



Urvesh Desai

Portfolio Manager for Macro Strategy Investments

THE EUROPEAN UNION DEBT CRISIS

In June this year, I attended an investment strategy conference in London which, in part, focused on the European debt crisis. With the torrent of newsflow daily on the subject, there is no doubt that this has been dominating market movements due to the uncertainty it has created.

While many of the peripheral Eurozone countries are facing fiscal woes, it is important to note that these are for very different reasons. For instance, in Portugal and Ireland the crisis is due to the government guaranteeing their respective country's bank debts; whereas in Greece it is much more of a typical fiscal crisis that is the result of excessive spending.

With Greece being the proverbial weakest link in the chain, the possibility of the beleaguered nation exiting the European Union (EU) is often spoken of. It should be noted, however, that an exit of the EU by any member country was never envisioned. There are no provisions for such a scenario, and no process has been defined for how this would be accomplished. Of course this does not make it impossible, but it does make it a last resort, and justifiably so. Such an outcome is hardly likely to be good for Greece, as its borrowing costs would increase tremendously, making the fiscal situation worse. Nor would it be beneficial for the remaining EU countries as the euro would, no doubt, strengthen significantly which would be to the detriment of the export-fuelled economic recovery.

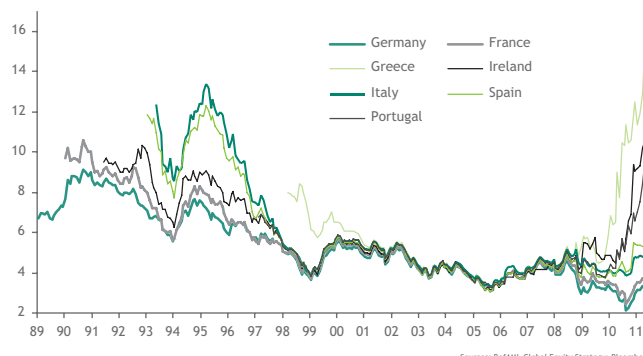
Potential outcomes

There are myriad possibilities ranging from the calamitous to the more optimistic. The worst potential outcome for all parties is a disorderly and messy default by Greece on all outstanding debt. The biggest risk here would be the contagion it would unleash into the European and, most likely, global banking systems.

The latest solution to Greece's debt woes has taken the immediate pressure off Greece. Importantly, for the politicians in Europe's creditor countries, it included fairly substantial 'haircuts' for the holders of Greek debt - so these governments were not bailing out investors completely at the expense of their tax paying public. For the stability of the financial system, the restructuring was "voluntary" and therefore avoided a complete technical default. While the package improved the sustainability of Greek's long-term debt in the market's opinion (as can be seen by the recent fall in the Greek 10-year yield), the 10-year yields of Italy and Spain continue to climb. This continues to be a risk to the European financial system.

A haircut is when the value of a creditor's debt is reduced by a certain percentage.

European government bond yields since 1990



In addition, other risks are likely to continue creating volatility: Ireland may choose to walk away from the bank debt it has chosen to guarantee; the threat of political backlash in both borrower and lender EU countries; and the ECB hiking interest rates may put further pressure on house prices and, hence, the banking system.

Investing through uncertainty

With so many potential outcomes, and still so much that could go wrong, it is not easy to see how one should invest. With all the noise, it is important to stand back and look at the longer-term consequences. The Macro Strategy Investments (MSI) framework of 'Theme and Price' helps us do this.

We have spoken about our theme of Big Government for a while. In short, the spiralling deficits of many EU economies have resulted in a severely deteriorating environment for bonds issued by these governments. As can be seen from the above graph, going into the Credit Crisis, yields were close to multi-decade lows, placing these bonds clearly in the Expensive, and hence SELL ALL quadrant.* Our portfolios have therefore had little or no exposure to these bonds.

The situation in the Eurozone is expected to take several years to resolve, and during this period the countries within the Euro region on average will likely face higher borrowing costs. Without being able to borrow as cheaply as they once did, there will be a need to spend less or tax more. This will act as a drag on economic growth, and therefore our global equity portfolios are underweight the euro region as well.

There will no doubt be bouts of risk aversion which will cause certain parts of the bond market to do well as safe havens. However, these would likely be only short-term rallies in a longer-term trend of weakness. This is why investing with the correct perspective of the larger secular trends, like we do at MSI, is crucial for investing in such uncertain times. Our clients get the benefit of this longer-term view in the multi-asset class portfolios we manage.

*Refer to our June 2010 newsletter on www.omigsa.com/MSI

Market Commentary

The last 12 months has been a "year of two halves": The second half of 2010 saw risk assets perform remarkably well as concerns about Eurozone sovereign debt eased, and Ben Bernanke injected additional liquidity into the US economy; then, in the first half of 2011, equity markets struggled as the sustainability of global growth, the tragic earthquake in Japan, and the resurfacing of Eurozone debt issues, led to bouts of risk aversion. At home, the South African equity market, assisted by the strength of the rand, outperformed global equity markets in the second half of 2010. However, this outperformance was partially reversed in 2011, with the resources sector leading the underperformance of the local market, as investors contemplated a slowdown in Chinese and global growth, and the impact this could have on commodity prices and companies.

Globally, bonds and gold have performed well this year, as investors sought safe-haven investments.

offshore weight have contributed to good year-to-date returns. Equity exposure, which was heavily weighted to resources shares, was reduced in April, this added value as the resources sector underperformed for the remainder of the quarter.

The risk aversion in the market presented an opportunity to add risk to the portfolios again, and we increased exposure to risk assets near the lows in June. The funds have the capacity to further increase equity exposure should market experience another move lower. Our preferred asset class over the next three to five years remains equity, particularly offshore equity.

Old Mutual Stable Growth Fund and Optimised Defensive Fund

The funds have delivered good one and three year returns in excess of cash and inflation, returning 11.3% and 7.9% per annum, respectively. Equity exposure was reduced in April, which partially protected the portfolios from the fall in equity markets in June. The position in inflation-linked bonds also offset the impact of the equity market.

The funds increased exposure to equity late in June as we saw more value in the markets at these lower prices, and felt that sentiment was approaching extreme levels. While equities remain our preferred asset class for the next three to five years, we remain mindful of the risks to the portfolios and the risk appetite of our investors when implementing this preference.

Old Mutual Real Income Fund

The fund continued to perform well in this last quarter, with longer-term performance well above cash returns and inflation. The cautious positioning adopted by the fund in recent months meant that it was able to weather the fall in equity markets quite well. Positions in the best-performing asset classes (inflation-linked bonds, gold, nominal bonds and property) have also protected the portfolio and smoothed the returns achieved - an important trait for a fund of this nature.

Towards the end of June we increased the equity exposure, following the correction in equity markets. This increase has been achieved through the purchase of quality businesses with good dividend yields and growth potential. The fund remains exposed to high-yielding counters, but at the same time attempts to reduce the risk of capital loss.

Fund performance and commentary

Old Mutual Flexible Fund and Optimised Aggressive Fund

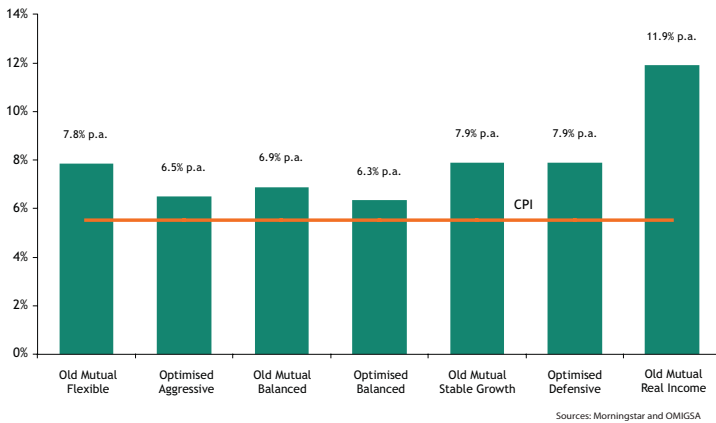
Over the last three and five years, the funds have outperformed, and with lower volatility, the average general equity unit trust fund. They have also delivered good returns over the last 12 months. Their flexible nature allowed for them to be well positioned for the recovery in risk assets in the second half of 2010, and then for a somewhat reduced exposure to the equity market during 2011.

We felt that the elevated levels of anxiety and caution in the market presented an opportunity to add risk to the portfolios again, and we increased equity exposure towards the end of the second quarter. The preferred asset class remains equity and, within that, offshore equity. As such, the vast majority of the funds' offshore exposure is in the offshore equity markets.

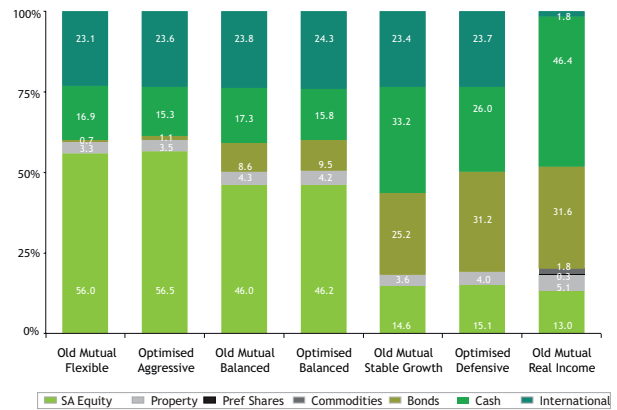
Old Mutual Balanced Fund and Optimised Balanced Fund

The funds have delivered top quartile returns over the last 12 and 24 months. The preference for offshore equity over local equity and a higher

3-year performance to 30 June 2011



Asset analysis as at 30 June 2011



Performance to 30 June 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	19.6%	7.8%	11.3%		2.37%*
Optimised Aggressive fund	17.4%	6.5%	9.7%		
Target	13.1%	13.5%	14.9%	CPI+8% p.a. over rolling 3 years	
UT Peer Average	15.5%	6.3%	9.3%	Flexible Category	
Old Mutual Balanced Fund	17.5%	6.9%	9.6%		2.36%*
Optimised Balanced Fund	15.6%	6.3%	9.0%		
Target	11.1%	11.5%	12.9%	CPI+6% p.a. over rolling 3 years	
UT Peer Average	12.3%	6.1%	8.6%	Prudential Variable Equity Category	
Old Mutual Stable Growth Fund	11.3%	7.9%	-	Launched June 2007	2.21%*
Optimised Defensive Fund	11.3%	7.9%	9.2%		
Target	9.1%	9.5%	10.9%	CPI+4% p.a. over rolling 3 years	
UT Peer Average	9.5%	7.2%	8.2%	Prudential Low Equity Category	
Old Mutual Real Income Fund	11.2%	11.9%	9.6%		1.39%
Target	8.1%	8.5%	9.9%	CPI+3% p.a. over rolling 3 years	
CPI	5.1%	5.5%	6.9%		

*TER as at 31 March 2011

Sources: Morningstar and OMIGSA

For more information, visit www.omigsa.com/misi

Old Mutual Investment Group (South Africa) (Pty) Limited is a licensed financial services provider, FSP 604, approved by the Registrar of Financial Services Providers (www.fsb.co.za) to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. Old Mutual Investment Group is a wholly owned subsidiary of Old Mutual (South Africa) Limited. Reg No 1993/003023/07.

The investment portfolios are market-linked. Products are either policy based or utilised in collective investment schemes. Investors' rights and obligations are set out in the relevant contracts. Market fluctuations and changes in rates of exchange or taxation may have an effect on the value, price or income of investments. Since the performance of financial markets fluctuates, an investor may not get back the full amount invested. Past performance is not necessarily a guide to future investment performance.

In respect of pooled, life wrapped products, the underlying assets are owned by Old Mutual Life Assurance Company (South Africa) Limited, who may elect to exercise any votes on these underlying assets independently of Old Mutual Investment Group.

In respect of these products, no fees or charges will be deducted if the policy is terminated within the first 30 days. Returns on these products depend on the performance of the underlying assets.

Old Mutual Investment Group has comprehensive crime and professional indemnity insurance, as part of the Old Mutual Group cover. For more detail, as well as for information on how to contact us and on how to access information please visit www.omigsa.com.

* These are the A-class fund Total Expense Ratios (TERs). The portfolio performance is calculated on a NAV-NAV basis and does not take any initial fees into account. Income is reinvested on the ex-dividend date. Actual investment performance will differ based on the initial fees applicable, the actual investment date and the date of reinvestment of income. Lump sum basis. Performances are in ZAR and as at 30 June 2011.

Sources: Morningstar and OMIGSA. Unit trusts are generally medium- to long-term investments. Past performance is no indication of future growth. Shorter term fluctuations can occur as your investment moves in line with the markets. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Unit trusts can engage in borrowing and scrip lending. The fund's TER reflects the percentage of the average Net Asset Value of the portfolio that was incurred as charges, levies and fees related to the management of the portfolio. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TERs. A schedule of fees, charges and maximum commissions is available from the company. You may sell your investment at the ruling price of the day (calculated at 15h00 on a forward pricing basis). Certain funds may be capped to be managed in accordance with their mandates. Different classes of units apply to these portfolios and are subject to different fees and charges. Old Mutual is a member of the Association for Savings and Investment SA.