

OMIGSA Comment – Warren Jervis, Sector Head: Small Companies

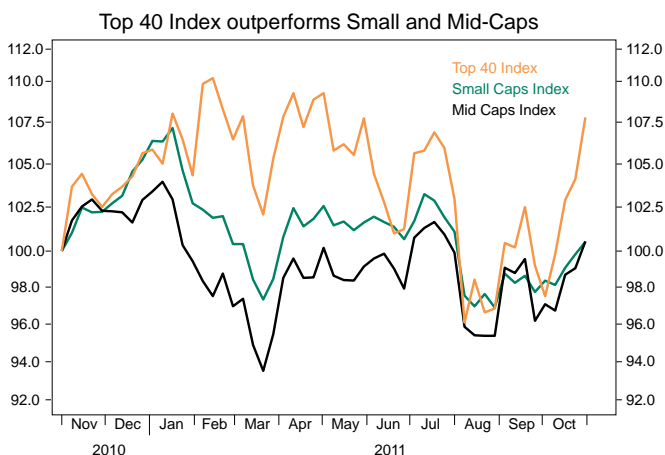
Small caps: Risk not as extreme as you may think



In the current market volatility, small and medium-cap shares are generally being overlooked in favour of the larger, more dominant companies in the local market. And although this cautious approach may make sense for certain investors, any well-balanced long-term equity portfolio ought to comprise at least 10% in small cap companies and even more in mid-cap companies, in order to benefit from

the potential alpha (excess returns) available.

A recent RisCura study showed that small and mid-cap shares have posted a 14.5% return p.a. over three years, and over a longer period of nine years, the small cap index shows generation of between 2.0-2.5% alpha per year, for only about 10% additional risk. This level of risk is not as extreme as people think - while the potential alpha upside is quite large.



Still, close and expert management of such a portfolio is key, requiring identification of companies with reasonable profit expectations, trading on large discounts to their actual value, and on the verge of becoming large cap shares. Currently, companies like Omnia, AECI, City Lodge and Trenchor fit these criteria.

Recently the FTSE/JSE small cap and mid-cap indices have outperformed, returning -2.3% and -2.0%, respectively, for the three months ending 30 September 2011, while the FTSE/JSE Top 40 Index returned -6.6%.

21 – 27 October 2011 in a nutshell

Global: European stocks were higher Friday, as investors continued to take on risk given the positive sentiment generated on the back of Euro-zone leaders' agreement on a regional bailout package. Both the Emerging Markets and Euro Stoxx 50 indices gained more than 9%.

South Africa: South African stocks reacted well to news from Europe, with the FTSE/JSE All Share Index gaining 5.24%. The Resources 20 Index delivered 8.34%, the highest return of all the local sectors.

Markets and Economics – Highlights

Global

- A slight improvement in U.S economic growth may signal that recovery, while painfully slow, had not stalled. According to the Commerce Department, the total output of goods and services grew at an annual rate of 2.5% from July to September, almost double the 1.3% rate in the previous quarter. According to the data, consumers spent more, especially on health care and utilities, and businesses invested more in software and vehicles among other items, spurring the fastest growth in a year. Economists think that the pace is not brisk enough, however, to recover lost ground, relieve unemployment or even entirely dispel fears of a second recession. The rate of growth was slightly above economists' predictions of 2.3%.
- A recent deal struck in the Euro-zone is expected to result in a €100 billion reduction in Greece's €350 billion debt mountain and a drop from the current 160% of gross domestic product to 120% by 2020. Banks and other private investors have agreed to accept a 50% loss on holdings of Greek government bonds. In addition, Euro-zone leaders agreed a new bailout worth up to €100bn until 2014. The agreement replaced a deal in which Euro-zone states initially offered €109 billion in aid and banks had agreed to take a 21% haircut. Meanwhile, the €440 billion European Financial Stability Facility (EFSF) may be ramped up to give it an estimated firepower of about €1 trillion. Euro-zone leaders have to act fast, as the latest purchasing managers' indices have shown the slowdown has undeniably started, with PMI sinking to 47.2 this month from 49.1 - some way below the 50 mark that divides growth from contraction.
- Russia left borrowing costs unchanged, at 8.25%, after inflation slowed and consumer demand spurred the economy. Up from 3.4% the previous quarter, economic growth in Russia expanded by 5.2% last quarter, the most in three years, as lending to households spurred demand, according to the Economy Ministry. Due to the difficult situation in the Eurozone, it is predicted that Russia's final quarter growth in 2011 will not match the third quarter figure, but Russia is still on track to achieve its 4% GDP growth target for the year. Inflation is also beginning to be brought under control, dropping to 7.2% from 8.2% the previous month.

South Africa

- In his Medium-Term Budget speech, Finance Minister Pravin Gordhan downgraded SA's 2012 economic growth forecast to 3.4% from 4.1% in February. With revenues lower than expected, he also raised the 2011-12 budget deficit forecast to 5.5% of GDP from 5.3% previously. The deficit is then expected to narrow to only 3.3% of GDP by 2014-15. Gordhan said that the total consolidated expenditure by government is expected to rise from R885,8-billion to nearly R1,25-trillion by the 2014/2015 financial year. Government spending/GDP between the period of 2002/2003 and 2009/2010 increased from 27,2% to 33,8%, signalling that despite the lower economic and revenue growth, public expenditure has continued to expand. Gordhan also indicated that investments will support the increase in electricity generation capacity, improve the roads and railways networks, increase water and sanitation programmes and assist in improving telecommunications.
- South Africa's Producer Price Index (PPI) registered a growth of 10.5% year-on-year (y/y) in September from 9.6% in August, according to Statistics South Africa, higher than the I-Net Bridge forecast of 10.3% y/y. This higher annual rate was attributed to increases in the PPI for mining and quarrying from +12.3% in August to +17.7% in September. There was also an increase in products of petroleum and coal - the annual rate increased from +25.1% in August to +27.1% in September, Stats SA said.

Key Indicators:

Market	Index	Movement for the period		Year to Date
		%	Index Value @ 27.10.2011	% Performance Return
United States	S & P 500 (US\$)	5.69%	1,285	2.11%
Europe	Euro Stoxx 50 (Euro)	9.03%	2,477	-11.32%
Emerging Mkts	MSCI Emerg Mkts (US\$)	9.49%	994	-13.66%
South Africa	FTSE/JSE All Share (ZAR)	5.24%	32,453	1.04%
Global	MSCI (US\$)	7.19%	1,251	-2.28%
ZAR/Dollar	Rand/US \$ (ZAR)	-5.34%	7.71	16.57%
ZAR/Pound	Rand/£ (ZAR)	-3.58%	12.39	20.17%
ZAR/Euro	Rand/Euro (ZAR)	-2.72%	11.23	23.53%
JSE	Industrials	3.47%	27,967	-8.03%
JSE	Financials	2.95%	21,779	0.61%
JSE	Resources 20	8.34%	53,976	-4.13%
JSE	Small Companies	1.17%	31,859	-5.52%
JSE	Listed Property	0.51%	389	0.39%
JSE	RAFI@ 40	5.18%	6,708	0.79%
JSE	RAFI@ ALSI	5.52%	6,437	-0.47%
JSE	SWIX	4.42%	6,781	0.55%

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