MAY 2007

FUNDAMENTALS

INVESTMENT PERSPECTIVES FOR INSTITUTIONAL INVESTORS

PERFORMANCE THROUGH FOCUS

Top comment

Rian le Roux
Head of Economic Research

'Despite the series of interest rate increases last year, consumer confidence has been, and continues to be, very high.' See page 6.

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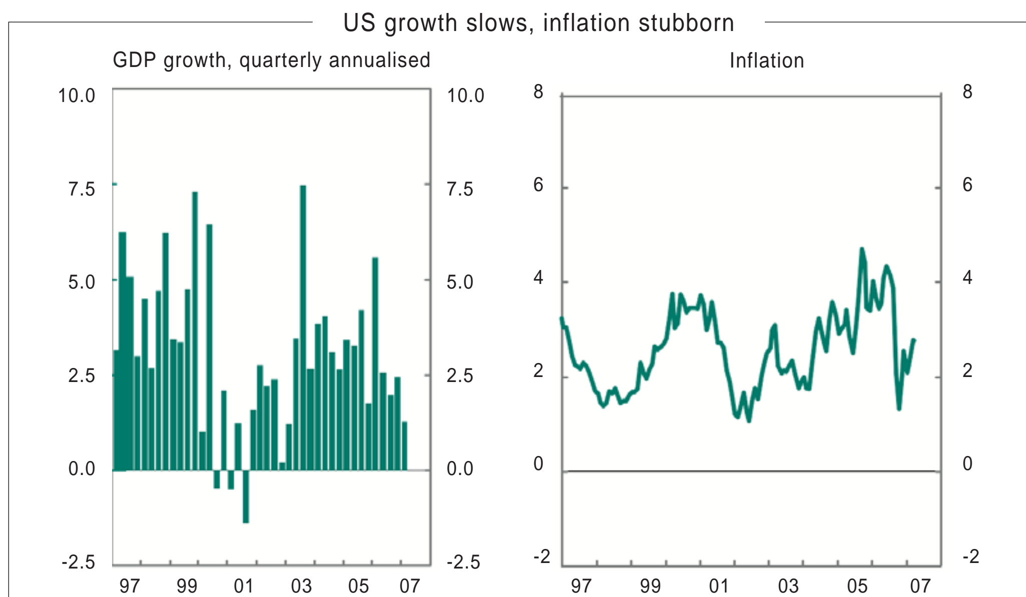
OLD MUTUAL
Investment Group

Commentary for the period ending 30 April 2007.

GLOBAL ECONOMY

OMIGSA VIEW
While downside risks to the US economy can certainly not be downplayed, we still think it unlikely that the US will enter a full-blown recession. While the peak in the global interest rate cycle has not been reached yet, we think it unlikely that central banks will drive the world economy into a recession.

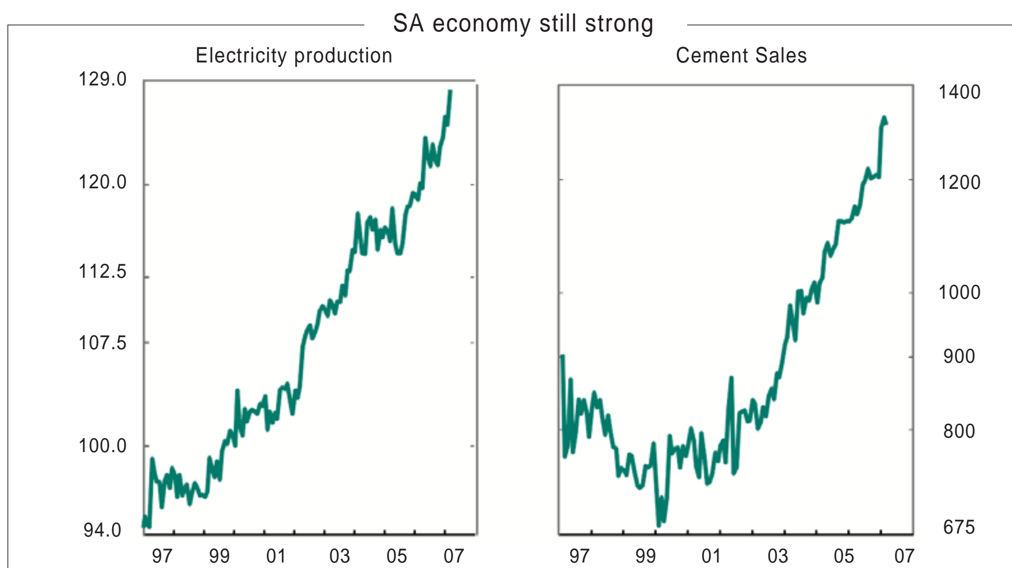
- Concerns about the health of the US economy remained high during April. First quarter 2007 growth ingross domestic product (GDP) slowed to only 1.3% annualised, the slowest pace in four years.
- Ongoing severe weakness in housing activity, problems with loans to sub-prime borrowers (i.e. those with poorer quality credit credentials) and a sharp slowdown in spending on investment by companies remain the key reasons for the ongoing concerns over the severity of the slowdown in the US.
- A further concern is that inflation has remained uncomfortably high, leaving little hope for lower interest rates in the near future.
- On a more positive note, a number of indicators of economic activity came in a little stronger than expected in March, suggesting that the slowdown has not intensified further.
- With concerns about the US economy mounting, all indications are that the rest of the world is still growing at a solid pace. Indicators from the Euro-area, Japan and China point to sustained solid growth, as is the case for most other emerging markets.
- The ongoing strength in commodity prices, emerging market currencies and shipping rates for bulk freight also suggest that global activity remains solid.
- With activity still solid outside of the US, interest rates are set to rise further across a fairly broad spectrum of countries.



LOCAL ECONOMY

OMIGSA VIEW
Our long-held view that the SA economy will outperform the expectations of most analysts is not only proving correct, but we expect this to remain the case for some time to come still. Short-term inflation risks remain relatively high, given strong demand, still rising food prices and the sharp hikes in the petrol price. This holds a risk that the Reserve Bank may be forced to raise rates again some time later this year.

- The local economy continues to grow strongly and a host of indicators point to very robust activity growth during the first quarter of 2007. Official GDP data, due for release towards the end of May, will likely again reveal growth of over 5% annualised during the first three months of the year.
- Given such a solid start to the year, growth for the full year may well match the average 5% a year over the past three years, despite last year's interest rate hikes.
- In a related development, overhauled data from StatsSA now indicate some 750 000 more people employed in the formal economy than previously thought. This has raised the question whether the overall size and the growth rate of the economy is not still being underestimated.
- While the strong expansion in the local economy is to be welcomed, it does also bring with it the risk that the local economy could overheat, ultimately putting upward pressure on inflation.
- On the positive side, the foreign trade deficit narrowed quite sharply in the first quarter, although the deficit still remained sizeable. With imports likely to remain high as the investment drive gathers further momentum, the balance of payments risk still looms large. So far, the shortfall has been adequately covered by capital inflows, but the risk to the rand from such a large deficit cannot be ignored.
- Recent inflation numbers have again raised concerns over the outlook for inflation. CPIX inflation rose to 5.5% in March and producer price inflation to 10.3% - both four year highs.



GLOBAL ASSET ALLOCATION

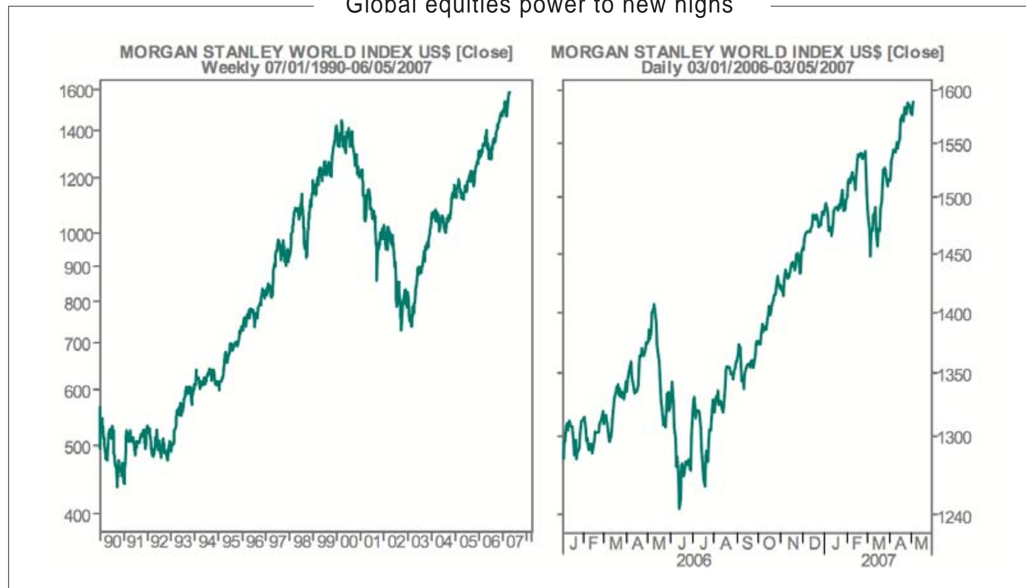
OMIGSA VIEW
Equity market valuations remain reasonable, but are less attractive after the recent run-up. Earnings growth is expected to slow through 2007 but remain positive. Equities are still the preferred asset class, but with increased risk. Bond markets generally look unattractive at current yields. A weaker dollar and negative carry make US bonds relatively poor value on an unhedged basis. Other major bond markets are vulnerable to rising short-term rates. We prefer cash to bonds on a risk-adjusted basis.

- Global equities powered ahead through April, with the MSCI World Index establishing new all-time high levels. The index was up 4.6% for the month.
- Strong growth was again reported from China, which was seen as further confirmation that global growth could remain firm while the US economy slowed.
- Emerging market equities were among the strongest markets, with India recovering well after a poor first quarter.

CONTINUED

- US equities also rose strongly, with good reported earnings numbers, but the Japanese market lagged considerably.
- US bond yields remain well below the Fed Fund rate in anticipation of cuts in the official interest rate as the economy slows.
- US growth has not been as weak as the market anticipated. We think a US rate cut is unlikely for some time, until inflation pressures ease.
- Bond markets in the UK and Europe are unlikely to perform well with official interest rates expected to rise further.
- The US dollar remains vulnerable to further weakness.

Global equities power to new highs



LOCAL ASSET ALLOCATION

OMIGSA VIEW

The SA equity market is at an advanced stage of a bull trend. This implies greater volatility going forward as the market fluctuates between fear and greed. Typically, a mature bull market can deliver excess returns and we think it is premature to exit equities. However, it is appropriate to have a balanced portfolio as the valuation cushion has been removed. The risk to short-term interest rates remains to the upside as domestic growth is strong. Therefore, we prefer cash to bonds. Property is tactically vulnerable, following its very strong run, but its fundamental outlook is very positive for the next two years.

Local market recovers and closes above 27 000

- The JSE continued to steam ahead, gaining 3.5% for the month and bringing the year-to-date returns to 14.2%.
- Allied to rand strength, this made the JSE one of the best performing markets in the world in April. World equities gained 4.5% in US dollars.
- The strength was heavily biased to mid- (up 7.2%) and small-caps (up 9.6%), with local financial and industrial shares outperforming resources.
- Rand strength benefited bonds during the month, which gained 1.6%, double the 0.8% return from cash.
- Year-to-date cash and bond returns have been identical and our preference remains with cash due to its lower volatility.
- Listed property is performing more like small-cap shares than a fixed income asset. It gained 7.8% and 24.7% for the month and year-to-date respectively.

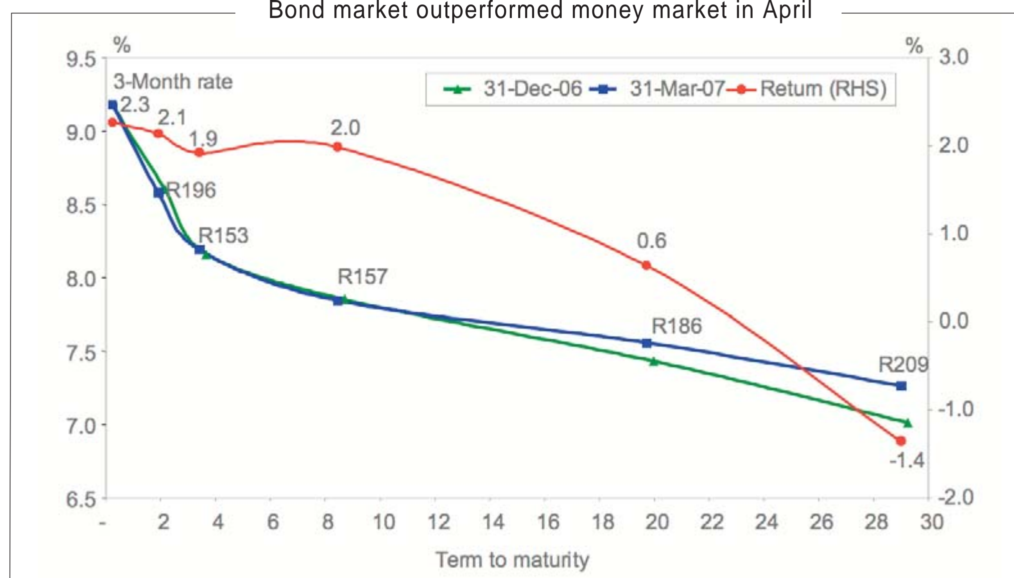
FIXED INCOME

OMIGSA VIEW

The focus has shifted away from short-term inflation concerns to the benign medium-term outlook. This strengthens our long-held view that the central bank will keep the key repo rate unchanged. However, long-dated bonds have priced in most of the good news and remain unattractive. We thus, continue to favour short- and medium-dated bonds. We will continue to invest in 12-month NCD's at levels above 9.5% and thereby maintain an overweight duration tilt in the money market. In the bond market, we will utilise weakness to position funds for yield curve normalisation, thus steering away from very long-dated bonds that are deemed expensive on a relative basis.

- The central bank left the repo rate unchanged at the April Monetary Policy Committee (MPC) meeting.
- A stronger rand, stable oil prices and lower grain prices eased concerns about short-term inflation risks.
- As a result, the slope of the yield curve inverted slightly in April.
- The All Bond Index delivered a return of 1.6%, outperforming the money market during the month.
- Twelve month NCDs are still trading at relatively attractive levels despite a post-MPC meeting rally of about twenty basis points.
- Given the view on monetary policy, we continue to believe that twelve month assets offer good value at levels above 9.5%.
- Risks to this view include the usual unpredictable behaviour of the so-called inflation volatility drivers, such as the currency, oil and food prices.
- However, the combination of a $60 a barrel oil price, an exchange rate of R7.50 to the dollar and an annual food price increase of 7% allows enough room for CPIX to decelerate to below 4.5% in the third quarter.

Bond market outperformed money market in April



MARKET INDICATORS

AS AT 30 APRIL 2007	DY%	PE RATIO	1 MONTH %*	12 MONTH %*
FTSE/JSE All Share Index	2.2	16.1	3.5	36.7
FTSE/JSE Resources Index	2.1	15.8	-0.6	35.2
FTSE/JSE Industrial Index	2.0	15.8	6.4	40.2
FTSE/JSE Financial Index	3.2	14.0	6.5	34.0
FTSE/JSE SA Quoted Property Index	5.8	17.2	7.8	32.4
ALBI BEASSA Bond Index			1.6	6.0
STEFI Money Market Index			0.7	8.0
MSCI World Index (R)			1.4	36.6
MSCI World Index ($)			4.5	17.6

* TOTAL RETURN INDEX PERCENTAGE CHANGE

ECONOMIC INDICATORS

	LATEST DATA		PREVIOUS YEAR
EXCHANGE RATES:			
Rand/USD	Apr - 07	7.0	6.0
Rand/UK Pound	Apr - 07	14.0	11.0
Rand/Euro	Apr - 07	9.6	7.6
Rand/Aus$	Apr - 07	5.8	4.6
COMMODITY PRICES:			
Gold Price ($)	Apr - 07	678.1	633.7
Gold Price (R)	Apr - 07	4 794.0	3 913.8
Oil Price ($)	Apr - 07	68.0	72.3
INTEREST RATES			
Prime Overdraft	Apr - 07	12.5%	10.5%
BA Rate	Apr - 07	9.0%	7.0%
R157 Long-bond Yield	Apr - 07	7.7%	7.4%
INFLATION:			
CPI (y-o-y)	Mar - 07	6.1%	3.4%
CPIX (y-o-y)	Mar - 07	5.5%	3.8%
REAL ECONOMY:			
GDP Growth (y-o-y)	Dec - 06	5.2%	4.9%
HCE Growth (y-o-y) (Household Consumption Expenditure)	Dec - 06	8.0%	6.0%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	Dec - 06	14.4%	10.3%
Manufacturing Production (y-o-y) (Seasonally adjusted)	Feb - 07	7.2%	4.0%
BALANCE OF PAYMENTS:			
Trade Balance (cumulative12 month)	Mar - 07	- $9.4bn	- $4.6bn
Current Account (% of GDP)	Dec - 06	-7.8%	-4.1%
Forex Reserves (incl. gold)	Mar - 07	$26.9bn	$23.9bn

(All information relates to month end.)

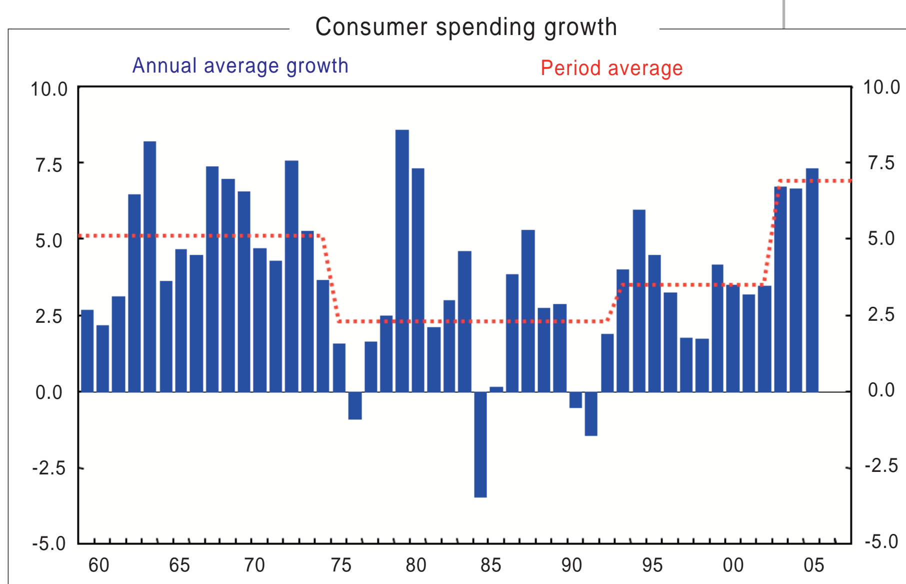
Consumer spending and investment booms continue

Rian le Roux
Head of Economic Research

The pace and extent of the consumer and investment booms have been consistently underestimated for the past few years and, though we expect some tempering in the growth of consumer spending, double-digit growth in fixed investment spending is likely to continue for the next few years at least. Old Mutual Investment Group SA chief economist Rian le Roux explores the driving factors behind the twin consumer and investment booms and what to expect going forward.

SA has experienced a strong expansion in both consumer and investment spending for the past few years, with growth rates in these key economic variables far exceeding those notched up during the previous 25 years. SA's real household spending growth, as measured by household consumption expenditure (HCE), has averaged 6.9% year-on-year growth over the past three years, compared to only 3.0% year-on-year in the two preceding decades. At the same time, investment spending growth, as measured by gross fixed capital formation (GFCF), has accelerated to 10.7% year-on-year on average between 2004 and 2006, compared to only 1.1% year-on-year between 1980 and 2003.

These impressive growth rates have tied in squarely with the view that we have had since 2003 that the economy is heading for structurally higher growth and lower inflation and that it will outperform most expectations. We did not believe that we were stuck in a 3.5% growth rut, as some other commentators did, and our confidence proved justified, with local growth in gross domestic product averaging 5% p.a. over the past three years.



We still believe that a number of key changes in the local economic landscape that have taken place over the past decade are still not being factored in sufficiently by most analysts when they assess prospects for South Africa for the next five to ten years.

First, is the fundamentally different global environment, characterised by strong growth, increasingly coming from the emerging markets, and structurally high commodity prices. We believe this could last for quite some time.

Secondly, between 1990 and 2003 SA implemented significant structural changes and, as a result, the economy is today fundamentally healthier, more competitive and 'freer' than during the 1970s and '80s.

Thirdly, people underestimate the positive impact on consumer, business and foreign confidence of greater stability and predictability in economic policymaking, inflation, interest rates and economic growth.

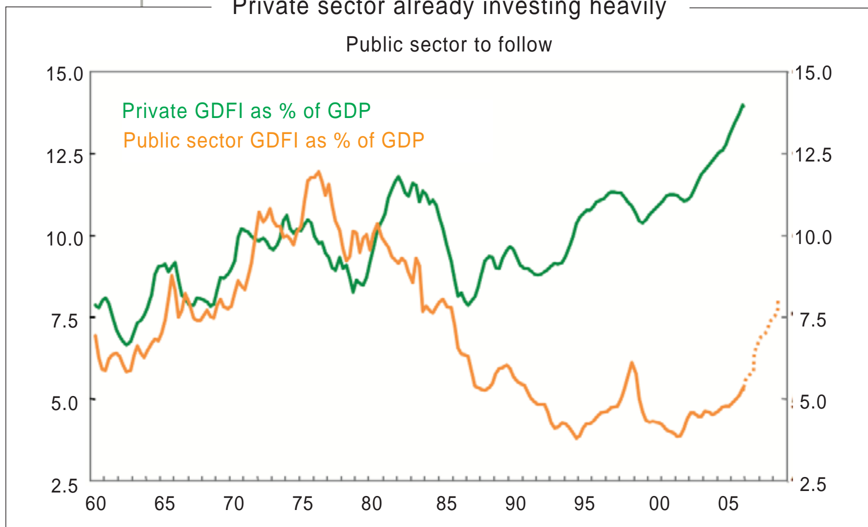
Fourth, global economic and local policy headwinds through the second half of the 1990's have mostly turned into tailwinds, providing solid support to the local economy.

In SA, we have managed to achieve 3% growth under difficult circumstances through the second half of the 1990s, so why do people find it difficult to believe that we can fare much better when circumstances become generally far more favourable?

Returning to the consumption boom of the past several years, it is often asked what drove the boom and whether it can last. The key drivers behind the boom were strong and predictable real income growth (driven by real wage growth per worker, a rise in employment, tax cuts and growing government transfer payments to low income households), generally low inflation and interest rates and a sharp improvement in households' balance sheets as asset prices (residential property, share prices, etc) rose sharply. The currency has also delivered a 'positive consumption shock' over the last few years, with the firmer rand bringing down the cost of imported consumer goods, in some cases sharply.

Therefore, it should come as no surprise that consumer confidence has been, and continues to be, very high, despite the series of interest rate increases last year.

On the negative side, household debt levels have built up sharply over the past few years, from a low of 50% of after tax incomes in 2002 to all-time highs of over 70% currently. However, while the stock of debt has risen sharply, the debt servicing cost has risen far less, owing to lower interest rates in recent years. So, while the debt ratio has hit new highs, the interest servicing burden is currently still only about two-thirds of the peak reached in 1998, when local interest rates peaked at well over 20%. Nevertheless, with interest rates having moved up, one would expect credit-based spending to slow over the remainder of the year and into 2008.



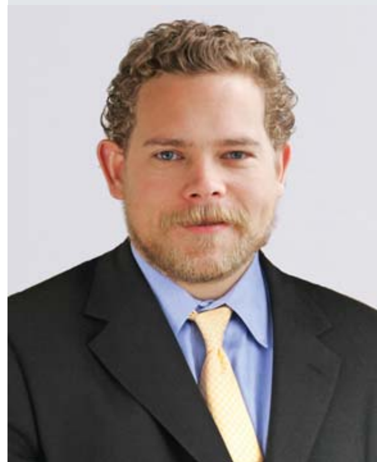
Overall we believe that, in the absence of any major shocks, consumer spending will continue to grow at a healthy pace in real terms over the next few years, although it is highly unlikely to be sustained at the pace of the past three years. We would expect growth to return to a more sustainable 3% - 4% over the medium term.

When it comes to fixed investment, the private sector has been spending heavily over the past decade, but the public sector lagged badly up to last year, when it gathered strong momentum.

Thanks to its improved fiscal position, the government is finally able to commit substantial amounts - some R500bn through 2014 - to improve and expand the country's infrastructure after two decades of underinvestment. Underpinned by this, we believe GFCF growth of 10% or more is sustainable for the next few years, thereafter slowing to between 5% and 8%.

Key risks to sustained consumer and investment spending include a further widening of the current account deficit, rising inflation and capacity constraints in the economy. We are dependent on large capital inflows to finance the deficit, and this financing could become a problem at some point. At the same time, consumer inflation may be well contained currently, but much higher inflation in capital goods prices could eventually put upward pressure on prices at the consumer level. At some point there is also certain to be a cyclical downturn, but these cycles should be more moderate than in the past, given the favourable economic backdrop that has been created over the past decade.

The new face of leverage in the financial system



Derrick Wulf
Sector Portfolio Manager, Dwight Asset Management

(Dwight Asset Management is one of the US investment managers in the Old Mutual Group.)

In the past two decades, the capital markets have grown immensely in their complexity and sophistication. The growth and evolution of the derivatives markets, of securitised products, and of CDO markets have created new risk-transfer mechanisms that have had immeasurable impacts on the ability of investors to isolate and manage various forms of risk. These advancements have vastly improved liquidity in the capital markets, easing financial conditions for investors, businesses, and consumers alike. However, these new financial products have also helped create the means for various entities to assume large amounts of leverage, and to do so relatively inexpensively. The degree of leverage built into the financial system today has created its own unique risks, some of which have recently begun to reveal themselves to investors.

To a corporate credit analyst, leverage is generally defined as a company's debt-to-equity ratio, and, by that measure, leverage in the corporate bond market today is near its lowest level in decades. Earnings growth has been strong, and many companies have reduced outstanding debt. Indeed, in the past several years we have seen impressive improvement in the balance sheets of American corporations, and this is a large part of the reason that credit spreads have recently approached their tightest levels in a decade. However, this trend may now be in the process of reversing itself. The pace of leveraged buyouts has become fast and furious in recent months, with $188 billion worth of LBOs announced just in the first quarter, according to Bloomberg. Meanwhile, numerous companies have announced or expanded stock buyback programs, some of which have been financed with debt, as these companies seek to increase shareholder value. While most corporate bond investors still agree that corporate balance sheets have the strength to withstand modest increases in leverage, nobody likes to see it actually occur.

Other parts of the US economy have shown much less restraint. Consumers, for example, have been on a massive shopping spree that has sent the personal savings rate into negative territory every month since April 2005, according to the Bureau of Economic Analysis. Many have purchased homes they can't afford, while countless others have refinanced their mortgages into higher-proceeds loans in order to monetise accumulated equity. Thus far, the spending habits of consumers have been supported by personal income growth arising from tight labour markets, but the income gains haven't kept up with expenditures. According to the Federal Reserve, household debt payments have risen to nearly 15% of disposable income, higher than at any time since the Fed began compiling this data.

Inasmuch as the intended purpose of leverage is to increase the profit potential for a given venture, the consequence of leverage is a sharp reduction in the margin for error. Individuals seeking to profit from the housing boom during the first half of this decade had taken out large amounts of debt to maximise their real estate holdings. The recent spike in mortgage defaults is in no small part a symptom of increased leverage among consumers.

Investors have become acutely aware of the risks that leverage poses to the consumer sector: homebuilders and consumer finance companies were among the worst performers in the financial markets during the

first quarter. Concerns that a troubled mortgage industry and a weak housing market will threaten the health of the overall economy also caused stock markets to falter, volatility to spike, and credit spreads to widen from their recent tights.

It was a different form of leverage, however, that caused the most damage during the first quarter, and this kind of leverage has many investors worried about greater risks to the financial system.

The securitisation of assets, such as mortgages or other receivables, has drastically expanded the market for loans and has created an efficient means by which issuers can manage portfolio risk and investors can share in the earnings. Securitisation has vastly improved liquidity for such assets, broadening the range of financing options for lenders and ultimately lowering the cost to borrowers. The tranching of securitised debt has also created a credit enhancement mechanism that allows significant portions of a deal to be cushioned from the risk of losses in the underlying collateral. In fact, the senior classes of securitised products have proven to be extremely safe and stable investments. The subordinated classes, however, particularly those near the bottom of the capital structure, have in recent months experienced a great deal of volatility.

The most subordinated tranches of an asset securitisation are in effect highly levered to the performance of the collateral pool. Investors who own the very bottom of the capital structure of an asset-backed deal can lose their entire principal, even if the vast majority of the loans never become delinquent. These types of classes caused the most pain for investors in the sub-prime mortgage market as defaults rose in the first quarter.

Likewise, collateralised debt obligations (CDOs) buy debt securities, pool them together, and issue new securities backed by the pool of debt. In the asset-backed market, CDOs have typically purchased mezzanine classes of asset-backed deals, specifically the tranches rated BBB by the rating agencies. Some CDOs even buy the mezzanine tranches of other CDOs (those deals are often referred to as "CDOs squared"). The diversification achieved by purchasing bonds from different deals sold by different issuers, coupled with a senior/subordinated tranching structure, allows these CDOs to create large senior classes of securities rated AAA. But the lower-rated classes are again levered to the performance of the underlying collateral – in this case, securities that are themselves already a form of leverage. And if correlation in an asset class is high, the diversification doesn't help much.

> 'When leverage is taken on recklessly, significant losses are likely to follow.'

Because of their relatively high yields, these types of securities have become quite popular among investors, particularly among hedge funds that may themselves employ various forms of leverage in their portfolios. The demand for these securities has pushed spreads significantly tighter over the past several years. Improved pricing efficiency has increased the CDOs' demand for asset-backed securities, which in turn has driven the pricing on the assets used to create these securities. These forces have contributed to the decline in underwriting standards that many now blame for the significant rise in defaults in the sub-prime mortgage market. Similar trends in underwriting have also been seen in commercial mortgages, where the average underwritten loan-to-value ratio, a measure of leverage on secured loans, has been driven to all-time highs.

One can see where this is going. Leveraged investors buy levered bonds, which are backed by different levered bonds, which are backed by levered assets. This scenario leaves a razor-thin margin for error. But while financial innovation has amplified some of the risks associated with traditional investing, it has also created the means to hedge those risks. Credit default swaps, for example, allow investors to buy protection against defaults on the securities they own. As the mezzanine classes of CDOs and asset-backed securities plummeted during the first quarter, credit default swaps referencing those types of securities soared.

When leverage is taken on recklessly, significant losses are likely to follow. But when leverage is used to improve financial flexibility within the context of a disciplined risk-management process, it can be a powerful tool. The key to successfully navigating the complexities of the modern financial system is a thorough understanding of these tools, the risks they present, and the opportunities they create.

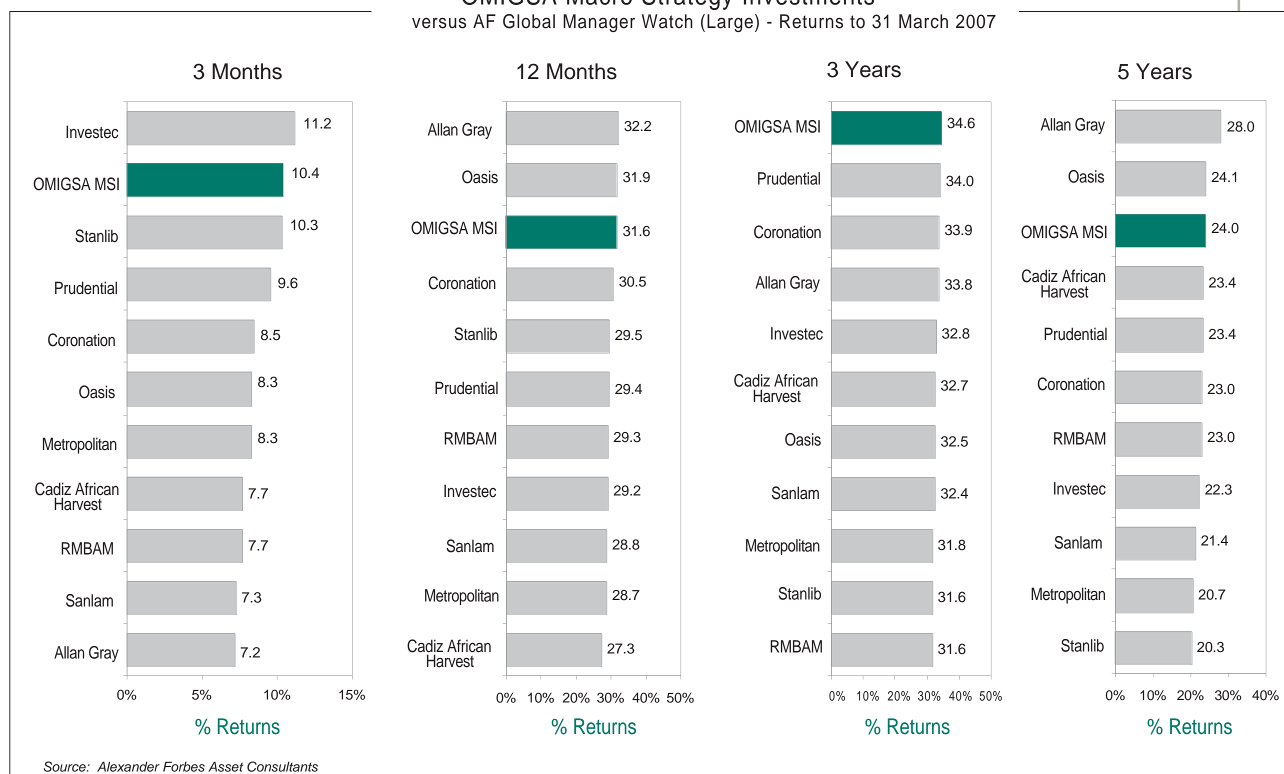
OMIGSA Performance review - 1st quarter 2007

Thabo Dloti
Chief Executive Officer

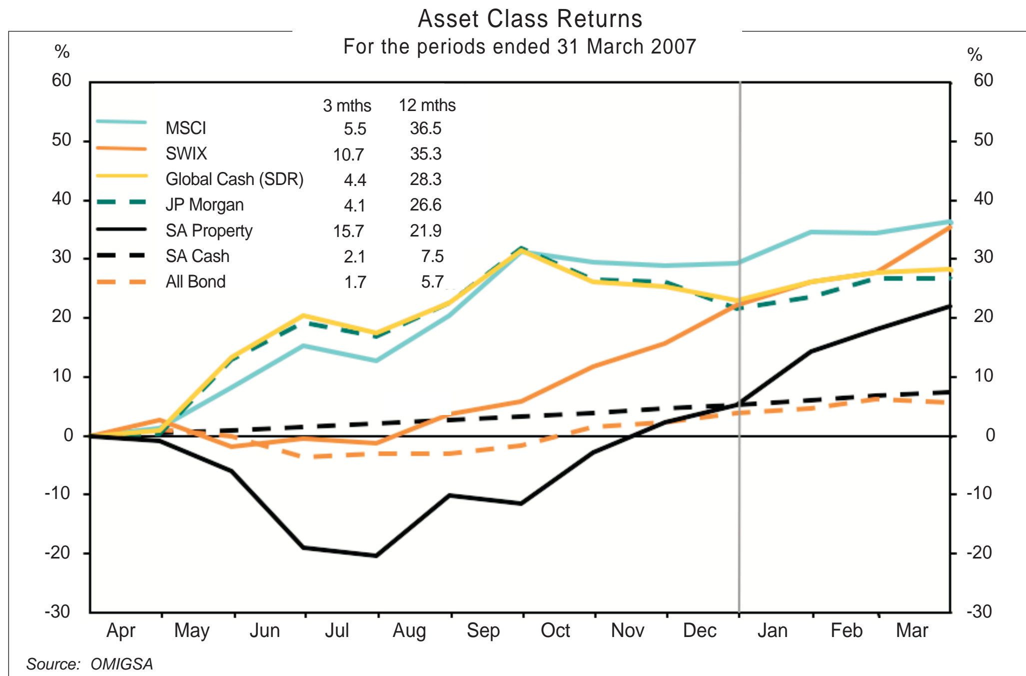
PERFORMANCE THROUGH FOCUS NO.1 IN THE ALEXANDER FORBES SURVEY

Old Mutual Investment Group's Macro Strategy Investments boutique continued to outshine its competitors by snatching the top spot in the performance rankings over three years to March 2007. The strong performance from our equity selection over recent months played a key role in placing us at the top, while our asset allocation calls have remained spot on.

The segregated retirement funds managed by this boutique consistently ranked amongst the top three best performing funds over both the longer and shorter term in the Alexander Forbes Global Manager Watch (Large) survey.



Our decision to remain significantly underweight in bonds continued to pay off as bonds continued to deliver disappointing returns of even less than cash. We believe that local share valuations have become



more expensive than international developed markets and have therefore reduced risk by switching out of local equities into offshore equities. However, we remain overweight local equities relative to our peers, as our view is that it will continue to deliver better returns than bonds. We prefer property shares to bonds, due to the growth potential in rental yields.

The more aggressively positioned Profile Pinnacle Fund also enjoyed another particularly strong quarter, ranking first out of twelve funds in the Alexander Forbes survey for Dynamic funds. It came in above the median fund for the year, remained second over three years and delivered the best return over five years. Both these funds continue to rank amongst the top three best performing funds in their respective groupings in the Alexander Forbes Manager Watch survey over rolling three year periods.

The unit trust funds managed by the same boutique also continued their enviable ability to outperform with the Old Mutual Balanced Fund (regulation 28 compliant) ranking in the top quartile of its sector over one, two and three years and the Old Mutual Flexible Fund (more actively managed asset allocation fund) ranking top quartile over the two and three year periods to March 2007.

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