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FROM 2011 TO 2012, AND THE BATTLE FOR RETURNS

What has not changed?

Amongst the turmoil in the world there have been some constants. Many of the themes we first named in 2010 continued to play out through 2011, and we expect them to remain relevant for years to come.

Theme #1: Big government — The developed world is drowning in US\$15 trillion of excess leverage, much of it within governments. Policymakers and politicians will continue to exert their influence and impact the global economy negatively as the Eurozone crisis and US fiscal policy gridlock continue to hamper growth. The world economy will stagger along with growth expectations for 2012 having halved. Elections in America and the ANC elective conference in Mangaung mean politicians will not be focused on delivering economic growth.

Theme #2: A low-return world — This was certainly the case in 2011, with the FTSE/JSE All Share Index limping in at 2.6%* at the end of 2012, and the MSCI World Free Index coming in negative at -5%* in US dollar terms. We expect that real returns will still be hard to come by in 2012, especially since local cash returns will be negative.

In addition, we have downgraded expected returns from global cash and bonds, while currency weakness is unlikely to support returns to the same extent in 2012.

Theme #3: Cash is trash — We have constantly highlighted how the deliberate policy of very low global interest rates is guaranteed to erode savers' real spending power to the benefit of indebted banks and governments. Unfortunately, South Africa has joined that club with accelerating inflation meaning negative real interest rates. We have cut our real return expectations on local cash to 1% over the next five years and savers will probably do worse. We think local rates may remain unchanged for the longest period since the 1950s.

Theme #4: Quest for yield — Themes 2 & 3 imply that investors will continue to search for yield. Most of investors' returns will come from dividends or interest as opposed to capital gain. For instance, the yields on South African government bonds were unchanged last year and the All Bond Index returned 8.8%. We expect the same thing will happen in 2012, although there is the potential for a positive capital gain. Last year bond yields were flat despite the headwinds of higher inflation, a weaker rand and

foreign selling on the back of global risk aversion. With the rand once again at fair value and inflation expected to peak, there is less risk on local bonds.

Property also delivered a solid return in 2011, which was driven primarily by yield with the FTSE/JSE Listed Property Index returning 8.9%. We have not cut our expected real return of 5.5%, as this asset class is still okay on a yield basis but it is threatened by the growing risk of negative reversions.

What has changed?

The rand

From being the third strongest currency in the world for 2010, the rand plummeted in 2011. It was the worst performing major currency in the world, down 17.5% against the US dollar by year-end. This meant that South Africans who invested offshore early in the year, enjoyed excellent growth in their portfolios.

Following its big move the rand is trading at fair value again. Therefore, we do not expect a materially weaker rand to boost offshore investment returns. However, when we consider investing offshore, we generally consider diversification and valuations, and currently both these points hold true as the benefits of risk diversification are perennial and, in our view, offshore equity valuations remain attractive.

Global bonds versus equities

In 2011 global bonds were the best performing asset class as investors panicked into safe havens and governments artificially influenced the market through quantitative easing. This has meant yields are even lower, guaranteeing a lower return for "buy and hold" investors. We expect investors will lose money in real terms.

On the other side of the coin, equities were sold down and underperformed. This was despite excellent earnings coming through and has meant that valuation multiples have improved sharply. Companies have recognised this and have decreased the number of shares in issue through corporate action and buybacks. As a result, the relative valuation between the two major asset classes has changed with equities now offering a much better return than bonds, purely through dividend yields.

* All indices quoted on a total return basis

Global equity

Earnings growth and global markets fell; this means that price:earnings multiples dropped sharply, resulting in markets becoming cheaper. This reflects an expectation for weaker economic growth and bad earnings for this year. From a valuations perspective, according to our model of theme and price, this asset class has become more attractive.

Global emerging markets

This was a theme that did not hold true last year due to "risk off" sentiment and increased rates. Emerging market currencies fell, bond yields rose and equities underperformed. The result for 2012 is that emerging market assets are now cheaper. The forward p:e is 9.4x and they are trading at a 20% discount to the historic average and a 13% discount to their developed world counterparts.

Looking forward, emerging markets will suffer from the same weak economy, resulting in falling earnings. However, their governments are solvent and their central banks can cut rates, which will provide some support. Therefore, we view last year's weakness as a buying opportunity.

Conclusion

Our longer term view of an overleveraged world delivering low real returns is unchanged, and 2012 should be no exception. This year will see low economic growth, falling Chinese property prices, earnings downgrades and political crises. We have changed some of our expected returns primarily to bring down cash and bond returns and we do not expect rand weakness to boost portfolio returns again.

However, the biggest change is in expectations — everyone expects a tough 2012. We view this as very positive as markets look forward and have priced in much of the bad news. There will also be good news: interest rate cuts in Europe and emerging markets; the European Central Bank (ECB) is printing money to support their banking sector; the Chinese will cut required reserve ratios (RRR); and there are even signs of life in the US housing market. This means that any surprises should be on the upside, especially where your equity investments are concerned. We are positioned for this.

This is our five-year outlook for real returns from asset classes, which we review every six months.

Asset Class	Real Return	View	Comment
SA		N	Long-term real depreciation
Equity	6.5%	N+	In line with long-term returns. Biased to upside
Property	5.5%	N	Good yield offset by negative reversion risk
Bonds	2.5%	N+	Attractive carry vs. cash and improving tactical outlook
Cash	1.0%	—	Lower rates for longer means lower returns
International*		N	Diversification is valuable
Equity	6.5%	+	Preferred risk-adjusted asset class
Bonds	-1.0%	—	Expensive, with a growing risk of capital loss
Cash	-1.0%	—	Cash is still unattractive

NB: These are long-term real returns expected over the next five years, as at 11 January 2012.

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

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