MAESTRO
Cautious Fund

PRESCIENT
LIFE LIMITED

INVESTMENT OBJECTIVE
The Fund is balanced across multiple asset classes, subject to the restrictions imposed by Regulation 28 of the Pensions Funds Act. It aims to minimise the probability of short-term (i.e. less than one year) capital loss. A conservative investment philosophy is adopted.

FUND BENCHMARK (BMK)
The Fund will measure itself against a benchmark consisting of 30% All share Index, 30% All bond Index (ALBI) and 40% Short term fixed income (STEFI) index.

LEGAL STRUCTURE
The Fund is a pooled portfolio on the Prescient Life Limited balance sheet. The appointed portfolio manager of the Fund is Maestro Investment Management (Pty) Limited, an approved Financial Services Provider in terms of the Financial Advisory and Intermediary Services Act, operating under licence number 739. Prescient Life Limited is a linked insurer governed by the Long Term Insurance Act. Prescient Life Limited issues investment linked policies. This Fund operates as a white label under the Prescient Life Licence.

FEE STRUCTURE
The annual investment management fee is 1.0%. The fee is inclusive of all underlying managers' fees, platform and administrative fees. In the case where the Fund is accessed and used as a Preservation Fund or Retirement Annuity an additional fee of 0.2% per annum is charged by Prescient.

FUND SIZE: R1 099 108

LONG TERM INSURER
Prescient Life Limited
(Reg no: 2004/014436/06)

AUDITOR
KPMG Inc.

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd
(Reg no: 2000/028796/07)

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The Maestro Cautious Fund

Quarterly report for the period ended

31 December 2011

1. Introduction

This Report focuses on the investment activities of the Maestro Cautious Fund during the recent past although it should be read in conjunction with previous editions of *Intermezzo*, wherein we documented some of the salient events in recent months. Appendix A contains a summary of the market activity during the December quarter.

2. The investment position of the Fund

The Fund's asset allocation is shown in Chart 1. Exposure to the equity market totalled 37.7% of the Fund, down from 38.9% in September. Bond exposure was flat at 23.5% while cash represented 38.9% of the Fund, 1.4% more than in September.

Chart 1: Asset allocation at 31 December 2011

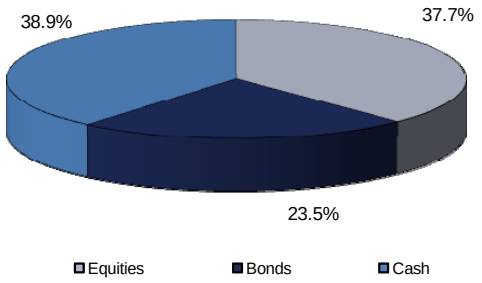
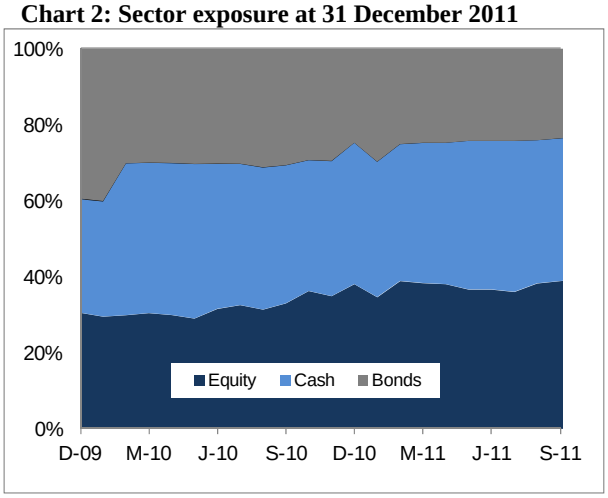


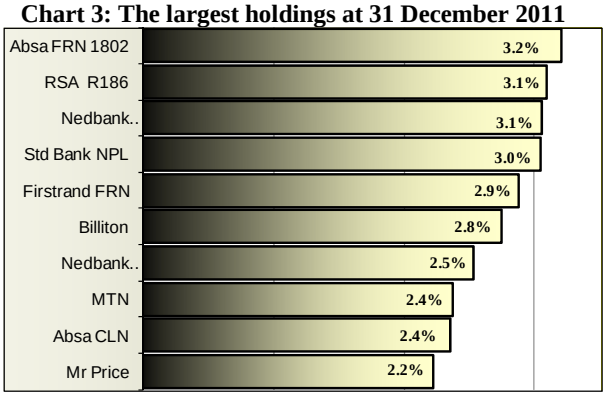
Chart 2 depicts the historical allocation to the major asset classes, expressed as a percentage of the total Fund.

Chart 2: Sector exposure at 31 December 2011



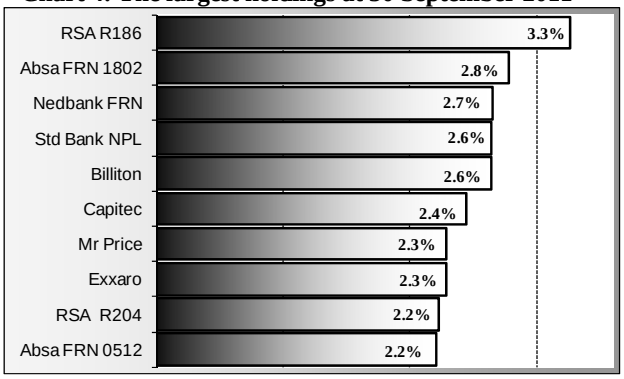
3. **The largest equity holdings**
The largest holdings at 31December are listed in Chart 3 expressed as a percentage of the Fund's equity portfolio.

Chart 3: The largest holdings at 31 December 2011



The largest holdings at the end of September are listed in Chart 4. The relative rankings changed somewhat over the course of the final quarter of 2011. The largest ten holdings constituted 27.5% of the Fund, up from 25.5% in September.

Chart 4: The largest holdings at 30 September 2011



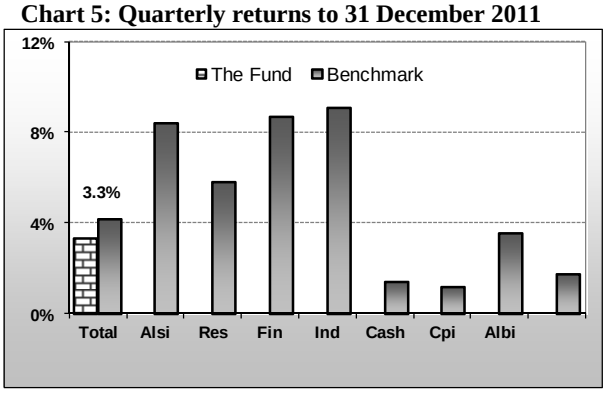
4. **Recent activity on the Fund**
The investment objective on this Fund is to *achieve short-term stability and moderate capital growth through the assumption of lower levels of risk.* We would emphasise the "short-term" aspect of this objective; as it is used as a Fund that facilitates members to preserve capital either prior to retirement (1 to 3 years) or post their working life.

The Fund has been designed in accordance with the rules and regulations that govern Regulation 28 of the Pensions Fund Act. It is not open to the retail public and can only be accessed through a company's Provident/Pension Fund or by individuals who have preservation money or wish to either transfer or purchase a Retirement Annuity (RA). These RA's can then be converted into living annuities when the time arises.

Besides the relative changes in asset allocation due to market movements, no major changes took place.

5. **The performance of the Fund**
Turning to the performance of the Fund Chart 5 depicts the returns for the quarter against the major indices. ***The un-annualised return on the Fund during the December quarter was 3.3%*** which can be compared to the Maestro Cautious Fund benchmark of 4.2%**.** Appendix A summarizes the major developments during the quarter for your convenience.

Chart 5: Quarterly returns to 31 December 2011



The Fund's quarterly equity return produced 5.3% and can be compared to the Maestro equity benchmark and All share index returns of 9.0% and 8.4% respectively. We have commented extensively in recent fund summaries and *Intermezzo* about the state of markets during the past few months and refer you back to those publications – you can find back copies of *Intermezzo* by clicking here - to refresh your memory about the salient features of this period. I also refer you to Appendix A, which details the nature of the market movements during the quarter. Like so many other periods of the market in the past year the December quarter was unique, anything but normal, so do pay close attention to what happened each month; it has a direct bearing on the Fund's quarterly and annual returns.

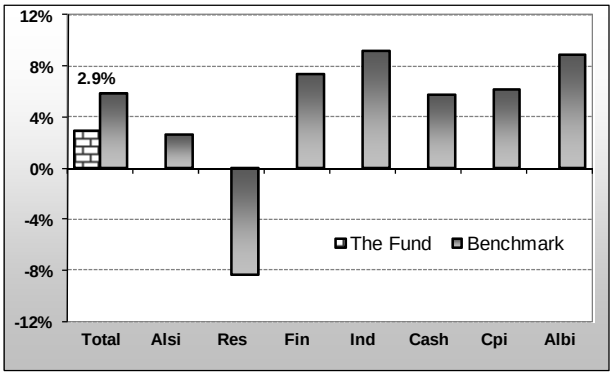
You will see from Appendix A that the over-riding characteristic of the past quarter was *late-month surges*, which caused havoc with any form of short-term risk management within the portfolio. After having registered a sharp (-5.8%) decline in the September quarter (-3.6% in September alone) the equity market rose dramatically in October, particularly in the last few days of the month. In the face of the sharp rally, which was led by large caps and resources shares, the Equity Fund was unable to keep up with the surging index, given its conservative positioning and bias in favour of industrials. Consequently, the portfolio lagged the market in October and November but outperformed in December; this is hard to see if you simply look at the quarterly returns.

To expand further on the quarterly returns, basic materials led the charge in October, which further exacerbated the underperformance by the portfolio in that month, given that the Fund is underweight in that sector. However, during December that sector lagged the overall market badly, giving the Fund the opportunity to catch up lost ground. The Chart summarizes the net result for the quarter: the industrial index gained the most, up 9.1%, followed by financials up 8.7% (thanks to a 16.6% surge in Old Mutual late in December) and then basic materials, up 5.8%. Despite the basic material sector lagging, the large cap index actually rose the most during the quarter, up 8.5%, while the mid and small cap indices rose 8.2% and 6.8% respectively. All of the latter out-performance came in October, during the market surge, when large caps rose 10.3%, while mid and small caps rose only 4.8% and 1.9% respectively. So you can see, it was a very strange quarter by way of market activity.

One of the reasons the Equity Fund lagged the overall market in general and the industrial sector in particular during the quarter, was not so much what the Fund held, but rather *what it did not hold*. SABMiller, Tiger Brands and British American Tobacco (BAT) are all large cap, index heavyweights. All did very well during the quarter – remember it was driven largely by the late surge in October. When that type of market behaviour occurs it is nearly always driven by large cap, index heavyweights; mid and small caps tend to lag. And that's exactly what happened in October; during the December quarter Tiger Brands rose 19.5%, BAT 12.0% and SABMiller 8.6%; the industrial and All share indices rose 9.1% and 8.4% respectively during the quarter.

The quarterly returns of the largest holdings in the Fund, excluding dividends, were as follows: Billiton rose 9.4% (it declined 19.2% in the September quarter), MTN 8.5% (-7.9%), Mr Price rose 18.6% (-1.3%), Capitec -3.3% (6.1%), Aspen 6.0% (8.6%), Sasol 15.1% (-5.9%), Cashbuild 14.6% (8.6%) and Steinhoff 2.1% (-2.1%). Other holdings across the equity portfolios under our management which disappointed included those in Metmar, which declined 25.4% during the quarter, B&W 21.1%, Grindrod 6.7% and Investec 2.5%. On a more positive note, shares which rose sharply included Coronation Fund Managers 13.5%, City Lodge 22.4% and Kumba 17.1%.

Chart 6: Annual returns to 31 December 2011



The annual returns to end-December are shown in Chart 6. ***The annual return of the total Fund for the year was 2.9%*** which can be compared to the benchmark return of 5.8%. Inflation rose 6.1% during the year and the All bond index rose 8.6%.

The Fund's equity annual return to end-December was -4.4% and can be compared to the Maestro equity benchmark and All share index returns of 6.1% and 2.6% respectively. The difference between these two indices provides some insight into the market features during the quarter, as does the respective sector returns in the chart above. Despite the weak rand, which declined 18.1% during 2011, the basic material sector ended the year down 8.3% as concerns about the slowing global economy weighed on the prospects for mining companies. The financial and industrial indices, on the other hand, posted respectable returns under the circumstances, finishing the year 7.4% and 9.2% higher respectively. Bearing in mind that the Maestro equity benchmark specifically increases the weighting of the two latter sectors and reduces the basic material weighting, you will understand why the Maestro equity benchmark has risen so much more than the All share index. Not shown in the chart above are the annual returns of large, mid and small cap index, which rose 2.2%, 4.7% and 1.1%.

The main detractors from the Fund during 2011 were B&W, which declined 52.0%, Metmar 50.5%, Implats 28.2%, Grindrod 26.1%, Wilson Bayly 24.3%, Investec 22.5%, Blue Label 19.2%, Anglos 13.7%, Billiton 11.7% and Abil 11.5%. On a more positive note Cashbuild rose 24.2%, Exxaro 23.3%, Coronation 21.1%, Mr Price 20.0% and Kumba 17.8%. These returns exclude dividends i.e. the changes reflect only the share price movements.

You might recall that the largest detractors during 2010 included Arcelor Mittal, Altech, both of which we have sold, and Digicore, which declined 0.3% in 2011. The largest contributors in 2010 were Capitec (which rose

only 3.7% in 2011), Mr Price, Blue Label (one of 2011's detractors), Exxaro and Abil (also a 2011 detractor). From this brief analysis, you can see that at least three of the investments (Capitec, Blue Label and Abil) that dragged the portfolio lower in 2011 were part of the reason it did well in 2010. This is not surprising – it is unreasonable to expect shares to continue rising significantly every year (with the exception of "stars" like Cashbuild and Mr Price); investment is a long-term activity and it should be expected that excellent companies like Capitec and Abil mark time occasionally. We hold these three companies (Capitec, Blue Label and Abil) in high regard and have no intention of selling them. We believe they will again contribute to the portfolio's performance i.e. rise at a rate greater than that of the market, in the fullness of time. But it never happened in 2011; these companies detracted from the returns last year. The same could be said for other 2011 detractors such as Billiton, Grindrod, Investec and Wilson Bayly. We would concede that we should have been more aggressive in reducing these holdings in the past year, with a view to buying them back again at lower levels. By and large, we don't really think this "more aggressive" approach will add to the Fund's long-term returns, although we have agreed amongst ourselves that we should be more pro-active in 2012.

While on the topic of selling shares just because they underperform for a period, it is worth highlighting that Cashbuild and Mr Price have, during past quarters, also topped the list of detractors, but that hasn't stopped them from rising 2 965% and 1 496% (or 40.8% and 31.9% per annum) respectively, during the past ten years – and that excludes dividends. Admittedly, these are two remarkable companies, but the point remains the same; short-term, aggressive trading does not necessarily add to long-term returns.

The historical performance of the Fund does not yet stretch to 3 years, but we look forward to reporting these figures to you by the end of this calendar year.

6. Closing remarks

And so it is that we draw the curtain on 2011. Equity markets moved lower, risk and volatility abounded, governments toppled or went bankrupt or both, politician's ineptitude was visibly manifest, the world was shaken and affected by numerous natural disasters and Osama is dead. And when all is said and done we are not really in any better position than the one we entered 2011 in.

That said, many companies registered good earnings growth, inflation is not out of control, interest rates are still relatively low and are likely to remain that way for a long time, the lights never went out and life goes on. It is fair to say that we and many other investors around the world appreciate more fully the problems we face and what it will take to resolve them. In addition, much of the bad news is already reflected in asset prices. Remember it is not bad news that affects markets as much as surprises; it is the *unexpected* that moves markets, not the expected. And a lot of people around the world by now expect the worst.

All that remains is to thank you once more for your loyal support through what has been a tough and frustrating year for us. We value your support and don't ever take it for granted. And we look forward to continue serving you throughout what is likely to be another very eventful year.

David Pfaff
On behalf of the Maestro team
17 February 2012

Appendix A

A summary of market behaviour – December 2011

We comment extensively on market movements from month to month in *Intermezzo* and in the letters accompanying your statements. We therefore provide only a summary here of the salient features of market behaviour during the December quarter. The returns of selected equity, bond, commodity and currency markets are shown in Tables 1 and 2.

Table 1: Selected returns – equity markets

	2010 (%)	Sept quarter (%)	Dec quarter (%)	2011 (%)
Japan	-3.0	-11.4	-2.8	-17.3
Hong Kong	0.1	-21.5	4.8	-20.0
Germany	16.1	-25.4	7.2	-14.7
UK	9.0	-13.7	8.7	-5.6
US (S&P500) and large cap	15.5	-13.7	11.9	2.5
S&P Mid cap	24.9	-20.2	12.5	-3.1
S&P Small cap	25.0	*-20.1*	*16.8*	-0.2
MSCI World index	***9.6***	***-17.1***	***7.11***	***-7.6***
Brazil	1.0	-16.2	8.5	-18.1
Russia	22.5	-29.7	3.0	-21.9
India	17.4	-12.7	-6.1	-24.6
China	-14.3	-14.6	-6.8	-21.7
MSCI Emerging market index	***16.4***	***-23.2***	***4.1***	***-20.4***
JSE All share	***19.0***	***-5.8***	***8.4***	***2.6***
JSE All share ($)	***32.4***	***-20.6***	***7.9***	***-16.0***
Basic materials	11.7	-10.8	5.8	-8.3
Financial	16.6	-3.1	8.7	7.4
Industrial	27.4	-3.3	9.1	9.2
Gold mining	12.5	19.5	0.7	6.9
Large cap (Top40)	17.2	-6.6	8.5	2.2
Mid cap index	30.3	-2.0	8.2	4.7
Small cap index	24.7	-2.4	6.8	1.1

You may recall, and it is very evident from Tables 1 and 2, that the September quarter was a very weak and unprofitable one. The good news is that, despite no real progress being made to resolve the "crisis of the moment" i.e. the Eurozone sovereign debt crisis, global markets nevertheless recovered some composure and registered strong gains during the December quarter. Although the quarterly returns on their own look good, they in no way compensated for the weak September quarter, with the result that the annual returns for 2011 in respect of equities and commodities are much worse than those for 2010 – refer again to Tables 1 and 2, which include the annual returns for both years.

It is ironic that the countries, by and large emerging ones, which are growing at faster rates than the developed markets, registered much weaker equity returns. One of the reasons for this is that investors are looking ahead and seeing that the effects of rising interest rates and policies aimed at slowing inflation and consumption in emerging markets are gaining traction, resulting in emerging market growth slowing quite sharply. The net result was a 7.6% decline in the MSCI World index during 2011 but a decline of 20.4% in the MSCI Emerging market index. There is still a perception that the US economy, currency and investment markets offer investors the best means to protect the value of their investments. The US equity market registered a gain of 2.0% - one of the few markets to post a positive return – versus the declines in the Bric equity markets of between 18.1% and 24.6%. Concerns about the slowing world economy in general and emerging markets in particular weighed heavily on commodity markets, which ended 2011 sharply lower.

Table 2: Selected returns – bonds, commodities, currencies

	2010 (%)	Sept quarter (%)	Dec quarter (%)	2011 (%)
SA All Bond index	15.0	2.9	3.3	8.9
SA Cash	6.9	1.4	1.4	5.7
Barcap Global Agg. Bond index	5.5	1.0	0.2	5.6
Emerging market bonds	12.5	-1.6	4.8	8.1
US 10-year bond	7.9	12.1	1.2	17.1
US Corporate bond	9.5	2.3	1.8	7.5
US High yield bond	15.2	-6.3	6.2	4.4
Cash (US dollar)	0.1	0.0	0.0	0.1
DJCS Hedge index	11.0	-4.6	-0.9	-2.3
Brent (Oil)	21.6	-8.6	4.5	13.3
Gold	27.7	7.6	-2.8	11.7
Silver	80.3	-13.1	-7.5	-8.0
Platinum	20.1	-12.3	-10.4	-22.9
Palladium	102.8	-19.3	2.6	-21.0
Copper	31.0	-23.2	5.8	-21.7
Nickel	34.5	-21.0	-0.2	-26.8
Baltic Dry index	-41.0	34.4	-8.5	-2.0
CRB Commodity index	13.9	-11.9	2.5	-5.4
S&P GS Commodity index	18.4	-9.5	6.4	3.9
Euro dollar	-6.5	-7.5	-3.2	-3.2
Sterling dollar	-3.1	-3.0	-0.2	-0.7
Swiss franc dollar	10.9	-7.3	-2.9	-0.3
Rand dollar	11.3	-15.7	-0.4	-18.1

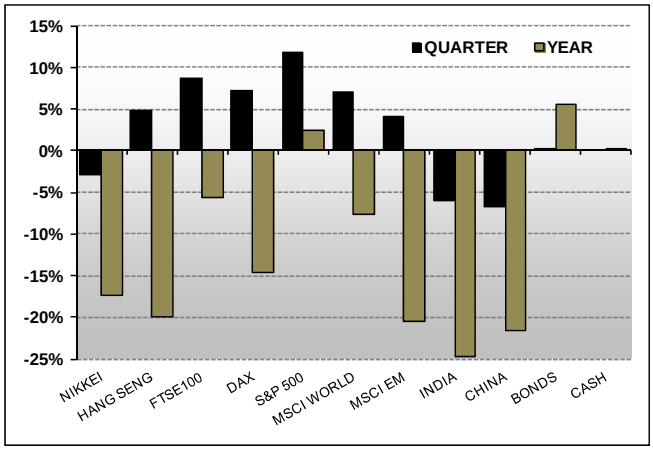
Gold proved to be a reasonable store of value, rising 11.7% for the year, despite two spine-chilling drops of about 15% in September and December. The only real safe havens during

2011 in our opinion and with the benefit of hindsight were firstly, the oil price, which gained 13.3% after a 21.6% rise in 2010 but which also never suffered any major declines during the year, and secondly, US Treasury bonds, which although volatile, benefitted from a real "flight to safety" by investors. The 10-year US Treasury bond rose 17.1% after a 7.9% gain in 2010, while the Barclays Capital Aggregate Global bond index ended 2011 5.6% higher after a 5.5% rise in 2010. Despite all the weaknesses of the US economy and their politics, the dollar proved resilient against most other currencies.

Global investment markets

Chart 1 summarizes the quarterly and annual returns of the major equity, bonds and cash markets. You can see clearly from this chart that the positive quarterly returns were insufficient to lift annual returns into positive territory.

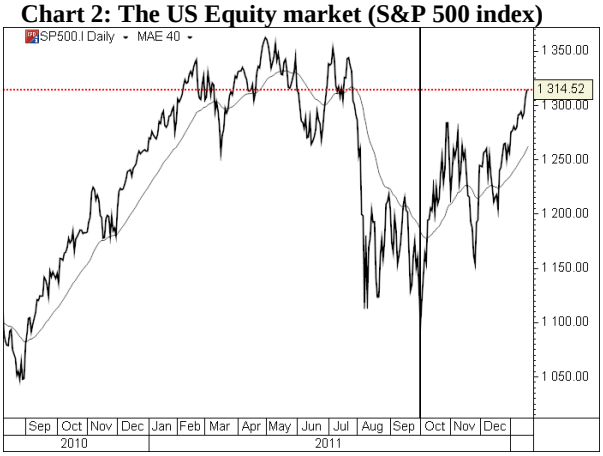
Chart 1: Global returns to 31 December 2011



While by no means comprehensive, the following were some of the features of the quarter that caught our attention.

- *The sharp gains at the end of each quarter:* Charts 2 and 3 depict the movements of the US and German equity markets over the past year. The thick vertical line in all the ensuing charts depict the start of the December quarter as a reference point off which to measure the quarterly return. It is apparent from most of the charts just how weak global markets were during the September quarter and consequently also how many of them rebounded during the December quarter – refer again to Chart 1 which depicts the quarterly returns. It is also clear from these charts that the strong quarter was unable to make for lost ground earlier in the year, with the exception of the US equity market, the oil price and bond markets. What is less clear from equity market charts are the month-end surges which we referred to in the Quarterly Report. Table 3 lists the month-end behaviour of the US, German and SA equity markets, which will give you an idea of how volatile the markets were and a sense of how difficult it was to make sense of these bursts and to manage money within such an environment.

Chart 2: The US Equity market (S&P 500 index)



Source: Saxo Bank

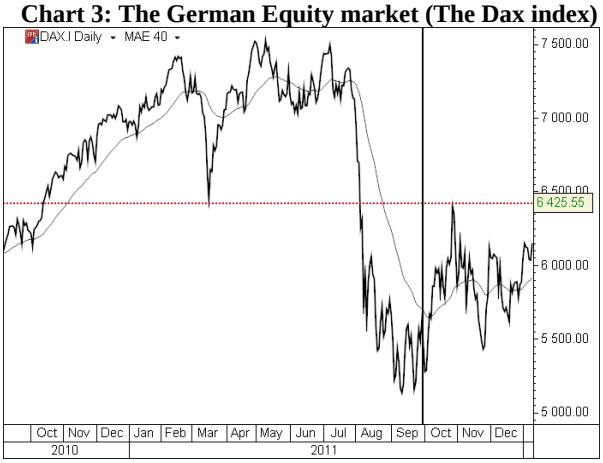
Take a closer look at Table 3. It depicts the US, German and SA equity markets, showing both the month-end surges and the eventual monthly returns. Thus, between 22 and 31 August the US equity market (S&P500) rose 8.5% but it still ended down 5.5% in August. The German market (Dax) surged 5.7% between 22 and 31 August but that did not prevent it from declining 19.2% for August as a whole. In October, between the 1st and the 28th it surged 21.7% but still ended the month "only" 11.6% higher. In some months, the surges bore no resemblance to the eventual direction of the market. In November for example, the US and German markets surged 7.6% and 12.2% during the last four trading days (the 25th to the 30th) yet despite these enormous gains the markets still ended *down* 0.3% and 0.9% respectively! If you look closely at Charts 2 and 3 you will see how volatile and traumatic a month November was.

Table 3: The Wild West: month-end surges and actual monthly returns (%)

	22-31 Aug	*Aug*	1-28 Oct	*Oct*	25-30 Nov	*Nov*	19-30 Dec	*Dec*
S&P500	8.5	*-5.5*	16.9	*11.0*	7.6	*-0.3*	4.3	*1.1*
Dax	5.7	*-19.2*	21.7	*11.6*	12.2	*-0.9*	4.0	*-3.1*
JSE Alsi	5.9	*-0.3*	10.9	*9.3*	5.4	*1.6*	0.8	*-2.5*

At the risk of stating the obvious, the US and German markets would be regarded by many as "stable, highly efficient markets. Table 3 "busts" that myth beyond belief, highlighting how unstable and uncertain equity markets were for just about all of 2011. Ironically, the respective ranges of the surges for the SA equity market were, in every instance, lower in magnitude despite the volatile rand which added yet another element to the turbulent cocktail.

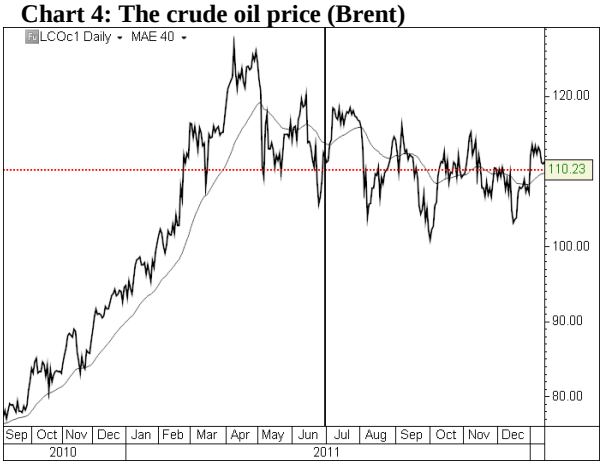
Chart 3: The German Equity market (The Dax index)



Source: Saxo Bank

- *The gains across market capitalizations (caps):* You will be aware that we watch the respective returns across market capitalizations (market caps) or size of companies very closely because firstly it tells us a lot about the prevailing risk appetite of investors and secondly because history shows us that large cap shares, which dominate most major global indices, perform worse and are more volatile than mid and small caps. Although this is hard to believe and there are still many who would dispute this statement, the facts are there as a matter of record. During times of uncertainty, volatility and economic weakness investments in smaller companies are, generally speaking, less profitable but they tend to more than catch up when the environment improves. As a consequence, you would understand our surprise that mid and small cap companies did not performed worse during the past year. It is true that this was the case in the US in 2011 (US large caps rose 2.5% but mid and caps fell 3.1% and 0.2% respectively) but the situation in South Africa was different (SA large caps rose 2.2%, mid caps 4.7% and small caps 1.1%). During the September quarter when sentiment was very negative US mid and small caps performed poorly but in SA large caps performed the worst due to concerns that a slowing global economy would affect large companies like Anglo and Billiton more than most. As sentiment improved through the December quarter the usual pattern of returns across market caps resumed i.e. mid and small caps outperformed larger ones. The point of this analysis is that last year taught us an important lesson in the prevailing climate*: concerns about a slowing global economy are more powerful than concerns about market capitalizations*, in addition to which *a weak rand is no guarantee that basic material companies*, which are mostly large caps, *will outperform small ones*. As the global economy begins to slow in 2012 we would do well to heed this important lesson about the behaviour of large, resource-orientated companies, specifically those listed on the SA equity market.
- *The oil price:* although no one has commented on it in too much detail we think one of the "best kept secret" safe havens, at least so far this decade, is turning out to be the oil price. Despite the prospect of a slowing global economy the oil price showed no real signs of declining – refer to Chart 4. The Arab spring or Iran crisis may have supported the oil price, but there always seems to be a reason for the price remaining elevated. We expect oil to remain firm during 2012.

Chart 4: The crude oil price (Brent)



Source: Saxo Bank

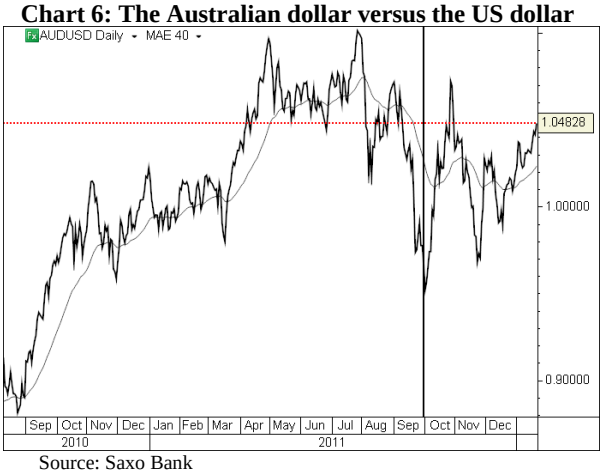
- *The behaviour of the Swiss franc:* another intriguing aspect of the quarter, at least for us, was the fact that investors have not yet plucked up enough courage to take on the Swiss National Bank (SNB) and test their self-imposed "peg" to the euro at around the 1.20 level – see Chart 5. You will recall that, following the dramatic strength in the Swiss franc against virtually all currencies, the SNB intervened heavily and declared their intention to peg the franc to 1.20 euros and defend that level. Although we wish no harm on any currency or country, it is surely only a matter of time before speculators take on the franc and test the SNB's resolve. We know from history – the battle over sterling which led to it being summarily ejected from the then-prevailing European Monetary System comes to mind – that no central bank is bigger or has deeper pockets than the market. We miss the safety that the franc offered investors and we think it is only a matter of time before the SNB's peg is tested in an effort to reclaim the Swiss franc as a safe haven. Safe havens are currently in very short supply.

Chart 5: The euro in terms of the Swiss franc

Source: Saxo Bank

- *Stable emerging market currencies:* You will be familiar by now with the weak markets in September and their subsequent partial recovery in the December quarter. We note with interest that emerging market currencies were very quick to recover some ground lost in the September quarter. Chart 6 depicts the Australian dollar while Chart 14 depicts the rand's movements over the past year.

Chart 6: The Australian dollar versus the US dollar



Source: Saxo Bank

While the rand declined marginally (-0.4%) during the quarter it was nothing like its 15.7% collapse during the September quarter. It resilience in the December quarter should be seen in the light of the ongoing commodity price weakness; the rand is typically weak when commodity prices are weak, but this was not the case during the December quarter. Despite the fact that most emerging countries have embarked an easing phase of monetary policy i.e. interest rates seem to have peaked, emerging currencies showed noticeable strength during the December quarter. This speaks to a theme that we believe will re-emerge this year, namely a search for yield on the part of global investors. With interest rates in developed countries either non-existent or at historically low levels, investors continue to search for yield (income) where they can find it. This factor will support certain emerging countries, particularly those with budget surpluses. From the behaviour of global markets last year one thing was apparent: as soon as investors regain some form of confidence in the future, they buy emerging market currencies and equity markets. When they fret about the future, they sell them. This phenomenon is likely to continue throughout 2012, which if nothing else will prolong the volatility and uncertainty of currencies in general and emerging market currencies and the rand in particular.

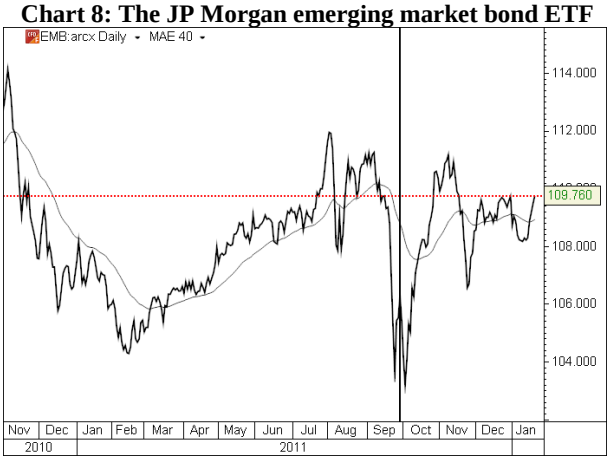
Chart 7: iShares Barclays 20+ year Treasury Bond Fund

Source: Saxo Bank

- *Strong bond markets:* we have already alluded to the strength in the bond market during 2011 – at least in US, German and corporate bonds. Chart 7 depicts the exchange traded fund (ETF) of the US long (in excess of 20-year duration) bond and Chart 8 the Emerging market bond ETF. Ironically, we doubt there is any *real* investor appetite for long-term bonds at yields (rates of interest) lower than 2.0%, the prevailing level of US and German 10-year bonds. Rather, investment into these bonds is being driven by a fear that any other investment will not retain its value over this period, or simply by a lack of alternatives. With yields at these levels, which are below the prevailing respective inflation rates, anyone investing into bonds is dooming themselves to a negative real return for the next ten years, assuming of course they hold the investment for this period. While this gives an inkling into how fearful investors are at present, one cannot ignore the strength in the bond market during 2011 and 2010. With yields so low, it is hard to see how they can go lower still. We thus find little value in bonds at prevailing levels, and

would rather take the risk of some capital growth for which we will be compensated by a (dividend) yield in some cases two or three times the prevailing yield on bonds.

Chart 8: The JP Morgan emerging market bond ETF



Source: Saxo Bank

- *The Eurozone crisis:* what can we say about the Eurozone crisis that has not been said already or that you don't already know?! You must be as sick and tired of it as we are, yet it is unlikely to go away and we do not foresee any material progress being made on the major issues within the next few quarters. It is likely to dominate the investment landscape for the early part of 2012, notwithstanding the robust start to 2012 made by both the euro (refer to Chart 9) and equity markets.

Chart 9: The euro dollar exchange rate

Source: Saxo Bank

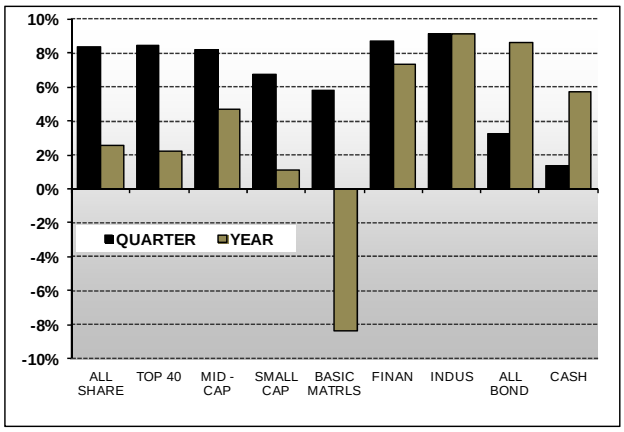
Chart 10: The sterling dollar exchange rate

Source: Saxo Bank

Local investment markets

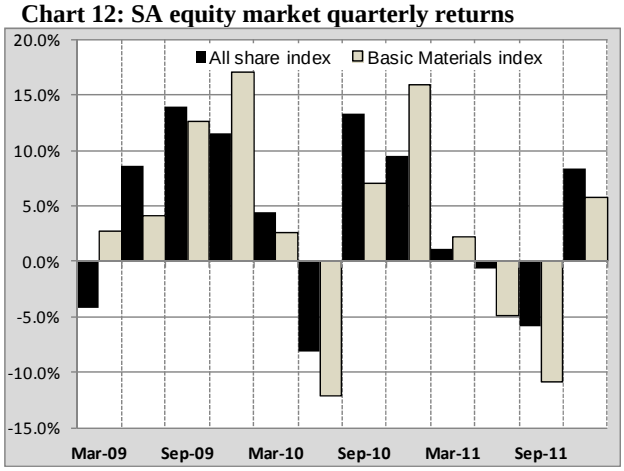
Turning to the South African investment markets, Chart 11 depicts the quarterly and annual gains in the major indices for period ended 31 December 2011.

Chart 11: Local returns to 31 December 2011



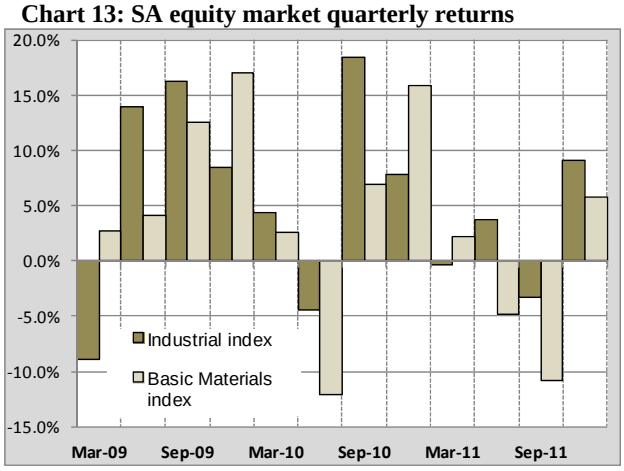
The same features that prevailed on global markets prevailed on local ones. Chart 11 shows that, with the exception of the basic material sector, 2011 proved to be a profitable year although by historic standards the absolute level of returns was quite low. The industrial and financial sectors posted reasonable returns during the quarter and year. What is not that evident from the chart is the extent of volatility that investors have endured during the past few years. Chart 12 depicts the quarterly returns of the All share and basic material (resource) indices between December 2009 and 2011. It is very clear from the chart just how volatile the market has been. After the strong gains in 2009, which represented the bounce after the 2008 meltdown, the returns have vacillated between positive and negative values with effectively only two consecutive quarters (September and December 2010) of positive returns.

Chart 12: SA equity market quarterly returns



While one would expect the basic materials index to be volatile, Chart 13 shows its returns together with those of the industrial index over the same period. Even a casual glance shows that the industrial has been anything but stable over the period. In many instances it has been even more volatile than the mining sector. It has been hard to make sense of all the volatility, particularly when the source of this volatility was outside the country (largely in Europe) and driven almost entirely by headlines, as opposed to concrete achievements. At the risk of sounding like an old man, back in the old days and before the advent of "new normal" environment, one would have expected a volatile market to rise or fall by a couple of percentage points. But note the scale of the charts – the range is from -15.0% to 20.0% which is extraordinary when you consider we are talking about quarterly returns and not annual ones. Refer again to Table 3 to get a better understanding of how abnormal the market conditions have been over the past few years.

Chart 13: SA equity market quarterly returns



In closing

It is not our habit to pass comment on our views for the future in the Quarterly Report. The purpose of the document is to serve as a record of what has transpired during the quarter. Our views will be shared in other reports sent during the normal course of reporting.

Chart 14: The rand dollar exchange rate

Source: Saxo Bank

That said it is worth ending this summary of market movements with a few comments about the future. Firstly, with regard to the global economy, we have little doubt that the rate of growth is slowing. The Eurozone is in all likelihood in a recession already and there is a fair chance their economic momentum will slow even further. The US might see reasonable growth early in 2012 but this is likely to slow towards 2013 as they become mired in electioneering and as their political machine becomes even more paralysed – it is already all but broken. This would not be that serious were it not for the fact that, firstly the US remains the global engine of growth and secondly, the US is facing enormous challenges and is facing the very real prospect of another few years of low or no growth in critical areas that affect ordinary people, such as the housing and labour markets. We continue to be very concerned about the long-term future of the US economy, although that does not mean sentiment will turn against it in the short- term. If you need a reminder about how severe the US's future is, refer back to the report by Mary Meeker, which we discussed in the December edition of *Intermezzo*, which you can access by clicking here.

Perhaps the most vital economy of all, at least in the short to medium term, is the Chinese one. Growth there, too, is likely to slow, but the important issue is, to what extent? For now we will grant the Chinese authorities the benefit of the doubt in terms of engineering a soft landing, but one should not underestimate the effects of a hard landing or the effects on markets if investor sentiment changes due to a belief that the Chinese authorities might get it wrong. So we will be

watching the global economy for any signs of a larger-than-expected slowdown.

It remains true that the corporate sector is in relatively good health; the world's financial problems lie largely with governments and the public sector. But it makes little difference where the problems lie, given that we all inhabit one planet. Equities will remain cheap and volatile, and bond markets and the dollar are likely to continue strengthening as long as the degree of uncertainty about the current global crisis increases. As soon as there are any signs of tangible progress, we expect equities – and emerging markets in particular - commodities and emerging market currencies to rise sharply. If all of this sounds familiar, that is not surprising: it is exactly what we saw in 2011. We expect "more of the same", at least for the first half of the year.

Despite the uncertainty though, we think long-term investors will be rewarded for their patience. The world experienced a heightened degree of risk last year, yet many companies posted reasonable returns and continued to pay good dividends. The challenge for us is to seek out these companies for your benefit. Much of the bad news is already priced in to equity markets, which offers some hope that we will again see positive returns from equities in the coming year.

The Maestro Investment Team
31 January 2012