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2011: TIME TO DIVERSIFY OFFSHORE

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A strong chance that the rand will depreciate, the logic of diversification and attractive relative valuations offshore all indicate that now is a good time to increase your international equity exposure. In fact, as reflected in our newly-updated asset class view (see below), we believe that it will be the best-performing asset class in real terms over the next five years.

Long-Term Asset Allocation View
(Expected return over next five years.)

Asset Class	Real Return	View	Comment
SA		N-	Rand is becoming overvalued.
Equity	6.0%	N+	Full value on an absolute basis but still attractive relative. Grind higher.
Property	5.5%	N	Expected return continues to fall.
Bonds	2.5%	N	Limited potential for capital gains but attractive carry vs cash.
Cash	1.5%	–	Lower rates for longer means lower returns.
International*		N+	Diversification is valuable.
Equity	6.5%	+	Preferred asset class for 2011.
Bonds	1.0%	–	Longer-term bearish.
Cash	0.0%	–	Cash is still unattractive.

* The international return expectations above are in US dollar terms, any rand depreciation will add to these returns in rand terms.

In December, exchange control was further relaxed to allow investors to increase their offshore holdings. The timing of this relaxation could not have been better and investors in active asset allocation funds would likely already have had their offshore exposure increased by their fund managers. For instance, at MSI we have already taken advantage of the strong rand over the New Year period to increase offshore equity in the funds we manage.

If your risk tolerance allows, and you do not yet have maximum exposure, there are some compelling reasons to consider topping it up this year.

Diversification
First there are the obvious benefits of diversification – such as reduced risk and exposure to fast-growing companies and industries not available in South Africa (SA). Our detailed historic analysis shows that an optimal portfolio for an SA investor would hold more than 35% in international assets in order to capture these benefits. At the same time, local equity volatility is 30% higher than that of international equity, which means that investing abroad improves the risk efficiency of the portfolio.

Valuations
Looking at valuations, following 2010's exceptional performance by local equities (the FTSE/JSE SWIX gained 20.9% in rand terms and 34.5% in US dollar terms to be the best-performing major market in the world), the local equity market's previously relatively-attractive valuation has now been eroded. The current price:earnings (p:e) ratio of 17.2 times is high historically, and local companies will need strong earnings growth this year to produce good investor returns.

South African equities are no longer trading at a discount and therefore do not justify an overweight position. We are forecasting a real return of 6.0% per year over the next five years from SA equities, and 6.5% per year from international equities – both forecasts are marginally more conservative than our previous view which was returns of 6.5% and 7.0% respectively.

The rand
Our local currency was the third-strongest major currency in the world in 2010! While impressive, it also means that the real value of the rand is now expensive by historic measures. While the big global investment themes remain supportive of the rand this year, these themes are weakening. The table indicates factors that count for and against rand strength going forward.

For the rand	Against the rand
√ The global emerging markets (GEM) theme	× Gradual rate hikes elsewhere
√ Strong demand for commodities	× Possible slowdown in emerging market growth (particularly China)
√ Relatively-high local interest rates	× An upside surprise in US growth
√ The quest for yield	

So, where is opportunity?
The rand theme, relative equity valuations and the benefits of diversification all increase the appeal of offshore equity investments, but where in the world does opportunity lie? At MSI we think it may be beneficial to consider Japan and Africa – two markets that sit at the two extremes of the development spectrum, each with their own attraction.

Japan
Japan offers a contrarian trading opportunity – the equity market has experienced massive underperformance for years, and is currently trading at the same levels in real terms seen 30 years ago. Its shares are un-loved and under-owned, which is shown by the market's price:sales ratio of 0.6 times. We believe that Japan's previous headwinds have now turned to tailwinds, spurred by a better global growth environment and the potential of yen intervention. Given its cheap valuations, now could be a good time to buy.

Africa
Africa represents a longer-term opportunity for higher returns, albeit with higher risk. The continent is truly the last investment frontier, with good growth prospects but underdeveloped equity markets. With its large resource base, it offers a leveraged play on the emerging consumer – particularly through soft commodities like food.

Locally, equity likely to be top asset class
At MSI we favour local equity over property, bonds and cash, although our theme of a low-return world still applies and all asset classes will return less over the next five years than in the "naughties". This means investors need to save more in order to retire with adequate finances.

Given the market's relatively strong 2010 performance, we will see it "grind higher" in 2011. This will be driven by earnings growth, particularly from resources.

For more details on our current asset class outlook please refer to the commentary under Asset Class View at www.omigsa.com/msi.

Market Commentary

Global equity markets continued their surge into the year-end, with the MSCI All Country Index gaining 5.5% in rand terms in December, bringing the gain for 2010 to a respectable 11%. South Africa was no exception, with the FTSE/JSE All Share Index (ALSI) gaining 6.2% in December and 19% for the year. The fact that the rand was one of the strongest currencies in the world, gaining almost 12%, meant the JSE was one of the best-performing markets in the world, beating developed, emerging and all of the BRIC markets.

The big theme last year was "cash is trash" and investors were forced to search for return and yield in other asset classes. This was particularly true in South Africa where interest rates were cut 1.5% to their lowest levels in 35 years. The lower rates were good news for listed property, which was the best-performing asset class, up nearly 30% for the year, and local bonds, which gained 15%. Unfortunately, these capital gains pushed the yield on these asset classes down by 1%, meaning lower future returns. We retain our view that real returns in the next decade will be lower than the one past. Despite this, we look forward to 2011 as there is always investment opportunity for those who seek it.

Fund performance and commentary

Old Mutual Flexible Fund and Optimised Aggressive Fund

The funds finished the year strongly, bringing their returns for the year ending 31 December 2010 to 15.9%. This was comfortably above their target of inflation + 8%, and was better than the Domestic - Asset Allocation - Flexible unit trust sector average of 14.2%. An overweight position in listed property added value, while investing in international shares relative to South Africa detracted from their total returns. However, this diversification does result in a smoother ride, and the funds have delivered similar returns with much lower volatility than a pure equity fund. The recent announcement around the relaxation of offshore exposure limits means the funds can move to 25% in international assets and, as opportunities present themselves, we would expect the offshore percentage to increase. This is line with our expected long-term risk adjusted returns.

Old Mutual Balanced Fund and Optimised Balanced Fund

The funds delivered a 12.7% return in 2010, which is a real return of over 9%, considering that inflation was only 3.5%. Relative to the competitors in the unit trust Variable Equity category (+10.6%), this was a good result. Active buying of shares during the second quarter's correction meant they benefited from the rally in the second half (H2) of the year. In fact, their H2 returns were greater than their returns for the full year, highlighting once again how volatile performance can be. This reinforces the importance of sticking to your longer term plan. In the next year investors can expect the funds to increase their diversification offshore.

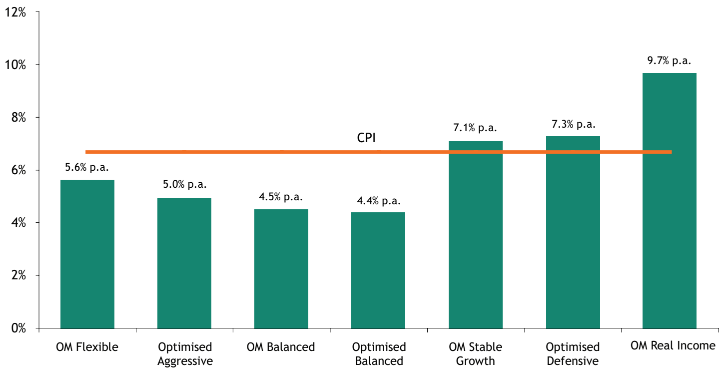
Old Mutual Stable Growth Fund and Optimised Defensive Fund

The funds delivered a return of 9.7% for the year ending 31 December 2010, which is a real return of 6.2% compared to its target of CPI + 4%. Performance was in line with their competitors, with the average fund delivering 9.7%. The funds benefited over the year from their holdings of listed property, equity and bonds, while their international holdings and cash detracted from performance. The funds hold these assets for diversification, and in fact we expect we will increase their international assets to take advantage of the strong rand. Looking forward, we expect a grind higher for markets, but their equity holdings should do better as they are overweight a number of the laggards in 2010 such as Anglo American and MTN, which still offer good value.

Old Mutual Real Income Fund

Old Mutual Real Income Fund enjoyed a remarkable year, delivering a return of 14.2%, which was the third best in the Prudential Low Equity category, despite being a lower risk fund. This return was delivered through some good asset allocation and some excellent stockpicking. However, it was also helped by the surge out of cash driving up asset prices. We do not expect the same effect in 2011, and therefore do not expect such high returns.

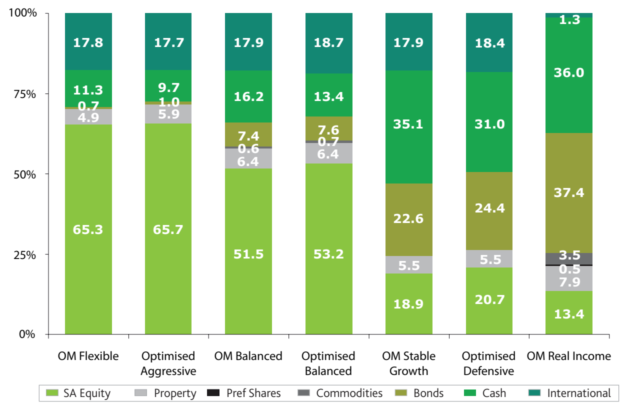
3-year performance to 31 December 2010



* The Old Mutual Stable Growth Fund does not have a 3-year track record yet.

Sources: Morningstar and OMIGSA

Asset analysis as at 31 December 2010



Sources: Morningstar and OMIGSA

Performance to 31 December 2010	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	15.9%	5.6%	12.8%		1.36%
Optimised Aggressive Fund	12.7%	5.0%	11.3%		
Target	11.5%	14.7%	14.7%	CPI+8% p.a. over rolling 3 years	
UT Peer Average	13.6%	4.6%	10.7%	Flexible Category	
Old Mutual Balanced Fund	12.7%	4.5%	11.1%		1.34%
Optimised Balanced Fund	11.6%	4.4%	10.1%		
Target	9.5%	12.7%	12.7%	CPI+6% p.a. over rolling 3 years	
UT Peer Average	10.8%	5.4%	10.0%	Prudential Variable Equity Category	
Old Mutual Stable Growth Fund	9.7%	7.1%	N/A	Launched June 2007	2.23% (September 2010)
Optimised Defensive Fund	9.8%	7.3%	9.6%		
Target	7.5%	10.7%	10.7%	CPI+4% p.a. over rolling 3 years	
UT Peer Average	9.8%	6.6%	8.8%	Prudential Low Equity Category	
Old Mutual Real Income Fund	14.2%	9.7%	N/A	Launched April 2006	1.38%
Benchmark	6.5%	9.7%	9.7%	CPI+3% p.a. over rolling 3 years	
CPI	3.5%	6.7%	6.7%		

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