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THE ROLE OF INTUITION

In a Q&A a few weeks ago, a client asked us if there was room for intuition in our investment process. The knee-jerk response to this question is: no, due to the negative connotation of basing investment decisions on a gut feeling, versus the confidence inspired by detailed research and a disciplined process. After all, at Macro Strategy Investments (MSI), the bedrock of our philosophy centres on integrating theme and price, both of which are based on scientific analysis.

On a bottom-up basis (price), we use HOLT's CFROI (cash flow return on investment) valuation methodology for our equity valuation work. This basically examines the cash generated by the business relative to capital invested, and helps us to compare the current share price to the actual value of the company. This valuation helps us determine whether a share is cheap or expensive, and therefore where it finds itself on the vertical axis of the diagram below.

On a top-down basis, we use longer-term macroeconomic analysis to determine our themes, and even though economics is often mocked as the "dismal science", it is backed up by rigour and logic.

Figure 1: Our philosophy illustrated

'Integrating Top-Down and Bottom-Up'		TOP-DOWN Macro Environment Markets Themes	
		BAD THEME Deteriorating Environment	THEME Improving Environment
BOTTOM-UP Valuations	HIGH Expensive	Sell All	Reduce
	LOW Cheap	Buy Some	Buy Lots

Source: Macro Strategy Investments

Clearly our philosophy is rooted in the common sense and insight that are the results of this detailed top-down/bottom-up analysis.

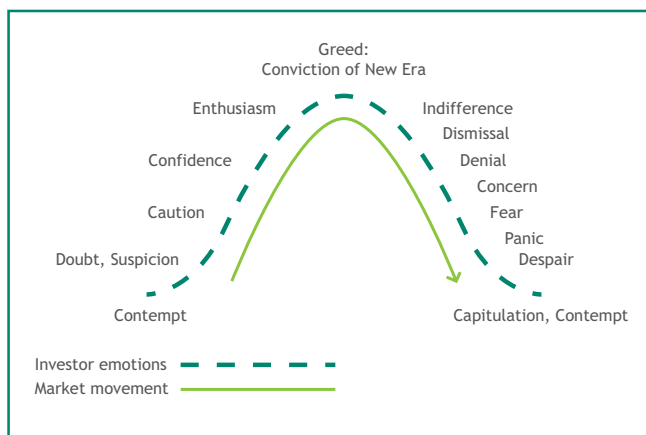
So, if a share is cheap, we buy; conversely, as assets become more expensive, we sell. Thus the trick, as you will read later, lies in the ability to assess when a theme is about to strengthen and the price is at its cheapest, just before it begins to rise, or where both theme and price have peaked, and are about to weaken.

All this analysis is contrary to the Efficient Market Hypothesis (EMH), which negates the need for valuations analysis and macro research. However, the recent extreme events in markets make a travesty of the EMH. Further, it has always been apparent that behavioural finance, or investor psychology, also plays an important role when assessing share price movement, as investors react emotionally to prevailing conditions. The following diagram illustrates the wide range of emotions experienced by investors at various stages of the market cycle.

EFFICIENT MARKET HYPOTHESIS IN A NUTSHELL

EMH refutes the need for both macroeconomic analysis and fundamental valuations and states that there is no such thing as an undervalued share, as markets automatically price in the effects of all available news and economic events that could impact their value, and therefore fair value is inherent in the nature of a share price.

Figure 2: Investor psychology cycle



The emotions of fear and greed have the ability to push markets well away from fair value, disproving EMH, resulting in abnormal distributions and fat tails (that is, a marked deviation from the expected return due to events or investor behaviour).

Our philosophy takes this into account and guides us to be cognisant of prevailing conditions. The key is to move against the herd; intense discipline is required to step away from human emotions, and to maintain a rational and objective approach. This discipline is reinforced by process. Therefore, if you refer to the diagrams, you will see that as investors are fearful and despairing we are "Buying Some". On the other hand, we are "Reducing Exposure" when investors are confident and enthusiastic, and the stock price is buoyant. This protects us from falling in love with a company or theme and holding on to the stock for too long.

Intuition, on the other hand, defined as "thoughts and preferences that come to mind quickly and without much reflection", is an anathema to fund managers as it seemingly flies in the face of this required rigour.

And it is here that the "knee-jerk" reaction mentioned previously is proven wrong, for arguably the most challenging aspect of making investment decisions is gauging exactly when a theme has run its course and the environment is about to turn. It is at that point that we want to sell and lock in profit - just before the theme weakens, and while the price is still high. This is typically when theme is at its most popular. The converse is also true, with the world appearing darkest before dawn - then we seek to buy.

It is the extreme psychological states of "greed", "conviction of a new era", "fear" and "capitulation" that signal the turning points of major themes, and an investment manager must be able to recognize these, and use them to their advantage.

For instance, at the worst of the sub-prime crisis, bad news became good news as it forced central banks to panic, which pushed interest rates to zero and created the liquidity that markets needed in order to recover. These "turning points" in markets are obvious in hindsight, but when they are happening, it is often intuition that guides a portfolio manager to choose the right time to shift into either a "Sell All" or "Buy Lots" position (figure 1).

Therefore, we would conclude that there is a role for intuition in asset management. Importantly, the reliability of that intuition is improved by experience, which is why we place great value and emphasis on the breadth and depth of experience of our team.

Market Commentary

The FTSE/JSE All Share Index (ALSI) gained 1.1% on a total return basis in the first quarter of 2011. This was despite a very strong previous quarter, escalating conflict in the Middle East and North Africa (MENA), a rising oil price, inflation fears in emerging markets, and the tragic consequences of and uncertainty created by the earthquake and tsunami in Japan.

Developed markets outperformed emerging markets for the quarter, although some emerging markets such as Russia and Hungary delivered solid returns. The energy sector was a clear winner across many markets. Global bond yields were generally higher over the quarter, with the All Bond Index (ALBI) falling by 1.6%. It was notable that, despite the events mentioned above, the US dollar did not play its traditional safe-haven role, and that the euro gained on the US currency on the back of indications by the European Central Bank (ECB) that rates could be raised.

We expect this to enhance the funds' returns relative to risk. While there has been no shortage of negative news flow, the markets have been very resilient, which again demonstrates that valuation and earnings remain the key market drivers. We also added some exposure to local bonds in the latter part of the quarter, as the spike in bond yields offers an attractive enhancement over the cash yield, which we believe will be fairly depressed over the next 12 months.

Old Mutual Stable Growth Fund and Optimised Defensive Fund

During the quarter, we increased the funds' exposure to international equity, specifically to Japan. The tragic events in Japan resulted in that market falling 20%, which pushed the price to book value to 1.0x, an exceptionally low level and a buying opportunity. However, reflecting the conservative and well-diversified nature of these funds, exposure was only increased to 2.5% of the total portfolio. We also made some small additions to local bonds as yields picked up to over 9% at the long end. While more risky than cash, local bonds are offering a lot more yield, which we believe will be valuable to our investors.

Old Mutual Real Income Fund

Higher-yielding asset classes, such as property and bonds, suffered capital losses during the quarter, creating a tough environment for the fund. However, diversification through exposure to gold, inflation-linked bonds and higher-yielding cash instruments acted to offset these losses, and the fund delivered a small positive return over the quarter. Despite the flat quarter, over the 12-month period ending March 2011, performance remained in double digits and the fund maintained its position in the top quartile of the Domestic-Asset Allocation-Prudential Low Equity category.

The good news is that both listed property and bonds are yielding 8.6%, which is 3% better than cash yields. We do not expect interest rates to increase in the short term, due to a fairly subdued demand environment, making these yields attractive. As a result, we hold 45% of the fund in bonds and property.

Looking forward, we expect that most of the fund's returns will be delivered through income as opposed to capital gains. The fund remains conservatively positioned in growth assets, although we did purchase some more British American Tobacco plc (BAT) at good prices during the quarter.

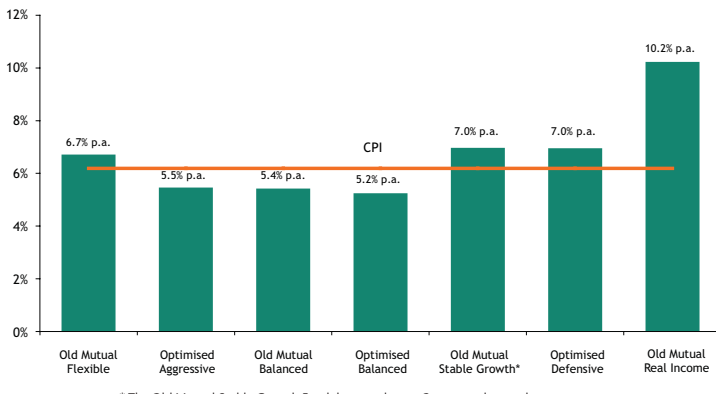
Fund performance and commentary

This year reminds one of the Shakespearean quote: "...full of sound and fury, signifying nothing". Despite all the drama, the funds were broadly flat over both the month and the quarter, which was in line with the equity market. Despite the volatility, we believe equities have the best potential to beat inflation, and we maintained our equity exposure at roughly 80%, of which 20% is invested in international equities. The tragic events in Japan resulted in that market falling 20%, which pushed the price to book value to 1.0x, an exceptionally low level. As we do not believe the fundamental investment case has deteriorated to that extent, we increased Japanese exposure at the lows.

Old Mutual Balanced Fund and Optimised Balanced Fund

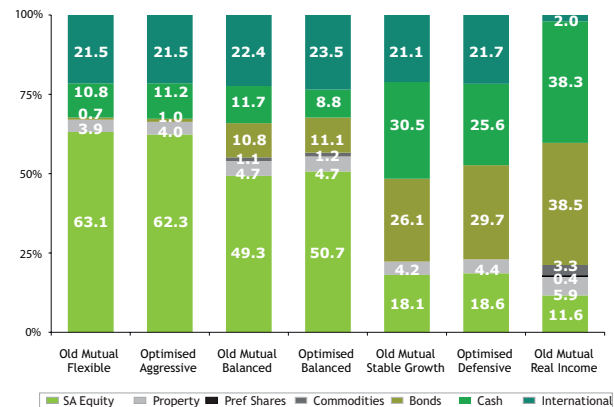
We increased our offshore exposure during the quarter, as offshore equities continue to offer better value than local equities. Over the medium term,

3-year performance to 31 March 2011



Sources: Morningstar and OMIGSA

Asset analysis as at 31 March 2011



Sources: Morningstar and OMIGSA

Performance to 31 March 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	12,8%	6,7%	10,2%	CPI + 8% p.a. over rolling 3 years Flexible Category	2.63%*
Optimised Aggressive Fund	9,7%	5,5%	9,1%		
Target	11,6%	14,2%	14,8%		
UT Peer Average	9,9%	5,4%	8,7%		
Old Mutual Balanced Fund	10,5%	5,4%	9,1%	CPI + 6% p.a. over rolling 3 years Prudential Variable Equity Category	2.52%*
Optimised Balanced Fund	9,1%	5,2%	8,3%		
Target	9,6%	12,2%	12,8%		
UT Peer Average	8,4%	5,6%	8,3%		
Old Mutual Stable Growth Fund	7,7%	7,0%	#N/A	CPI + 4% p.a. over rolling 3 years Prudential Low Equity Category	2.21%*
Optimised Defensive Fund	7,8%	7,0%	8,5%		
Target	7,6%	10,2%	10,8%		
UT Peer Average	7,6%	6,6%	7,8%		
Old Mutual Real Income Fund	10,1%	10,2%	9,1%	CPI + 3% p.a. over rolling 3 years	1.38%
Target	6,6%	9,2%	9,8%		
CPI	3,6%	6,2%	6,8%		

*TER as at 31 December 2010

Sources: Morningstar and OMIGSA

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

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* 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 28 February 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.

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