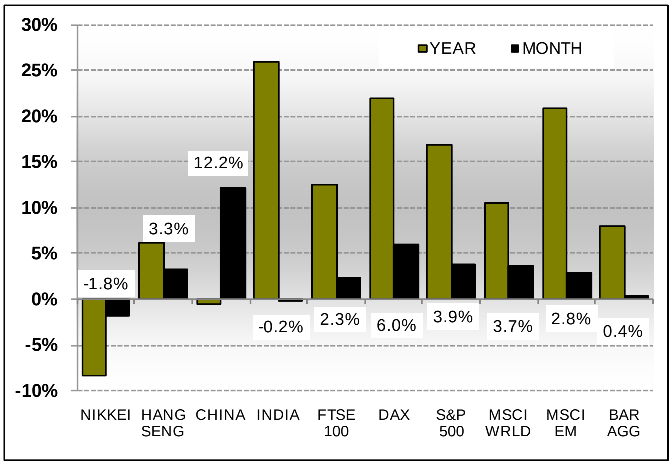
MAESTRO
INTERMEZZO
Investment Letter | 10th Edition | November 2010

October in perspective – global markets

As you are aware by now, investment markets continued their Fed-induced charge into October, although an air of caution appeared late in the month, which tempered the returns somewhat. The returns were still positive but less so than in September, which you will recall, went down as one of the most profitable months in the market ever. For a change, developed markets were more profitable than emerging ones: the MSCI World and emerging market indices rose 3.7% and 2.8% respectively, but the annual returns tell a different story, having risen 10.5% and 21.0%. Within the developed markets, the German market rose 6.0% despite the euro's strength against the dollar. Within emerging markets China enjoyed a splendid month, rising 12.2%, having lagged very badly so far this year. China's annual return of -0.6% is the only notable market which is still in the red; how ironic is that, given that it is one of the strongest growing economies in recent times!

Chart 1: Global market returns to 31 October 2010



The Fed's promise of more liquidity to the financial system (so-called QE2) may have kept the market bubbling, but it also increased the pressure on the dollar, despite all their jaw-boning about a "strong dollar policy". The euro and sterling rose 1.8% and 1.5% against the dollar, but more importantly the dollar weakness continued to exert upward pressure on commodity prices and emerging market currencies. Higher commodity prices are bringing unwanted inflationary consequences on all countries but particularly emerging markets, who can least afford them. By way of example, the October price increases in copper, palladium and silver were 2.1%, 11.7% and 8.9% respectively. The annual price increases in palladium and silver now stand at 97.5% and 44.6% respectively. At the time of writing copper has just risen to a record of nearly $9 000 per tonne, making it the first major commodity to surpass its 2008 peak. Before the start of the current boom in 2004, copper traded below $2 000, and has risen nearly 50% since June. China accounts for about 40% of copper demand.

Food prices are also being affected by the weak dollar, as well as by unusual weather conditions, speculative investor activity and policy changes within certain countries, all of which are aggravating the situation. The price of coffee recently rose to a 2-year high on the back of the lowest level of stocks since records began in 1960. Subsequent to the end of October, the price of sugar reached a 30-year high of 33.39 pence per pound, before experiencing the biggest sell-off in 30 years, collapsing 23.5% in two days. This kind of movement goes to show some of the volatility in food and other commodity prices; the weak dollar is a major factor behind this inordinate volatility.

Charts of the month

Having referred to the increase in commodity prices on the back of, inter alia, the weak dollar, without adding further comment, throughout this edition of *Intermezzo* we have plotted a few charts of selected commodities.

Chart 2: Corn prices

$ per bushel

Source: Gluskin Sheff

What's on our radar screen?

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

- *The SA economy:* there is a lot to report on this month with respect to the SA economy. Inflation dropped to its lowest level in five years, with prices rising only 3.2% in September from 3.5% in August. The Minister of finance, Pravin Gordhan, tabled the Medium term budget policy statement (MTBPS) late in October. It contained a number of significant announcements and was favourably received by the markets. The expected budget deficit was reduced to 5.3% of GDP, thanks to a cut in expenditure and a R30bn tax overrun which will be used to boost the country's foreign exchange reserves. Government's economic growth forecasts for 2010 were increased from 2.3% to 3.0% and to 3.5% in 2011 and 4.1% in 2012. Some exchange controls were lifted as part of the ongoing liberalization of the exchange control regime; noteworthy was the lifting of 10% exit levy on "blocked rands" and the change in foreign allowances to natural persons from a once-off R4m per natural tax payer to R4m per annum.

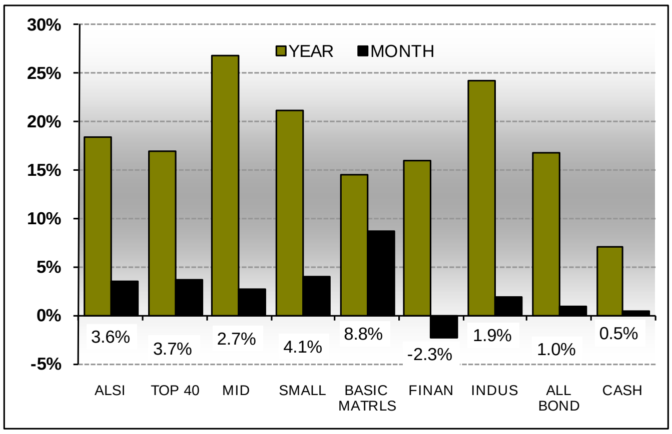
- *The US economy* grew at a rate of 2.0% in the third quarter, marginally higher than the 1.7% in the June quarter, although 70% of this growth came from an increase in inventories and not final demand. Real final sales only rose 0.6%. It is fair to say therefore, that it will not take much of a decline in inventories during the last quarter to bring about a decline in the growth rate, unless of course there is a strong rise in final sales.
- *The Indian and Australian economies***:** the Reserve Bank of India raised interest rates by 0.25% to 6.25% in early November and the Reserve Bank of Australia raised their rates by a similar amount to 4.75%.
- *The Chinese economy:* the Chinese economy and policies remain a key focus of investors and recent weeks have provided lots of food for thought. The economy grew by 9.6% in the September quarter, down from the 10.3% in the previous quarter. October inflation rose to its highest level in two years, to 4.4% from September's 3.6% and above the authorities' target level of 3%. China increased interest rates in October by 0.25% and also recently raised reserve requirements for banks. Industrial production rose at an annual rate of 14.1% in October (13.3% in September) while retail sales rose by 18.6% (18.8%).

Chart 3: The tin price
US cents per pound

Source: Gluskin Sheff

October in perspective – local markets
Similar to offshore markets, the SA equity market posted another positive month, despite September's huge returns. Although the rand firmed 0.3% against the dollar the positive sentiment towards the global economy led to a large gain in the basic material index. It rose 8.8% on the month, in stark contrast to the -2.3% and 1.9% returns of the financial and industrial indices. One should remember though that the basic material sector has lagged badly so far this year, although its return is still positive, so it had a bit of catch-up to do. On the back of a 3.0% increase in the dollar gold price the All gold index rose 2.1%, but is still one of the laggards in the SA market so far. Its annual return to end-September is only 9.7%, which compares poorly with the annual returns of the industrial, mid and small cap indices of 24.3%, 26.7% and 21.1%. The basic material index has risen 14.6% in the past year and the All share index is up 33.1% in dollar terms.

Chart 4: Local market returns to 31 October 2010



A few quotes to chew on
The phenomenon of quantitative easing (QE), whereby central banks inject additional liquidity into the market through the purchase of bonds (and other assets at times) on the open market, has generated intense debate in investment circles this year so far. The debate has gathered intensity since the Fed's announced their plans to inject an additional $600bn into the market over the next few months (QE2). The Fed pumped $1trillion into the markets under "QE1" last year. The following are some of the comments that have been made on the topic.

In answer to the question "Why bother?" *Ethan Harris, Merrill Lynch's North American economist*, responds as follows: "Think of the Fed as a group of soldiers in a fox hole. They have fired their bazooka and their rifle ammunition – cutting rates to zero – and they are now using their pistols. If that doesn't work they have knives and then hand-to-hand combat. The (Fed) is not going to give in to weak growth and eventual deflation without a fight."

"Any quantitative easing will go straight out of the US and to the rest of the world, which doesn't need quantitative easing". *Mohamed El-Erian, chief executive and co-chief investment officer at Pimco*, the world's largest bond manager.

The QE2 debate has also led to some rather convoluted thinking – at least in our opinion. For example, we had this gem from a credible economist (it is best that he remain nameless otherwise I will be in big trouble): arguing that the benefits of QE2 exceed the downside risks, he argued that

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"Fed policy may eventually cause a bubble in the credit markets, but because hot markets are not causing a corresponding boom in real activity, the consequences of that bubble are much less severe than the past bubbles in tech and housing" (*Ed*: say what?)

Chart 5: Soybean prices
$ per bushel

Source: Gluskin Sheff

Maestro returns to 30 September 2010
It is our habit to publish the returns on our equity portfolios once a quarter in *Intermezzo*. They can also be found on our website. Consequently, I list below the returns for various periods to end-September. A couple of comments are in order; *firstly*, clients would know what Maestro's investment philosophy is inherently cautious. This has counted against us in recent years firstly as we missed, at least to some extent, the dramatic bounce in equity markets since March 2009 and secondly, the abnormal investment environment deprived us for some time of one of our key skills and means to add value to client portfolios, namely our stock picking abilities. Under the unusual market conditions, investors seemed to draw no distinction between good or bad companies, rendering this part of our strategy ineffective, at least for a while. However, as markets are slowly returned to "normal" (if there is such a thing these days) this aspect of our management has again come to the fore. Hence, our *relative* returns have shown a steady improvement each quarter so far this year. You can see this by comparing our six-month returns to our annual ones and those of the market in Table 1.

Secondly, on a similar note, investors and clients may recall that our October and November 2009 *monthly* returns were some way below the market, for reasons we explained at the time; largely the result of a few index heavyweights like Anglo, Old Mutual and SAB Miller rising and taking the market with it, while we had no exposure to these shares. What frustrated us more at the time was that our view was predicated on our belief that the rand would remain firm, which of course was and has been correct. During those months the basic materials sector rose strongly in any event, partly on the back of Anglo-related corporate activity. With that by way of background, of course in our annual returns the month of October is now out of the base. Soon November will be out of the base, too. This has led to a dramatic improvement in our *relative* returns. The place where this is most noticeable is in the ranking of the Maestro Equity Fund. Some astute readers have already noticed the improvement. We won't comment more here, although will revisit the topic at the end of December, by which stage we will have more hard data to substantiate the discussion.

Table 1: Maestro annual returns to 30 Sept 2010 (%)

SA equity returns	6m *	1 yr	2 yrs	3 yrs	5 yrs	7 yrs
Maestro long-term equity portfolios	*6.4*	*16.9*	*11.5*	*1.5*	*16.0*	*24.4*
Maestro Equity Fund	*4.4*	*9.1*	*6.0*	*-0.3*	*10.0*	*N/A*
Maestro equity benchmark **	6.4	23.3	15.2	4.4	14.9	22.7
JSE All Share Index	4.0	21.2	14.2	2.3	14.9	21.9

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

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	Oct	**5.9%**	**13.1%**	**14.5%**
Maestro equity benchmark *	Oct	1.7%	13.5%	18.5%
JSE All Share Index	Oct	3.6%	12.5%	18.3%
Maestro Long Short Equity Fund	Sept	**3.7%**	**2.2%**	**2.1%**
JSE All Share Index	Sept	8.3%	8.7%	21.1%
JSE Financial and Indus 30 index	Sept	10.0%	16.6%	26.6%
Central Park Global Balanced Fund ($)	Sept	**8.1%**	**0.3%**	**2.6%**
Benchmark**	Sept	4.4%	3.5%	5.7%
Sector average ***	Sept	5.8%	3.4%	5.9%

* 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 ($)

Economic sustainability for South Africa is possible
Regular readers are aware that we have a tradition within Maestro that, on a team member's anniversary, they are asked to write an article for *Intermezzo*. They have carte blanche to select a topic; it doesn't have to be investment

related. Luke Sparks celebrated his first anniversary with us in August, and he writes as follows.

Returning from a recent trip that I have made to India I was met with an immediate strange sense of slow motion in South Africa. From a fast paced Mumbai or Delhi, a laid back SA is very refreshing for one's soul but also left me with a sense that our homeland is missing out on something. Overcrowded mega cities, gigantic and dirty slum areas and a constant sweltering heat make urban India less than desirable for many foreign tourists. However, with an average expected GDP growth in the high single digits over the next decade and a fifth of the world's population, I believe that it will be to South Africa's (and the rest of our continent's) disadvantage if it fails to pay attention to and learn from the economic fabric that is causing the sub-continent to be a success story in the making.

Source: National Geographic

Travelling through different cities in India I was amazed at the entrepreneurship of the Indians. From the tea (chai) sellers on almost every street corner in the cities to the IT pioneers in Bangalore (the Silicon Valley of India), the spirit of entrepreneurship, I believe, is making India into the economic superpower of tomorrow. In a town called Leh which is in Kashmir, northern India, I came across a number of groups of young children who repaired hiker's boots. After school they would walk around town with home-made shoe repair kits which consisted of shoe glue, some sort of sewing kit and shoe polish and offer to mend any foreigner's broken hiking boots, of which mine were a pair. The entrepreneurship spirit of the Indians is profoundly obvious and exciting and is evident across social, economic and educational classes. Small business is, and I believe will continue to be a massive driver and contributor to the future economic success of India.

However, also in Kashmir I met a man who told me that the best job to have in town was working for the local government, because of much shorter working hours and substantially higher pay. He said that the relatively few positions in local government departments, such as the post office, provided a sheltered employment and comparatively high wages and benefits to those fortunate enough to work in them. He was also open enough to say that to obtain a governmental job, it was common knowledge that you had to pay a bribe equivalent to an annual salary of an average worker! Inefficacy and corruption in government is definitely not a challenge which is unique to South Africa.

In 1978, China was the 100th largest economy in the world, today it is second largest. This was achieved through policies supporting small business and without the emergence of a single global brand. Similarly, Germany's economic recovery after the Second World War was driven by the emergence of family owned businesses. The creation of more governmental jobs, I believe is not what our country needs to truly tackle the higher unemployment and inefficiencies in our land. Government's ambitious goal of 5 million jobs being created in the next decade will not lead to our country's economic success in the long run if the majority of jobs do not come through the encouragement and support of small businesses. Better tax breaks for small businesses and simpler labour laws will encourage new businesses to start up and to hire more freely.

India is just one example out of many countries where the majority of economic growth has come from the bottom up through entrepreneurs starting small businesses. South Africa has an opportunity not to be left behind by the rest of the developing world if the correct economic policies are put into place and entrepreneurship is fostered.

Source: National Geographic

Chart 6: The copper price
$ per pound

Source: Gluskin Sheff

State of the nation – another opportunity at Maestro
An opportunity has arisen within Maestro for a person seeking a career in investment management. Although we have called the role one of Investment Administrator the opportunity is far greater. We are looking for someone to assist us in the "back office" initially, but depending on the attributes of the chosen candidate, our intention would, over time, guide them towards becoming what we call a "consummate investment professional". Luke Sparks is responsible for the Administration at Maestro at the moment but we would like him, over time, to train someone up for this role. The incumbent would, ideally, have a university qualification, and preference will be given to a bilingual female. If you know of anyone interested or suitable in this position, please let Luke (luke@maestroinvestment.co.za) know and he will send them a detailed Job Description.

File 13: Information almost worth remembering
Seeing that this is File 13, let's start off with something which comes straight out of Silly Street. A Senate committee in Brazil has approved a "happiness amendment" that, if passed by the Congress, would make happiness a fundamental right guaranteed by the country's constitution. And they are not alone in this regard; the English have been making similar noises.

On the back of the recent Chinese economic data, I came across these remarkable figures: the Chinese car market has grown at a compound annual rate of more than 30% over the past decade. China's light vehicle penetration is only 30 per 1 000 compared to 206 in Russian and 559 in Italy. This is likely to rise in future; the number of households able to afford vehicles is expected to double in the next five years from 35m to 70m. Forecasts for total light vehicles sales in China in 2010 are around 18m units.

Whilst on the topic of China and the "law of large numbers" I recently read that, thanks to a boom in initial public offerings (IPOs) by smaller, private companies, Shenzhen has overtaken Shanghai in term of the amount of capital raised so far this year. Shanghai is traditionally regarded as the main equity market of China. The Shenzhen stock exchange has seen $33.6bn raised so far this year through 246 company listings, which is triple the amount raised last year and some way below the $24.1bn raised in Shanghai. However, it is worth noting that Chinese banks have extended $900bn in new loans so far this year, which puts the Shenzhen market's achievements into perspective.

Table 3: MSCI returns to 31 October 2010 (%)

	Oct'10	YTD	Q3'10
Peru	16.6	49.2	24.4
Argentina	16.0	57.2	40.8
Mexico	8.1	17.2	11.2
Colombia	5.9	57.9	31.7
Turkey	5.6	35.6	31.9
Pakistan	5.2	4.2	0.1
Russia	4.9	5.6	13.1
Hungary	4.9	3.4	27.0
Poland	4.0	12.9	34.8
China	3.9	5.6	10.1
MSCI DM	**3.6**	**4.6**	**13.2**
Morocco	3.6	10.4	7.9
Singapore	3.2	15.1	14.7
EMEA	**3.2**	**13.4**	**21.1**
LatAm	**3.1**	**9.7**	**20.4**
MSCI EM	**2.8**	**11.8**	**17.2**
Australia	2.8	3.8	22.0
Taiwan	2.7	3.6	15.7
Indonesia	2.7	36.2	16.7
AP ex Japan	**2.7**	**10.2**	**17.0**
Malaysia	2.6	30.2	17.6
EM Asia	**2.6**	**11.9**	**14.7**
Hong Kong	2.1	17.1	21.1
Japan	2.0	3.3	5.0
Thailand	1.8	45.2	30.9
Philippines	1.6	37.7	28.1
Korea	1.5	12.8	17.0
India	1.5	18.8	15.0
Chile	1.4	36.3	32.4
South Africa	1.3	17.7	24.2
Brazil	1.2	2.4	21.0
Czech	0.2	-3.9	15.3
Egypt	-0.7	3.6	10.0

Source Merrill Lynch