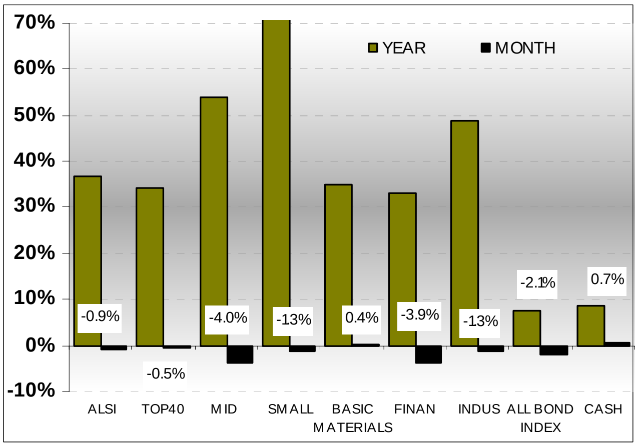
	Period ended	Month	Year to date	Year
Maestro Equity Fund	June	**0.3%**	**16.1%**	**39.4%**
Maestro equity benchmark *		-1.3%	11.0%	37.1%
JSE All Share Index		-0.9%	15.1%	36.9%
Central Park Global Balanced Fund ($)	May	**1.4%**	**6.6%**	**13.9%**
Benchmark**		1.1%	5.6%	13.7%

* 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

June in perspective – local markets

Similar to the global experience, June proved to be a tough month in local equity markets. A higher degree of volatility was evident although the market did well to contain its losses. Were it not for ongoing demand for commodity (resource) shares, particularly from global investors, the market would have ended a lot lower. Despite the 0.9% rise in the rand, admittedly against a weak dollar, the basic materials index rose 0.4% and was the only major index to rise during the month. Financials, down 3.9% after a similar decline in May, were not so lucky. For once the mid (-4.0%) and small cap (-1.3%) indices posted declines although their respective annual returns to end-June of 54.0% and 71.3% remain quite remarkable. Amongst the best performing sectors in June were beverages up 4.4% and fixed line telecoms 4.0%. The gold index declined 7.6% and general retailers 9.0%. Given the torrid time experienced in the global bond market the All bond index decline of 2.1% is unsurprising. Its annual gain is now a lowly 7.7%, which compares with the gain in the All share index of 36.9%. You might be interested to know that the 10-year compound annual (rand) return of the All share index to June is 17.6%, that of bonds 14.5%, cash 11.6% and inflation 6.5%.

Chart 3: Local market returns to 30 June 2007



File 13: Interesting information, but worth forgetting

As all South Africans will know the country was recently plagued by striking government workers, predominantly teachers and health workers. Although the strike has all but run its course, at its peak I couldn't help drawing parallels between a simultaneous strike in Germany. The parallels are not exact, but should place the SA strike in perspective. At the heart of the comparison is the remarkable difference between developed and developing (emerging) countries.

The SA strike was about labour rates and working conditions. Government had tabled a 6% wage **increase;** unions arrived with a demand of a 12% increase. The final offer by government was for an average 7.5% increase, together with concessions such as docking striking workers' pay over three, as opposed to one month, to issue final warnings to essential workers, who are legally not allowed to strike, instead of dismissing them, and an increased housing allowance from R456 to R600 ($86) per month.

Workers at Deutsche Telekom (DT), still 15%-owned by the German government, had embarked on a five-week strike. At issue was the fact that their employer planned to **cut** wages of between 50 000 and 160 000 workers by 12%. In the end, workers agreed to a 6.5% pay cut. They were also able to secure concessions such as cash compensation payments as the work cuts began to bite and job guarantees until 2012, but not before DT secured a 10% rise in working hours. Effectively, working longer for less pay means that workers' pay per hour will decline about 17% in stead of the 20% implicit in DT's initial proposal. DT estimates this will save about $920m by 2010, although DT has targeted a $6.8bn cut in costs by 2011 and still plans to shed another 30 000 jobs before 2011.

The official unemployment rate (September 2006) in SA is 25.5%. Unofficially, the rate varies, depending on who you speak to, between 30% and 40%. Two of largest allocations in government expenditure have consistently been for education (20% of total government spending in 2007/8) and health (12%). Sadly, these departments remain in terrible disarray.

The official unemployment rate (June 2007) in Germany is 9.1%, currently at a nine-year low. As they say in the US, "go figure"…