



Anil Thakersee

Portfolio Manager for Macro Strategy Investments

GOLD: BUBBLE OR SAFE HAVEN?

“It gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.” Warren Buffett

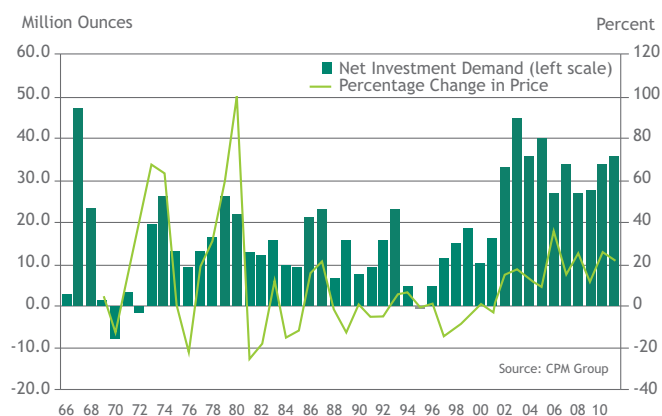
The price of gold reached record highs in the first half of 2011, further extending its bull market which began a decade ago in 2001, after gold prices bottomed at US\$255 an ounce. Since then, the yellow metal has delivered a return of 19% p.a. As a result of these impressive gains, many investors are concerned that the gold price is in a bubble, and that it will all end in tears, as it often does when a bubble finally bursts. At the other end of the spectrum are the gold bulls, for whom gold is a safe haven in a debt-burdened global economy and faced with a structurally weaker US dollar.

Demand for gold

Due to its low or even negative correlation with traditional asset classes, and its safe haven status in times of financial and economic distress, gold does offer investors diversification benefits.

The chart below shows the steady net accumulation of gold for investment purposes over the last decade. The introduction of gold Exchange Traded Funds (ETFs) has boosted physical demand, with the popular US-listed SPDR Gold Trust ETF having reached a market capitalisation of just under \$60 billion. Also, the support of high-profile investors such as George Soros and John Paulson has raised its profile as an alternative investment option. While we could debate cause and effect, there has been a clear correlation between the net accumulation by investors and the price of gold.

Investment demand's effect on gold prices
Price change through January 2011



The two other sources of demand are fabrication demand (jewellery, dental, etc) and buying from international central banks. Fabrication demand has been less robust in recent years on the back of a rising price, while central banks have turned net buyers after a sustained period of being net sellers. Rising reserves in developing nations with little existing exposure have been an important driver. China, India and Russia have been important buyers in the last few years, but the buying has been fairly broad based. The most recent buyer has been Mexico, which increased its reserves by US\$4.6 billion in February 2011.

Supply of gold

Until recently, the supply of gold from mining has been less significant than it is currently, due to net selling from above-the-ground supplies, namely the physical reserves held by the International Monetary Fund (IMF) and global central banks.

While the South African gold mining industry has been decimated by a precipitous decline in production over the last few decades, global production has responded to higher prices and has steadily increased in recent years, and is expected to continue to grow at a moderate pace.

Prices

Gold doesn't neatly fit into the traditional asset class boxes. It is not consumed in the same manner as a traditional commodity, such as copper. While the use of gold and silver as currency is documented going back to ancient Egypt, it no longer has an effective role in international finance. This is what makes gold difficult to analyse: it isn't a traditional commodity and it also isn't a pure monetary asset.

Comparing gold to the S&P 500 Index (as a proxy for financial assets) shows the metal trading at the upper end of the long-term range. Comparing gold to a basket of commodity prices also shows it is trading above the long-term average relationship.

MSI gold positioning

Regular readers will be familiar with MSI's philosophy and that we incorporate both theme and price in our investment decision-making process. It is clear that the theme has been, and currently remains, positive for gold, supported by a weak US dollar and a heavily indebted public sector in the developed world.

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

The signposts we will be watching to indicate whether the theme for gold is changing are: a change in the dollar's fortunes; rising interest rates in the US and the rest of the developed world; and/or a credible implemented plan to deal with the structural deficits.

In terms of price, gold is no longer as cheap as it was in 2001, and now looks expensive based on its long-term relationship with both financial assets and commodity prices. This does not prevent it from becoming even more expensive, but it does indicate the risks of holding it have increased.

As a result, we have recently sold gold holdings in our globally diversified balanced funds.

Market Commentary

Europe was in the headlines once again: Portugal received a bail-out package, while Greek debt was downgraded, with some form of default already being priced in. Local gross domestic product (GDP) data came in above expectations, boosted by manufacturing.

Globally, inflation concerns and rising commodity prices were centre stage in recent months, and several central banks have either acted or warned on those concerns. However, recent economic data and the decline in some commodity prices have once again thrown open the race between inflationary forces – on the back of loose policy, and deflationary forces – on the back of the unwinding of this loose policy.

As a result, bonds were the winners in May as the equity market gave back a little, with the MSCI World Index declining 2% for the month in US dollar terms. Over the month, the All Bond Index (ALBI) gained 1.4%, inflation-linked bonds gained 2%, and listed property was flat.

Fund performance and commentary

Old Mutual Flexible Fund and Optimised Aggressive Fund

The poor return from local equity markets this month offset the positive effects of the funds' international investments and, as a result, their performance was broadly flat. This highlights the benefit of their diversified nature, which over the past three and five years has enabled them to deliver competitive returns at reduced volatility.

We have not made any major changes to the positioning of the portfolios, although early on in the month we used the opportunity of rand strength to top up the international holdings. The funds are running with a slightly higher cash level (23%) than normal, which we intend to invest as opportunities present themselves. Therefore, weakness in markets is potentially a positive to create buying opportunities.

Old Mutual Balanced Fund and Optimised Balanced Fund

The funds have been underweight bonds in favour of property and cash for some time now, and this has contributed to returns. However, provided we receive a margin of safety over what we believe will be long-term inflation, we will now look to add to bonds, with a preference for inflation-linked bonds. We have been adding exposure to offshore assets in a disciplined and steady manner, and the funds show a strong preference for offshore equity over local equity, based largely on relative valuations.

Old Mutual Stable Growth Fund and Optimised Defensive Fund

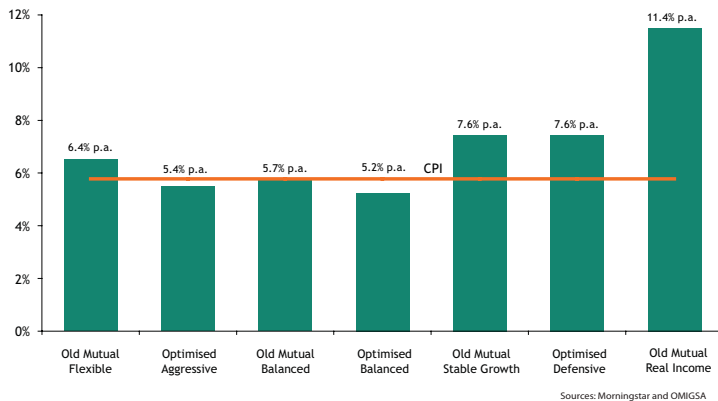
Despite the decline in the local equity market the funds delivered solid positive returns above what cash achieved. This was due to strong performances from the local bond and international holdings. The rand weakness in the month meant that international markets delivered a positive rand return, despite falling in their own currencies. The funds remain well-diversified, which is an important means of reducing the risk of losing capital. Over the last 12 months, the funds have delivered a 10.9% return – ahead of inflation, cash and the average of the unit trust sector.

Old Mutual Real Income Fund

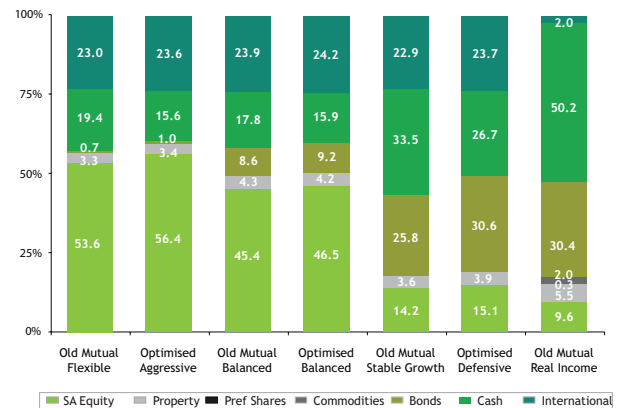
In spite of the decline in the local equity market, the fund delivered a very solid performance. This was due to its low level of equity holdings, particularly resources shares, which led the market down in May. The bond holdings, especially inflation-linked bonds, also boosted returns as lower yields resulted in capital gains.

Over the last 12 months, the fund has delivered a return of 11.4% and a very similar return over three years, during which period it has been the best performing fund in the Domestic-Asset Allocation-Prudential-Low Equity category. However, looking forward, it will be very difficult to deliver such high returns because both cash and bond yields are lower.

3-year performance to 31 May 2011



Asset analysis as at 31 May 2011



Performance to 31 May 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	17.4%	6.4%	11.0%	CPI + 8% p.a. over rolling 3 years Flexible Category	2.52%*
Optimised Aggressive Fund	16.7%	5.4%	9.9%		
Target	12.3%	13.6%	14.8%		
UT Peer Average	15.4%	5.5%	9.4%		
Old Mutual Balanced Fund	16.6%	5.7%	9.7%	CPI + 6% p.a. over rolling 3 years Prudential Variable Equity Category	2.44%*
Optimised Balanced Fund	15.0%	5.2%	9.0%		
Target	10.3%	11.6%	12.8%		
UT Peer Average	12.2%	5.5%	8.8%		
Old Mutual Stable Growth Fund	10.9%	7.6%	#N/A	CPI + 4% p.a. over rolling 3 years Prudential Low Equity Category	2.22%*
Optimised Defensive Fund	11.0%	7.6%	8.9%		
Target	8.3%	9.6%	10.8%		
UT Peer Average	9.7%	6.8%	8.1%		
Old Mutual Real Income Fund	11.4%	11.4%	9.4%	CPI + 3% p.a. over rolling 3 years	1.38%
Target	7.3%	8.6%	9.8%		
CPI	4.3%	5.6%	6.8%		

*TER as at 31 March 2011

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.