OCTOBER 2006

FUNDAMENTALS

OMAM INVESTMENT PERSPECTIVES FOR INSTITUTIONAL INVESTORS

Top comment

Garth Taljard - Portfolio Manager

"Absolute return funds are generally structured for the more risk-averse investor who still wants to benefit from a rising equity market."

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ALWAYS
THINKING
INVESTMENT

OLD MUTUAL
Asset Managers

Commentary for the period ending 30 September 2006.

GLOBAL ECONOMY

In brief
- **Three key developments globally over the past quarter**
- **Falling oil and commodity prices raise fears of a global recession**
- **Global prospects still look good**

The third quarter saw three key developments globally: growing evidence of a moderation in growth, led by the USA; a pause in August in the interest rate tightening cycle by the US Federal Reserve and cautious optimism that the tightening cycle may be over; and a considerable decline in the oil price over the last two months of the quarter after reaching an all-time peak of over $75 in July. Other commodity prices also softened, although not as much as oil.

The lower oil price and other commodity prices, if sustained, is welcome news for the world economy from both a growth and inflation perspective, and should reduce the risk of any aggressive further tightening in policy by global central banks. However, the tightening cycle has not run its course outside the US, and other central banks are expected to continue raising rates for a while longer. On the negative side, the decline in commodity prices raised concerns that global growth may be slowing faster than was widely expected and that the world economy may be heading for a hard landing, or even outright recession.

We feel that these hard landing fears are exaggerated. US growth is clearly slowing, and it will certainly negatively affect other parts of the world, but we remain of the opinion that a recession is unlikely. Importantly, US companies are financially sound and profitability is very high, so business spending should lend solid support to growth as consumer spending slows. Moreover, although consumers currently face moderately weakening real estate values, the lower oil price, lower bond yields and higher equity prices will provide welcome relief. Elsewhere around the world, growth has generally remained solid, although it does appear to be slowing moderately. The slowdown is still concentrated in the US and some emerging markets, as activity in the Euro-area and Japan remains robust.

In summary, the recent decline in oil and other commodity prices, and the pause in the rate tightening cycle by the Fed, are good news for the world economy. Although further policy tightening is likely outside of the US, we remain optimistic that the present global growth slowdown will not degenerate into an outright slump later this year or in 2007.

LOCAL ECONOMY

In brief
- **Recent local developments mostly interest rate negative**
- **Risks increase of a sharper up-cycle in rates**
- **Medium-term growth outlook improved by the weaker rand**

Local economic developments over the past quarter were generally very negative for interest rate

prospects. These included upside surprises in producer price inflation (now over 9%), sustained strong domestic demand and credit growth, ongoing large monthly foreign trade deficits, and a renewed sharp weakening of the rand.

These developments have raised the risk of a repeat of the sharp up-cycle in rates that occurred in 2002 (400 bps in total) following the collapse of the rand the previous year. Should the rand weaken further and/or the local dataflow on the domestic demand boom, large trade deficits, and pipeline inflation pressures, not begin to improve soon, a bigger rate cycle is inevitable.

However, not all the news has been bad. The sharp fall in the oil price has, despite the weaker rand, caused a sharp fall in local petrol prices over the past two months, local maize prices have eased notably in recent weeks and there are some tentative signs that the boom in car sales, typically a leading indicator of overall trends in consumer spending growth, is slowing. However, much more good news over a broader front will be required to prevent a stronger up-cycle in local interest rates than the total of 200 bps in the cycle we have been forecasting until now.

While the short-term news is undoubtedly negative, an important and much needed rebalancing is occurring in the economy that will enhance medium- to longer-term growth prospects. We have often argued in the past that the SA economy will struggle to sustain 4%+ growth rates with a too strong rand. The weaker currency will therefore undoubtedly improve medium-term growth prospects as both exporters and local producers who compete with imports will benefit. Unfortunately, the weaker rand requires higher interest rates to ensure that all the benefits of the weaker currency are not undone by rising local inflation.

GLOBAL EQUITY MARKETS

Special report by OMAM (UK).

The global equity market rally continued during September. US equities set the tone for other markets, with the S&P 500 Composite Index gaining 2.6%. The Nasdaq Index outperformed for the second successive month, with a gain of 3.4%. Markets were helped by the continued fall in the oil price and a month of fairly benign economic data.

From a global sector perspective, energy continued to underperform, with a further fall of 4.5%. Oil prices have fallen from a high of $78 earlier in the summer to $60 at present, so the poor performance of the energy sector was unsurprising.

The best performing sectors included telecoms, financials (in light of the improved US interest rate outlook) and retailers (given improving US consumer confidence data). US interest rates remained on hold and US bond yields edged lower. The improved interest rate outlook and the perceived reduction in the risk of a US 'hard-landing' helped the US market to rally.

Good profits growth is expected over the next twelve months and if expectations prove to be correct a continuation of the rally is likely. Periods of volatility are to be expected however. Japanese equities lost 1% during the month. The market underperformed in the third quarter as investors became nervous about the change in interest rate policy and as they questioned whether the economy is strong enough to withstand a period of rising rates. The market remains 9% below its 2006 highs,which were hit in April. We believe the market is not particularly attractive at these levels. Valuations are not cheap and profits growth is forecast to be nearer 5% than 10% in the fiscal year ending March '07.

While the UK market gained 1.6%, it was the weakest performer amongst global markets. However, the small and mid-cap areas of the market fared much better than their large cap counterparts, with gains of 2.9% and 4.4% respectively.

Taking the quarter as a whole, small and mid-cap shares outperformed. However, in valuation terms, UK large-caps look more attractive than the mid-cap area of the market.

The global interest rate cycle remains delicately poised. In the US the top of the cycle is fast approaching, but in Japan and Europe further interest rate increases are likely as we move through the remainder of the year. As we have been saying for some time, once the US equity market starts pricing in the peak in domestic rates, share prices are likely to rally more strongly. At this point, a period of outperformance from US equities is a distinct possibility.

CONTINUED

Equity Market Summary

	Current Price Index	Local currency Total Returns* September %	YTD %
MSCI World	1373	1.2	11.2
S & P 500 Comp	1336	2.6	8.5
Nasdaq Comp	2258	3.1	4.2
FTSE All Share	3050	1.6	10.0
FTSE 100	5961	1.1	9.1
FTSE Mid 250	9997	4.4	15.9
FTSE Small Cap	3542	2.9	8.8
MSCI Europe ex UK	1209	2.8	13.6
Topix Japan	1611	-1.0	-1.3
MSCI AC Asia Pacific ex Japan	364	2.5	12.6

Souce: Datastream * except MSCI World which is US$ returns

In our view, the global economic outlook remains favourable for equities. Robust economic growth is flowing through to strong corporate profit growth and equity market valuations do not appear extended.

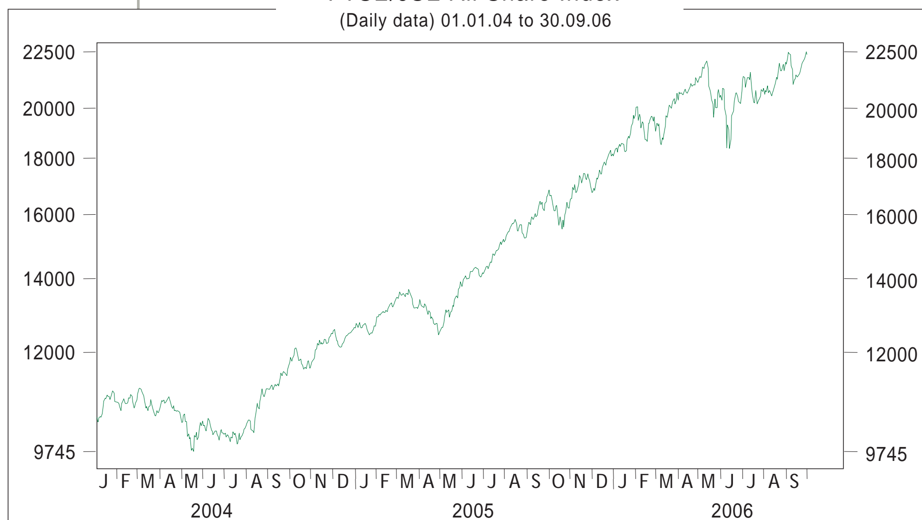
LOCAL EQUITY MARKET

In brief
- **Headline index recovers after weak second quarter**
- **Local equities still preferred over other asset classes**
- **Caution advised in terms of performance expectations**

SA equities recovered well following the significant sell-off in emerging market equities during the second quarter. The recovery took shape during August and the market recorded a new all-time high early in September. Following this new high, equities came under pressure, but recovered again late in the quarter. The All Share Index closed the quarter 6.3% higher, marginally shy of the high recorded early in September. This quarterly gain advanced the overall performance of the index for the calendar year to 26.3%.

Although the headline index performed credibly, the performances of the various equity sectors were very diverse. Mining shares, the darling of the market in recent quarters, started to lose momentum during the quarter. Gold shares lost 13.9% and platinum shares only gained 2%. The general miners performed in line with the headline index. Industrial shares were the winners in the quarter, with general industrial shares gaining 10.6%, while industrial shares with a rand hedge flavour did particularly well.

FTSE/JSE All Share Index
(Daily data) 01.01.04 to 30.09.06



Construction shares also performed well as the sector gained 17.6%, beverages added 14.6% and health care advanced by 14.3%. Telecommunications, one of the lagging sectors in previous quarters, managed to recover well and closed 16.5% in the black. Banks were once again disappointing with a return of only 3.8%.

The positive sentiment in the market was driven by a few factors. Firstly, share prices appreciated globally, and our market was no exception. Secondly, commodity prices started to lose some of their glitter and commodity-specific shares came under pressure as a result of the decline in some commodity prices. Thirdly, the weaker rand undoubtedly

supported the share prices of some traditional industrial rand hedges. Shares like Richemont, Liberty International and Remgro appealed to investors who wanted a hedge against a weakening currency without adding to commodity exposure.

CONTINUED

View

The equity market recovered well, following the sell-off in the second quarter. OMAM is on record as saying that we prefer local equities to the other asset classes on a secular or longer-term perspective. This view has not changed, but we are in no doubt that the market is more expensive in terms of its own history. SA equities have re-rated significantly against global equity markets. It is unrealistic to expect foreign investors to continue to support local share prices to the same extent as they have over the last 18 months. As a result, we are more cautious in our expectations of what equities can deliver over the next 12 months.

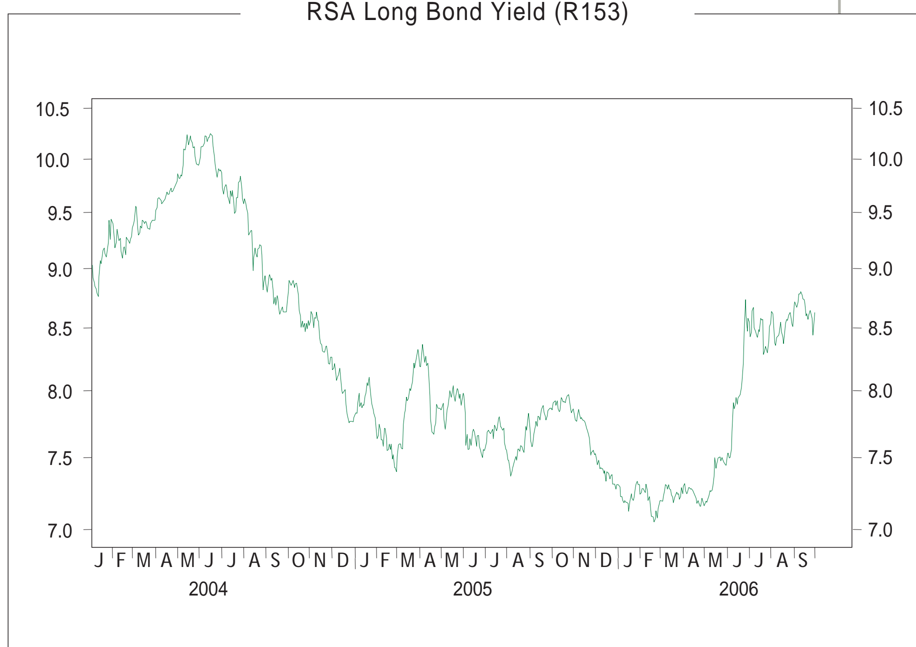
GLOBAL AND LOCAL BOND MARKETS

In brief
- **Global bond markets end the quarter stronger**
- **Local bond market reflects volatility, but ends flat**
- **Forward money market prices in the next 100bps repo rate increase**

Developed bond markets, in general, recorded strong positive performances during the quarter. The biggest gain in yield was in the US, where the benchmark 10-year Treasury yield declined by a total of 56 basis points (bps) from the high of 5.19% recorded at the end of June 2006 to a close of 4.63% at the end of September. Treasury market bulls were comforted by a series of interest-rate friendly economic data releases, particularly on the housing market front, which enabled the Federal Reserve Board to pause in tightening monetary policy for the first time since July 2004. The sharp decline in treasury yields led to the inversion of the yield curve - an indication that market consensus expects any combination of slower economic activity and an easing of inflation pressure to pave the way for rates to be cut as soon as next year.

Another very important development for fixed income markets was a dramatic decline in the US dollar price of crude oil as tensions in the Middle-East subsided. Emerging market sovereign debt spreads were quite volatile over this period. The spread of the US-dollar denominated index over the US Treasury curve fluctuated between the close of 221bps at the end of June to a low of 180bps, before worsening sentiment caused it to retrace to 218bps at the end of September.

Locally, the benchmark R157 government bond (maturity 2015) traded in a wide range of 63bps before closing at 8.63%, 2bps below the closing yield at the end of the previous quarter. Sentiment swings during the quarter were caused mainly by worse than expected producer price data and rand weakness on the negative side, while bulls just gained the upper hand on the back of sharply falling crude oil prices, strong global bond markets, and the influence of some technical factors. The yield curve has also inverted, signalling that the market expects another 100bps increase in the repo rate to be the end of the current tightening cycle.



Money market rates drifted higher in reaction to the 50bps increase in the repo rate, while also starting to price in future policy tightening. Three-month and 12-month NCD rates rose by 75bps each to 8.45% and 9.50% respectively. At the time of writing, the forward money market had priced another 100bps increase in the repo rate.

View

Global tightening is still expected to be an important theme with the added risk of some global growth slowdown. This could negatively affect emerging market countries like South Africa that are running imbalances such as the large current account deficit. Although we acknowledge the fact that the rand has depreciated significantly against a basket of currencies, risks of more weakness remain. This is forcing us to maintain a cautious stance in the near term.

MARKET INDICATORS

AS AT 30 Sept. 2006	DY%	PE RATIO	ZAR	USD	ZAR	USD
JSE EQUITIES			1 MONTH % CHANGE*		12 MONTHS % CHANGE*	
All Share Index	2.4	16.1	2.3	-5.3	36.1	11.2
Fin & Ind Index	3.5	51.0	3.9	-3.9	28.5	5.0
All Gold Index	0.9	45.6	-3.8	-11.0	31.3	7.3
			Last month		Last 12 months	
Value Traded (billions)			133.8	28.0	1735.5	253.8

* Price index only. Dividends included.

ECONOMIC INDICATORS

	LATEST DATA		PREVIOUS YEAR
EXCHANGE RATES:			
Rand/USD	Sept - 06	7.76	6.34
Rand/UK Pound	Sept - 06	14.48	11.22
Rand/Euro	Sept - 06	9.83	7.64
Rand/Aus$	Sept - 06	5.79	4.84
INTEREST RATES:			
Prime Overdraft	Sept - 06	11.50%	10.50%
3-Month NCD	Sept - 06	8.30%	6.85%
R153 Long-bond Yield	Sept - 06	8.63%	7.86%
INFLATION:			
CPI (y-o-y)	Aug - 06	5.4%	3.9%
CPIX (y-o-y)	Aug - 06	5.0%	4.8%
NATIONAL ACCOUNTS:			
GDP Growth (y-o-y)	Q2 2006	4.1%	5.2%
GDP Growth (q-o-q, annualised)	Q2 2006	4.9%	5.3%
HCE Growth (y-o-y) (Household Consumption Expenditure)	Q2 2006	7.0%	7.1%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	Q2 2006	9.7%	9.1%
BALANCE OF PAYMENTS:			
Trade Balance (12 mth cumulative)	Aug - 06	- $7.64bn	- $2.44bn
Current Account (% of GDP)	Q2 2006	-6.1%	-3.7%
Capital Account (% of GDP)	Q2 2006	7.4%	9.5%
Forex Reserves (incl. gold)	Aug - 06	$25.15bn	$19.13bn
OTHER:			
Manufacturing Production (y-o-y) (seasonally adjusted)	July - 06	5.4%	2.2%

(All information relates to month end.)

Garth Taljard - Portfolio Manager

Absolute Return Funds – tailored solutions for risk-averse investors

Much like the rest of the developed world, South Africa's investment landscape has been re-shaped over the past few years by growing demand from investors for investment solutions designed specifically to meet their unique needs.

Absolute return funds are but one example of the sophisticated solutions being developed these days by asset managers in answer to this need. After three years of strong growth, a huge variety of these funds are now available in South Africa, however all have the common goal of limiting downside risk while achieving real, above-inflation returns.

Absolute return funds – sometimes also called real return or targeted funds – are generally structured for the more risk-averse investor whose priority is capital preservation, but who still wants to benefit from a rising equity market. They offer a targeted level of capital growth with some capital protection, but there is no guarantee against losses. Implicit in this risk-return balance is the understanding that some of the potential returns may need to be sacrificed in order to achieve the mandate set for the fund.

The funds invest across most major asset classes, including fixed income, cash, property and equities, and many also use some derivative instruments like futures and options to limit downside market risk and lock in returns as they are earned. Cash and money market funds have generally been preferred investments due to their low risk nature, while inflation-linked bonds have also proven to be particularly popular given their inflation-hedging characteristics.

According to the Association of Collective Investments (ACI), the number of absolute return funds on offer (both retail and institutional) has more than quadrupled in less than three years, to stand at 68, compared to the 16 that were available at the end of 2003. This proliferation of absolute return funds has also attracted substantial asset inflows from investors over the past three years. As of mid-2006, assets in absolute return funds totaled R22.9bn and accounted for 5% of total assets under management in the local collective investments industry. This compares to only R5.1bn, or 2% of industry funds under management in December 2003. The popularity of these funds would appear to be the result of heightened risk aversion amongst investors arising from a number of factors, including: the global bear market of 2000 to 2003; an increasingly regulated investment environment that has made investment advisers more cautious; and a greater desire for a focus on absolute rather than relative returns within portfolios.

Of course, where one has this many similar funds, you will also find a significant amount of innovation as each attempts to differentiate itself from the competition. Within the absolute return category, there are almost as many different performance targets and levels of risk and capital protection as there are funds, and these are achieved within varying timeframes. While such a diversity of options can be appealing to investors, increased choice brings with it the need for greater diligence in research prior to investing. Rather than merely opting for the absolute return fund that has shown the best returns over the past three years, investors need to ensure that their choice of fund appropriately matches their risk and return profile with due attention given to the timeframe in which they hope to achieve their investment objective.

ABSOLUTE FUND INVESTMENT STRATEGIES

It is worth noting that the managers of absolute funds employ very different investment strategies, resulting in varying fund performances and risk levels. The four most popular strategies appear to broadly be as follows:

1. High cash with stock picking
In this approach, the manager will use a high proportion of cash and market hedging to keep risks low and rely on superior equity analysis (or stock picking) to achieve the desired return. While effective at capital preservation, the success of the strategy is largely dependant on the manager's stock-picking skills to generate the required returns.

2. High cash with diversification
The second strategy also involves a low degree of equity exposure, instead generating returns through contributions from shorter-term asset allocation. This means the manager invests across a diversified portfolio of assets, with the bulk of funds in cash to provide stability. The approach is likely to succeed in preserving capital, but investors may be left wondering how much of their potential returns are being sacrificed in the process.

3. Active management
The third strategy, as used in the Old Mutual Dynamic Floor Fund* amongst others, focuses on active management of equity exposure. It takes advantage of periods of strong equity market performance to maximise returns, while shifting into other asset classes in response to equity market downturns. Funds managed in this way generally feature a high level of capital protection, with some using derivatives to lock in previous returns. The idea behind this strategy is essentially to have the fund perform well during a bull market, while protecting capital during bear markets. It does, however, become difficult to record high returns in extremely volatile conditions where there is no clear trend.

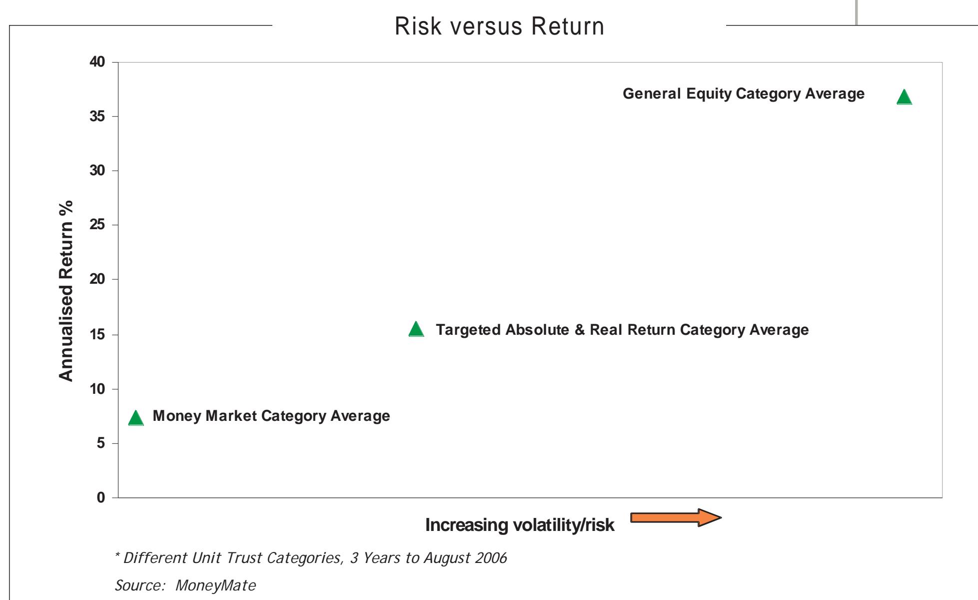
4. Low cash with stock picking
The final strategy also opts for lower cash holdings, while relying on either tactical (short-term) asset allocation or accurate stock-picking to generate the desired returns. Risk is managed through the use of derivatives and depends to a large extent on the ability of the fund manager to foresee equity market falls and identify less risky, undervalued shares.

It would be fair to describe the first two strategies as more "defensive" in nature, while the last two undoubtedly constitute a more "aggressive" approach.

Although many absolute return funds do not have a track record longer than three years - during which time South Africa has enjoyed a bull market - their performance history demonstrates that the category has indeed performed as it was designed to.

As shown in the accompanying graph, the average category returns of 15.5% p.a. over three years have comfortably beaten inflation and the money market fund category average of 7.4%. Importantly, this has come at a much lower risk than the equity market, where the average general equity fund returned 37.0% per annum over the period.

Despite the lower-risk characteristics of absolute return funds, prudence is still advised when investing - as is the case with any investment. Most importantly, investors must carefully consider



whether the fund's mandate suits their specific needs, and whether the fund appears likely to deliver on its mandate.

* The Old Mutual Dynamic Floor Fund, one of several absolute return funds managed by OMAM, aims to protect at least 90% of net capital invested over a 12-month period, while also returning CPI+4% per annum on a rolling three-year basis. The fund has outperformed both the category average and its benchmark, returning 18.3% p.a. for the three years to end-August 2006, compared to 6.9% p.a. for the benchmark (CPI+4%).

The importance of credit analysis in today's corporate landscape

Scott McIntyre - Portfolio Manager,
Dwight Asset Management

Over the past several years, US corporations have enjoyed a substantial run of global economic expansion, improved earnings growth and replenished balance sheets. This environment, combined with unprecedented market liquidity and historically low default rates, has created what appears to be a relatively benign credit environment. However, we believe there are three considerations, other than traditional balance sheet and income statement analysis, that should be at the forefront of investors' minds: financial policy, idiosyncratic risk, and possible defensive postures. Scott McIntyre, Senior Portfolio Manager at Dwight Asset Management, looks at these considerations. Dwight Asset Management is one of the US investment managers in the Old Mutual Group.

FINANCIAL POLICY

As the corporate sector struggles to maintain organic earnings growth and shifts its attention away from balance sheet repair, bondholders watch in trepidation as mergers and acquisitions and equity-friendly announcements flood the markets. While this behaviour should be a concern to bondholders, it must be considered within the context of the entire corporate structure. Free cash flow directed to stock buybacks may ultimately be a positive influence, as the resulting equity performance could hold corporate raiders at bay. Additionally, free cash flow directed at acquisitions could provide the basis for earnings growth for many years to come. While this systematic risk persists at different levels for different industries, it is important to determine at what level this activity is truly detrimental to the bondholder. In this environment, where balance sheets are healthy and earnings growth is difficult to come by, a balance of both creditor and equity concerns may be warranted. We must understand managers' long-term views and aspirations for their organisations and their industries to understand how they may deploy current and future cash flows.

IDIOSYNCRATIC RISK

Part of the strong liquidity mentioned previously can be attributed to the emergence of non-traditional investments, such as hedge funds and private equity firms. While these sources can be credited with spread tightening, as money is put to work in traditional cash bonds, they can also be attributed to spread widening, as private money looks to exploit under-leveraged companies with weak equity performance and large cash balances. Companies with this profile often become targets for leveraged buyouts. While Wall Street firms have developed various screening methods to determine which companies may be attractive to private equity firms, determining this type of idiosyncratic event risk often requires a more fluid analysis. This must incorporate the financial policy of the companies discussed above, as well as an understanding of the cash needs for the company and the cyclical nature of the industry and the specific business. Holding a large cash balance, or holding less debt than capacity, may not leave a company exposed to a leverage buyout, but determining whether this is truly a risk is an emerging and critical role for credit analysts. Finally, company-specific characteristics like family ownership or community presence may also play a part in these analyses.

DEFENSIVE POSTURES

A final focus in this low-yielding and decelerating growth environment is the consideration of defensive posturing. While pure alpha players such as hedge funds and equity houses search for yield, so too

do traditional long-term holders. Inherently, incremental yield has become increasingly difficult to achieve, and many investors reach for yield without full consideration of the underlying fundamentals. As the proverbial tide lifts all boats, downside risks increase as investors get paid less for growing event risk and the potential for a slowing economy. Market inefficiencies are difficult to find as investors shun the cyclical nature of the economy, the market, and individual companies. Thus, investors push up the valuations of companies, sometimes regardless of their potential. Selection of companies that offer competitive yield premiums and the potential for fundamental improvement then becomes crucial.

SUMMARY

The confluence of historically tight yield spreads, heightened event risk, and the entrance of additional financial players such as hedge funds points to the critical importance of an experienced credit research team. We believe there is an asymmetric risk/reward profile in the current environment. Therefore we believe that the prudent approach is to maintain a cautious stance until the market prices risk more favourably.

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