SEPTEMBER 2006

FUNDAMENTALS

OMAM INVESTMENT PERSPECTIVES FOR INSTITUTIONAL INVESTORS

Top comment

Arno Lawrenz - Head: Fixed Income

"A quiet revolution has been taking place among asset managers focused on the fixed income asset class."

See page 6

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ALWAYS
THINKING
INVESTMENT

OLD MUTUAL
Asset Managers

Commentary for the period ending 31 AUGUST 2006.

GLOBAL ECONOMY

In Brief
- **Welcome fall in the oil price and a pause by the Fed is good news for the world economy**
- **Global growth remains solid, but slows moderately**
- **Optimistic outlook for the world economy remains unchanged**

August saw two key positive developments on the global economic front. The first was a significant softening of the oil price from well over $70 per barrel to the mid-$60s by early September. The second was the decision by the US Federal Reserve to keep rates unchanged at its meeting on August 8, following 17 successive hikes of 25 bps each.

The lower oil price, if sustained, is welcome news for the world economy from both a growth and inflation perspective. The oil price of over $70 was clearly starting to negatively affect economic activity in oil consuming nations by sapping the strength of consumer demand and imposing a serious cost burden on companies. Moreover, it carried with it the risk of a sharp further tightening in monetary policy by central banks around the world in order to stave off potential inflation pressures. While the oil price risk has surely not disappeared, the recent softening is certainly to be welcomed.

Meanwhile, overall global growth has 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 solid.

In summary, the recent decline in the oil price and pause in rate hikes by the Fed are good news for the world economy. Although further policy tightening is likely outside of the US, we remain optimistic that central banks will not drive the global economy into a severe downturn 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**
- **Fortunately, it's not all bad news**

Whereas global economic developments were mostly favourable during August, local ones were generally not. The past month saw a number of developments that have raised concerns over the medium-term economic outlook for South Africa. The key issues were upside surprises to both consumer and producer price inflation, sustained strong domestic demand and credit growth, another large foreign trade deficit and a renewed weakening of the rand.

These developments have raised local interest rate risks and a further hike in October by the Reserve Bank now looks like a *fait accompli*. The bigger question is whether we could see a repeat of the sharp up-cycle in rates in 2002, when rates rose by a total of 400 bps compared to the 100 bps hike seen so far in this cycle.

The risk of a stronger than expected up-cycle in local rates has clearly increased, although we still

remain confident that the tightening will not be as severe as that seen in 2002. Importantly, inflation expectations and wage settlements are still considerably lower today than four years ago, and this cycle has seen the SARB reacting earlier to the growing inflation risks than was the case in 2002 when the tightening cycle started too late in our opinion. In the shorter term, the recent softening in the oil price has already led to a sizeable petrol price cut in September and another cut may occur in October, provided oil holds at the lower levels and/or the rand does not weaken sharply further.

That said, averting a more severe up-cycle in rates will require an improvement in the local macro-economic data in the coming months.

GLOBAL EQUITY MARKETS

In Brief
- **International equity market volatility continues**
- **Sanity returns to emerging markets**
- **Broadly benign environment for world equity markets**

Global equity markets continued to advance at a steady pace during the month. These markets worked particularly hard to not lose ground in the first two weeks of the month. The second half of the month was characterised by general strength, and most international markets ended August in the black.

US equities, as measured by the S&P 500 Index, gained a very solid 2.1% during the month and most other markets followed suit. In Europe, the CAC 40 added 3.1%, while the DAX copied this performance to the decimal. Japanese equities, which had lagged the rest of the world, bounced strongly in August as the Nikkei 225 jumped 4.1%. The only exception to this performance picture was UK equities, which closed the month 0.4% in the red.

These international market performances were the result of common drivers. Economic activity in the US has certainly shown signs of slowdown. Activity in the housing market is undoubtedly dwindling as soft data over a wide front confirms the slowdown. Payroll data supported the softer data, but showed no signs of a collapse in the job market. Inflation numbers were also well behaved and contributed to the view that the Federal Reserve Bank might well have concluded the hiking of short rates for this interest rate cycle. The lower oil price also contributed to the positive sentiment in the market. On the negative side, interest rates were hiked in a number of economies. In the UK, the Bank of England raised the repo rate by 25 basis points - its first hike in two years. Rates were kept unchanged in Europe, but Mr Trichet spoke of “strong vigilance”, indicating a possible hike in rates during October. Equity markets largely ignored these warnings and decided to focus on the positive data instead.

View
Our base case view still points to firm global growth, with the US being the only exception as it is likely to experience a more noticeable slowdown during the second half of the year. The general economic strength in other parts of the world is likely to support earnings numbers and, as a result, global equity valuations do not look stretched. Earnings momentum in developed countries will, however, slow from current levels, creating a broadly benign environment for world equity markets.

The market volatility reflects concerns about central banks’ overreaction to inflation scares. As future data releases send mixed signals, volatility is likely to continue. Markets currently reflect discomfort around prospective interest rates. This discomfort is largely discounted in the ratings of international equity markets.

LOCAL EQUITY MARKET

In Brief
- **Equities enjoy very strong month**
- **Local equities still preferred over other asset classes**
- **Caution should still be exercised in terms of performance expectations**

South African equities enjoyed an exceptionally strong month as the All Share Index recorded a return of 5.4% for the month. This firm reading advanced the overall performance of the index for the calendar year to 23.4%. It is worth noting, however, that this calendar year performance was not recorded in a straight line, but was subject to periods of extreme volatility.

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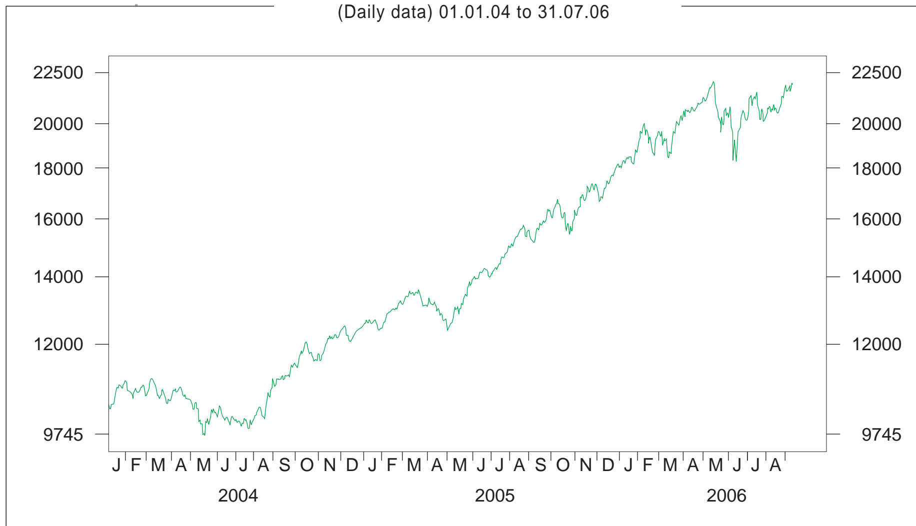


The market was strong across a broad front. Resources gained 5.6%, industrial shares advanced by 5.9% and the laggard of the year, financial shares, added 4.1% in the month. The star performer was the listed property sector that bounced by 12.7% during the month after the sector was heavily sold down during the second quarter. Gold shares were the exception, as the index lost 0.9% in the month due to a pull back in the gold price.

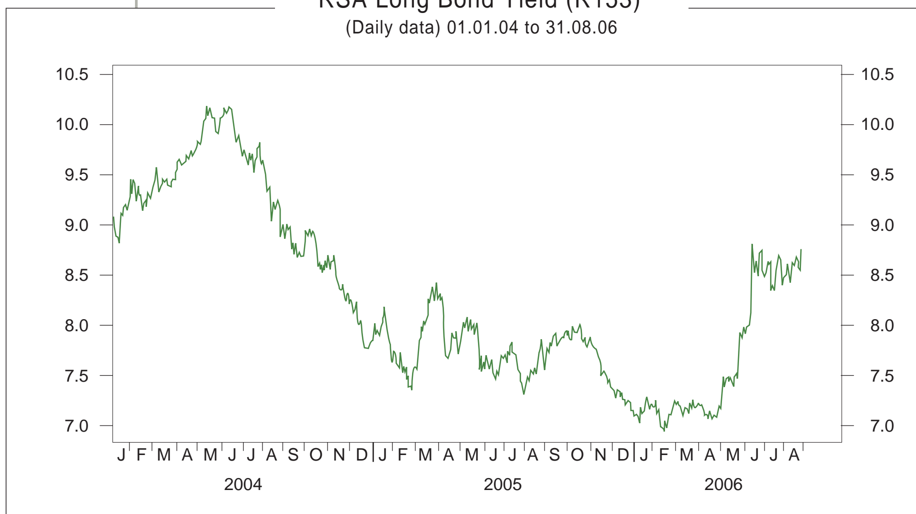
The positive sentiment in the market was largely driven by three factors. Firstly, share prices appreciated globally, and our market was no exception. Secondly, it was a very active month in terms of company results with local companies generally reporting strong results for the previous year or half-year. These results came through for both resource companies as well as financial and industrial companies. The absence of any significant negative surprises, in terms of the operational performance, boosted the share prices. Thirdly, potential corporate activity did nothing to harm the prospects for the equity market. Given these very dominant drivers, the market was quite prepared to ignore the higher inflation numbers both on the production and consumer side, despite the fact that they were undoubtedly negative for the short-term interest rate prospects.

View

The equity market recovered well following the sell-off in the second quarter. In fact, the market closed just shy of its all-time high recorded early in May. 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. However, 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 and we cannot expect foreign investors to continue to support local share prices to the same extent as they have been 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 & LOCAL BOND MARKETS

In brief:
- **Global bond markets gain on the back of soft US data**
- **Local market weakens following worse than expected economic data**
- **Forward money market rates price in another 100 bps repo rate increase**



Developed bond markets recorded another good month, led by a very strong bull rally in the US, where Treasury market bulls were comforted by a series of softer economic data releases, in particular on the activity front. The data served as an indication that the Federal Reserve will leave short-term interest rates unchanged, at least in the medium term. This bullish view is best illustrated by the sharp decrease of the US Treasury note by 25 bps to 4.75% during August, thus ending the month 50bps below the Federal Reserve's target. Most emerging debt markets ended the month largely unchanged from the previous month's close, after a retracement in the latter half of August eroded earlier gains.

Locally, the benchmark R157 government bond remained bound to the 8.50% and 8.80% range. Negative data surprises at month end, in particular private credit extension, PPI and external trade account data, forced the market to the upper end of the range, causing market yields to end the month at higher levels, with the R157 closing 12.5 bps weaker at 8.775%. As a result, nominal fixed rate bonds under performed both cash and CPI-linked bonds.

The money market reflected some volatility with a weakening bias. Money market rates closed the month slightly higher. Three-month and 12-month NCD rates have increased by 20 bps and 10 bps respectively. The forward money market is pricing the three-month rate to rise by just over 100 bps in five to 12 months time.

View

The outlook has not changed much. Global tightening is still expected to be the main theme with the added risk of global growth slowdown - particularly in emerging countries with relative large imbalances, like South Africa. We therefore maintain a cautious stance in the near term and prefer to hold cash and very short-dated assets.

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MARKET INDICATORS

AS AT 31 AUG 2006	DY%	PE RATIO	ZAR	USD	ZAR	USD
JSE EQUITIES			1 MONTH % CHANGE*		12 MONTHS % CHANGE*	
All Share Index	2.3	16.2	5.4	1.7	46.2	31.0
Fin & Ind Index	3.6	51.1	5.3	1.6	31.5	17.8
All Gold Index	0.9	71.6	-0.9	-4.4	78.6	60.0
			Last month		Last 12 months	
Value Traded (billions)			217.6	27.8	1700.7	241.3

* Price index only. Dividends included.

ECONOMIC INDICATORS

	LATEST DATA		PREVIOUS YEAR
EXCHANGE RATES:			
Rand/USD	Aug - 06	7.18	6.43
Rand/UK Pound	Aug - 06	13.66	11.55
Rand/Euro	Aug - 06	9.19	7.91
Rand/Aus$	Aug - 06	5.48	4.83
INTEREST RATES:			
Prime Overdraft	Aug - 06	11.50%	10.50%
3-Month NCD	Aug - 06	8.20%	6.90%
R153 Long-bond Yield	Aug - 06	8.70%	7.72%
INFLATION:			
CPI (y-o-y)	Jul - 06	5.0%	3.4%
CPIX (y-o-y)	Jul - 06	4.9%	4.2%
NATIONAL ACCOUNTS:			
GDP Growth (y-o-y)	Q1 2006	4.2%	5.5%
GDP Growth (q-o-q, annualised)	Q1 2006	4.2%	4.6%
HCE Growth (y-o-y) (Household Consumption Expenditure)	Q1 2006	6.7%	7.2%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	Q1 2006	8.2%	10.6%
BALANCE OF PAYMENTS:			
Trade Balance (12 mth cumulative)	July - 06	- $7.37bn	- $2.45bn
Current Account (% of GDP)	Q1 2006	-6.4%	-4.3%
Capital Account (% of GDP)	Q1 2006	8.3%	4.5%
Forex Reserves (incl. gold)	July - 06	$23.48bn	$18.64bn
OTHER:			
Manufacturing Production (y-o-y) (seasonally adjusted)	June - 06	6.2%	3.1%

(All information relates to month end.)

A quiet revolution in fixed income fund management

Arno Lawrenz - Head: Fixed Income

Over the past few years, South African investors have been the beneficiaries of a quiet revolution among asset managers focused on the fixed income asset class. Following the global trend toward investment specialisation, local asset managers have been moving away from their historic emphasis on simple bond or money market funds to offer a range of specialist, tailor-made investment products that meet the specific needs of investors.

Driving this revolution has been South Africa's move to a lower inflation, lower interest rate environment. Although this has clearly led to significant economic benefits, it has also rendered investments in the traditional fixed interest asset class relatively unattractive due to the low interest rates they now offer.

As a result, both institutional and retail investors have gone in search of higher-yielding investment solutions that still meet their fundamental requirements, which include a steady, growing income and low-risk returns.

SPECIALIST INCOME FUNDS PROLIFERATE

The local asset management community has responded to these needs by developing a host of new types of fixed interest funds, widely known as specialist income funds. Many of these do incorporate more traditional bond and money market instruments, but also draw on an array of sophisticated interest rate-based securities including forward rate agreements (FRAs), corporate, inflation-linked and convertible bonds, securitised debt, credit-linked notes, derivatives such as interest rate and credit default swaps, and even listed property and preference shares.

"a host of new types of fixed interest funds, widely known as specialist income funds"

Asset managers combine these listed instruments to structure funds aimed at delivering returns that beat the traditional benchmarks of inflation, money market or bond indices. Other specialist funds are tailor-made for investors and designed to achieve a specific, targeted return over time, given particular risk parameters.

Some managers go a step further and incorporate equities in their income funds as yet another way to achieve the requisite risk-return balance.

Because of the variety of interest rate-based instruments now on offer, the funds can and do vary widely in terms of both risk and return, even among those grouped in the same category. Managers now provide a far more specialised solution and the fact that these specialist funds are more technically advanced and so varied, means they require active management to ensure they deliver what they promise.

OMAM's new boutique approach to fund management will ensure that our team of fixed income investment professionals has the autonomy and flexibility required to focus on active management.

Following the proliferation of these specialist funds, the Association of Collective Investments (ACI) has categorised them into four fixed interest sectors to aid in regulation and investor understanding. These sectors are:

- Money Market Funds, which only hold securities averaging up to three months in duration;
- Bond Funds, which hold bonds of any duration;

- Income Funds, which may hold any type of interest-yielding security, but have a maximum average duration of two years;
- Varied Specialist Funds, which may hold income-yielding securities of any duration.

Meanwhile, funds incorporating some equity are included within the ACI's Asset Allocation category.

SA investors now have the choice of some 51 Varied Specialist funds, compared to only four in 2001, according to ACI data. In the past two years, this category has demonstrated the fastest growth within the fixed interest sector in terms of net inflows. As of 30 June, total assets stood at R47.3 billion, or 11% of all industry assets under management, compared to only R2.5 billion in June 2001.

While specialist fund assets have grown, demand for traditional Bond Fund assets has virtually stagnated. They can now claim a meagre R15.9 billion under management, versus R11.6 billion five years ago - which represents a much slower growth rate when compared to the Varied Specialist Funds.

SPECIALIST INCOME FUNDS OUTPERFORM

The flood of new money into specialist funds has been the result of their increased attractiveness to investors, based on their performance and the strong track records they have established for outperforming the more traditional fixed income funds. Investors have also become more familiar with their mandates.

Old Mutual's Enhanced Income Fund, launched in June 2004, is one such specialist fund that has outperformed average fund returns in the local Bond, Money Market and Income Unit Trust categories through June 2006 (see figure 1). To beat its benchmark All Bond Index (1-3 years), apart from bonds and money market instruments, it may also invest in listed property (maximum of 25%) and preference shares. To date, it has grown to almost R5 billion in assets under management.

Old Mutual's latest fund, the Real Income Fund, adds equities and listed property (combined maximum of 35%) to the full spectrum of fixed-interest securities it can hold to provide some level of capital appreciation and outperform its benchmark of CPIX inflation + 3% per year. It also has a strong inflation protection mandate, in which it seeks investments that will protect the capital in the fund against inflation.

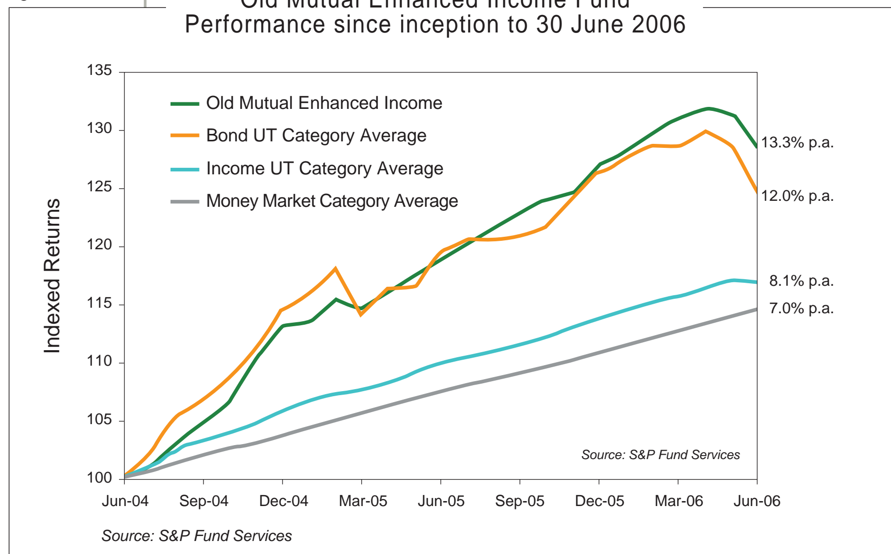
Rather than following the Old Mutual "house view" when it comes to equity holdings, the fund invests in equities that provide a hedge against specific inflation-drivers such as energy and food prices, amongst others. As of 30 June, 5.9% of the fund was invested in equities, with Sasol (1.5%) amongst the largest holding. Another 7.8% was invested in property, while a substantial 71.1% was in money market instruments.

The key here is to balance capital volatility against the prospective income and real return, bearing in mind that the typical retired investor detests capital volatility. So while innumerable studies have shown that equities are the best inflation hedge over time, investors have an imbalance between their return appetite (which is constant over time) and their risk appetite (which changes over time). Thus, when markets are perceived to be 'risky' the desire to protect capital becomes so overpowering that investors will want to shy away from asset classes such as equities, that are matched to their return appetite.

Add to this the persisting requirement for income, and it becomes a difficult task. In the Old Mutual Real Income Fund, the aim is to maintain a core holding of inflation-linked securities (predominantly government issues), which currently provide a real (inflation-adjusted) yield of in the region of 2.5% - 2.7%.

While this might not seem like an attractive yield, the effects of South Africa's re-integration with the rest of the world over the past decade mean that future inflation rates are more likely to reflect global trends to a greater degree than in the past. Real yields have

figure 1



Source: S&P Fund Services

already converged with those prevailing in much of the world. Therefore, it is likely that an implied inflation rate going forward of over 6% is too high.

Nonetheless, the important thing for investors is that total growth or return in the portfolio must exceed the combination of inflation and the nominal withdrawal rate. If a fund is aiming to achieve CPIX + 3% and if a client wishes to see both his capital and income keep pace with inflation, his nominal withdrawal rate cannot exceed 3%. This level is low by current standards, but it is a clear indication that current expectations regarding investment returns will need to be managed lower.

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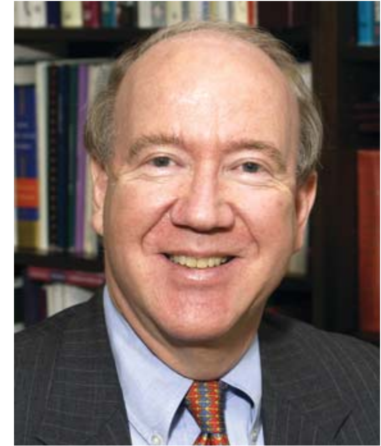
Global Equities – The Hunt for Opportunity



Ronald Frashure - President & co-CIO
Acadian Asset Management

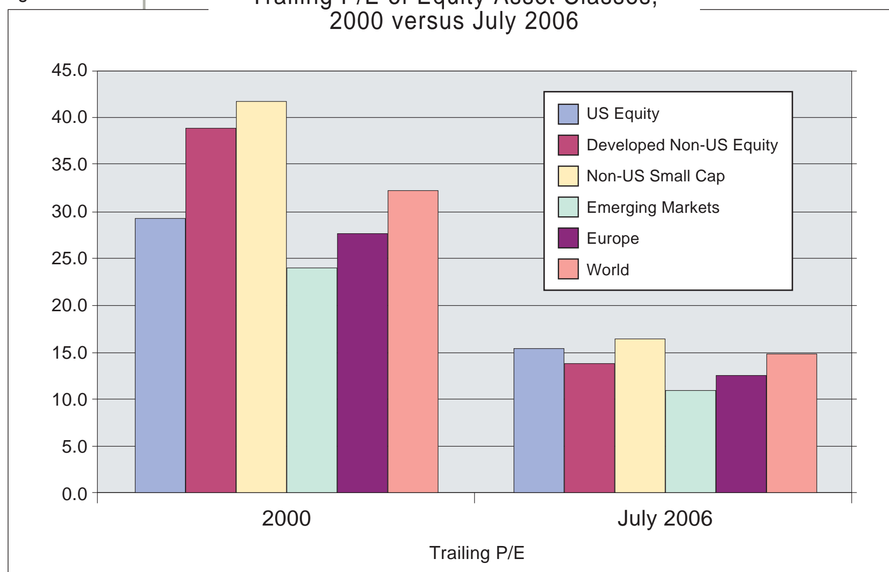
As we look at current valuation levels for global asset classes, major opportunities elude us. The strong performance of global small-cap stocks and emerging markets over each of the four years beginning in 2002, as well as the outperformance of non-US developed market stocks compared to US cap-weighted stocks, have leveled the playing field. At current valuation levels, there are potential risks in most global equity asset classes, depending on how the world economy, interest rates and inflation evolve over the next year and beyond.

Getting global asset allocation right remains one of the most critically important tasks facing fund sponsors. The choices that have to be made will have a huge influence on the rate of return achieved by funds, and this looms as a key issue in view of mounting demographic demands, rising spending needs on the part of endowments and foundations, and the reality of disappointing returns in some asset classes (such as broad US equities) so far this decade. In this article Ronald Frashure, President and co-CIO of Acadian Asset Management in the US, looks at the possibilities. Acadian Asset Management is a US asset manager within the Old Mutual Group.

VALUATION LEVELS

An analysis of world equity valuations at present shows a substantial degree of convergence of key measures such as price to earnings ratios. Most trailing p/e ratios are now in the teens, ranging from approximately 13 for emerging markets to approximately 20 for Japanese stocks.

figure 1



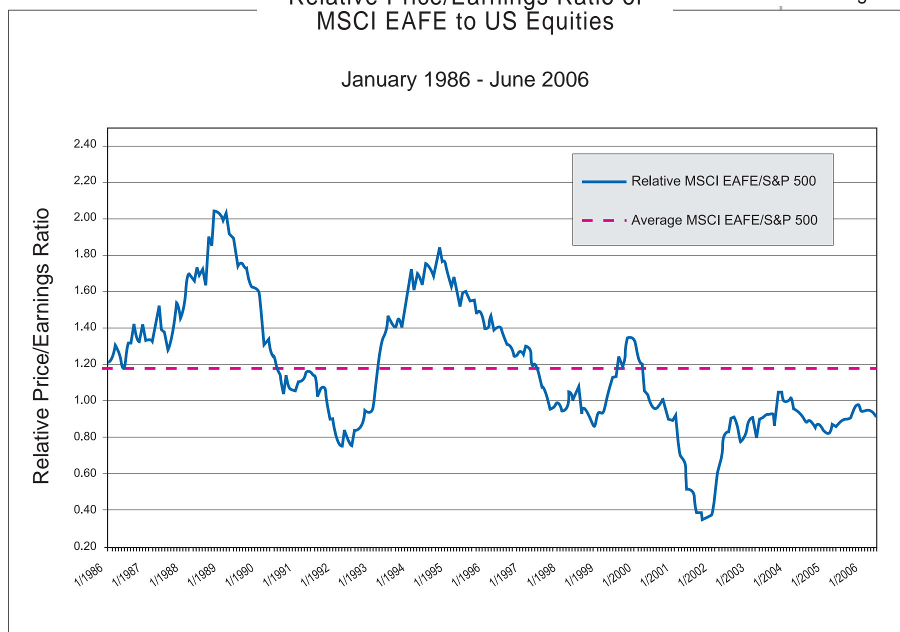
It is interesting to note the broader variation in valuations that was present in early 2000 before the investment bubble burst. At that time the S&P 500 index had a price/earnings ratio of close to 30 times, MSCI EAFE was at 38.9 times earnings (pulled up by high-flying sectors such as Japanese tech stocks and European telecoms), and emerging markets had a trailing p/e of 24.0 as some developing countries went through their own tech stock boom.

Wide swings in absolute valuation levels for global equity asset classes have also produced major variations in relative valuations and hence opportunities for timely shifts in asset allocation.

Figure 2 shows the relative price/earnings ratio of the MSCI EAFE index versus

broad US equities (as reflected in the S&P 500 index) over the last two decades. The recovery in the relative p/e of EAFE compared to U.S. equities has recently stabilised at around a 0.9 level, well below the average level of the last two decades. At this juncture, investors should take into account that Japan and Europe, the key components of EAFE, now seem to have moved to a self-sustaining economic growth track that could raise their GDP gains above those of the US over the intermediate term. This would be especially likely if the US economy succumbs (as it seems to be doing) to the higher interest rate regime that the Federal Reserve is pursuing. Other relevant variables in considering asset allocation would be a notable rise in the return on equity of corporations in Germany, the heart of the continental European economy, and a similar rise in the ROE of major Japanese exporting companies that began several years ago.

figure 2



RETURN PROJECTIONS

In answering the key question as to what rates of return we can reasonably expect from these valuation levels, Acadian uses a highly structured methodology. It takes actual valuations for an asset class as a starting point and then projects future potential returns based on forecasts of earnings and dividend growth together with possible changes in valuation, as driven by informed assumptions concerning inflation and interest rates.

Figure 3 shows annualised return projections over a five-year horizon, in local currency terms.

If we adjust the annualised return prospects for non-US equity asset classes to take account of a likely downward adjustment in the value of the US dollar, the rate of return projections for the next five years converge closely for all equity asset classes, from the standpoint of a dollar-based investor.

figure 3

Five-Year Annualised Rate of Return Projections (Local Currency) as of June 2006

Equity Class	Potential Annualised Return
U.S. Large Cap Equity	10.9%
Global Equity	9.6%
Non-U.S. Large Cap Equity	8.5%
Emerging Markets	8.4%
Non-U.S. Small Cap Equity	8.3%
U.S. Small Cap Equity	6.0%

So, if many of the asset allocation opportunities that we saw earlier in the decade have now been capitalised upon and return prospects have generally converged, what do we do with our asset allocation policy to meet critical objectives?

TAKE A GLOBAL APPROACH

The convergence of returns produces a strong rationale for treating all global stocks together in the widest possible universe for active portfolio selection. In general, the greater the breadth for active security selection, the more value can be added in any active strategy. This approach is quite different from the traditional custom of gaining international exposure through separate US and non-US mandates.

In decades past, separate portfolios were of minor consequence in terms of a fund's overall portfolio efficiency. Correlations between US and non-US assets were low, and international stocks often had more in common with securities of their home country than they did with securities of companies in the same industry around the globe. In addition, it would have been hard to identify a manager with equal skill in evaluating a substantial number of stocks across the world.

Today the situation is dramatically different. US and non-US stocks are more highly correlated as a result of globalisation. Companies, markets, industries and investment opportunities are becoming

increasingly global. In such an environment there is far greater loss of fund efficiency if portfolio mandates are split. Risk-return tradeoffs are sub-optimal and value-added is diminished by the failure to consider all available investment opportunities.

As we look at potential risks in the world markets relative to possible returns in different asset classes, the greatest difficulty in assessing their probability of occurring appears to lie within the US economy and financial markets. Specifically, major risks seem to be attached to how the US current account deficit will be resolved, whether through a dollar rout or a prolonged, more orderly decline. The much-discussed housing market in the US seems to pose a considerable threat if house prices in some areas fall hard and fast, and mortgage equity withdrawals, which have sustained the consumer economy, also decline. High debt levels pose risks of unknown magnitude and timing. These risks could push the p/e valuation for US stocks below its recent average level. However, mean reversion does not imply that we have to stop at the mean.

This prospect underscores the advantages of a global approach in order to avoid the worst outcomes in one's home market over an extended period. For example, the worst 10-year outcome for US investors in the domestic market was the decade ending in July 1982, just before the start of a bull market. During this time, the US returned 42.9%, while the MSCI world index returned 61.6%, about 1.5% a year more on average over the full period. Similar results have been found in other major markets. Global diversification helps greatly to mitigate the worst long-term outcomes in one's domestic market, regardless of where the fund sponsor is domiciled.

FOCUS ON ACTIVE MANAGEMENT

While return prospects may have momentarily converged, opportunities are expected to develop for asset allocation shifts as markets deal with increased volatility, tightening central bank policy and a likely slowing of the global economy over the intermediate term. Active management will be essential to capitalise on these opportunities at both the asset class and individual security level. In virtually all countries around the globe, Acadian has found it possible to create diversified portfolios of stocks that are significantly more attractive than the cap-weighted market. This is especially true of broad and diverse markets such as Japan, the United Kingdom and the United States.

LOOK BEYOND LONG-ONLY

The evidence is accumulating that long-short, market neutral (or dollar neutral) strategies based on disciplined valuation and strong risk control, can provide consistent alpha generation capabilities without market exposure. They thus have the capability to add value in down markets. If the risk factors cited earlier should come into play in global markets, such strategies could provide real benefits to a sponsor's overall asset allocation.

If continuous market exposure is desired, partially short approaches such as 130/30 strategies (on balance 130% long, 30% short) provide much of the potential increase in portfolio efficiency attainable in moving from a long-only constrained portfolio. In a world where alpha will continue to be elusive and expectations are muted for long-only returns, these portfolio alternatives may prove very useful to fund sponsors.

In conclusion, the search for gains from asset allocation and active stock alpha will be arduous, but rewarding, to the astute investor. In this respect, the more things have changed, the more they have remained the same.

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