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Actualising our philosophy

For regular readers of our monthly newsletter, our philosophy framework of ‘theme’ and ‘price’ should be a familiar sight; for the sake of new readers: when we are considering an investment idea we combine both ‘top-down’ and ‘bottom-up’ inputs in our decision-making process.

The ‘top-down’ input identifies prevailing themes by examining the macro environment and using long-term proprietary performance data to assess whether these themes are improving or deteriorating in relation to the asset or sector under consideration.

‘Integrating Top-Down and Bottom-Up’



‘Bottom up’ focuses on establishing the differential between what a company is intrinsically worth (valuation), as indicated by fundamental analysis, and its market value (current price). We determine this through the detailed analysis conducted by Old Mutual Investment Group SA (OMIGSA)’s team of equity analysts, and internal and external research. We then combine the outcomes of these approaches to evaluate the overall attractiveness of the investment idea. For example: an asset with an improving theme and cheap valuation would fall into the ‘Buy Lots’ quadrant. Then, as the share price increases and the environment remains strong, it will move to the ‘Reduce’ quadrant, top right, as we start to sell to lock in profit.

However, it is not always so clear. For example, we may identify a share that is attractive from a valuation point of view but is not supported by a theme; in this case we would potentially ‘Buy Some’.

The next steps

Once we have decided that we want to ‘Buy Lots’ or ‘Buy Some’ of a share, the next part of our process helps us determine its weight in the portfolio.

Roadmap

Our roadmap provides the details of what we believe will be the future path of the investment idea. Aspects such as the duration of the potential investment – whether is it a strategic or tactical call; and the nature of the investment – whether the share is defensive or cyclical, are documented.

For example: for a ‘Buy Lots’ share the roadmap may say: “This is a core holding and I expect the theme to play out over a longer period

of time, resulting in earnings growth above the current market expectations.”

Or, the roadmap for a share that is cheap, but is not supported by a theme may state: ‘Based on the relative underperformance and valuation of this share, I am buying some on a shorter-term tactical basis, and would look to sell 10% higher.’

Risk

The trade-off for return is risk. And while it is factored into our price and theme analysis, it is a crucial consideration that also needs to be addressed independently. This includes how volatile the share is and how it interacts with the market; its sensitivity to macroeconomic variables such as interest rates, currency fluctuations or the market itself (beta to the market in financial jargon) is also measured.

And, because we run integrated portfolios where the sectors and asset classes we include hold dynamic tension, we need to identify how the share fits in with the rest of the portfolio.

Position size: the last step

Once we have established which quadrant the investment fits into, defined its roadmap, and identified prevailing risks, we then determine the optimal amount to include in the portfolio.

Our framework in action: Life Healthcare

Top-down themes

On the diagram the theme falls in the ‘Improving Environment’ half, despite some regulatory headwinds. There are three primary themes that indicate a favourable environment for the company:

- **Low return world:** this environment favours defensive companies with earnings certainty
- **Search for yield:** this is a cash generative company with a growing dividend
- **Emerging markets:** emerging market exposure opens up good expansion opportunities; Life Healthcare has just announced an acquisition in India.

Price: valuations

According to our bottom-up analysis, Life Healthcare is currently trading at fair value. This means that it is no longer cheap; nor is it excessively overvalued.

Roadmap

This share is a core holding and we are currently overweight. We expect to remain invested unless the share outperformance is significant, in which case it will move to the ‘Reduce’ quadrant.

Risk

This is a defensive, lower beta share and provides good diversification for our portfolio. There are some regulatory headwinds, such as the proposed National Health Insurance; however, the risks to theme and price are fairly low.

Position Size

Everything considered above, our call is to have an overweight position in our portfolios.

Hopefully the above example sheds some light on our process framework.

Market Commentary

The sovereign debt crisis in Europe and global growth fears weighed heavily on equity markets in the third quarter of 2011. The FTSE/JSE All Share Index (ALSI) declined by 5.8% for the quarter in rand terms, and the MSCI All Country World Index declined by 18% in US dollar terms. Along with other emerging market currencies, the rand sold off sharply during the quarter, declining 20% against the dollar, 11% against the euro and 16% against the pound. In major developed economies, bond yields fell sharply and local government bonds gained 2.8% for the quarter, outperforming equities and cash for the second consecutive quarter. While markets may continue to be volatile, we currently see attractive entry levels in many local stocks.

Fund performance and commentary

Old Mutual Flexible Fund and Optimised Aggressive Fund

The funds suffered from the steep sell-off in global markets during the quarter. Some protection was provided by offshore diversification, cash and property, but broad exposure to growth assets resulted in a decline in asset values. Over the 12 months the recent sell-off has brought returns down to 2.6%. This reflects the volatility of markets, as in June; just three months ago, the returns were 19.6% over 12 months. In these uncertain times it is important to stick to a longer-term view, and we still see no alternative to equities to deliver decent, real returns into the future.

Old Mutual Balanced Fund and Optimised Balanced Fund

The funds have been positioned for global growth and over the last quarter risk assets have been volatile. Some of this risk was mitigated by having close to the

maximum of 25% in offshore assets, which benefited from the weaker rand. The funds also benefited from holding inflation-linked bonds, which performed well over the quarter. Looking forward, we see many shares offering attractive entry levels and remain constructive on equities.

Old Mutual Stable Growth Fund and Optimised Defensive Fund

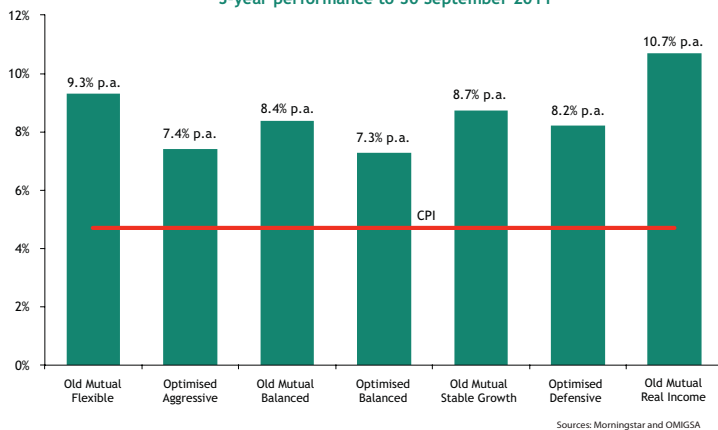
Diversifying the funds into international assets reaped its rewards this month. With all local asset classes except cash declining, the fund managed a positive return. This was largely due to the 5% position in Japan, which was up 12% in rand terms during September. The funds also managed a positive return over a tough quarter, and over the 12-month period returns were 6.4%. This was better than the sector, inflation, the money market, and the miserly 3.6% from the ALSI. However, reflecting the low returns available in the last 12 months performance was below the target of inflation + 4%.

Old Mutual Real Income Fund

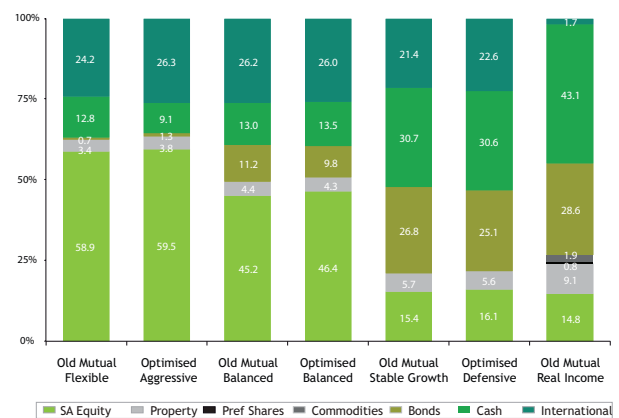
The fund suffered this month from its inability to own international assets. All local asset classes, with the exception of cash, fell in September while the rand depreciated by 15%. The fund has balloted all investors, asking for permission to invest internationally so that we can take advantage of opportunities outside of South Africa. These investments would still be in line with the fund's objective to create income and protect capital from inflation.

Over the quarter, the fund's very-conservative positioning meant a solid positive return, and over the year the fund delivered a return of 7%. While this is slightly below the target of inflation + 3%, it is a solid performance in light of the very meagre returns from most asset classes. Looking forward, we do not expect a hike in interest rates, so we will continue to search for yield in other asset classes.

3-year performance to 30 September 2011



Asset analysis as at 30 September 2011¹



Performance to 30 September 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	2.6%	9.3%	8.8%	CPI+8% p.a. over rolling 3 years Flexible Category	2.36%*
Optimised Aggressive Fund	3.0%	7.4%	7.8%		
Target	13.4%	12.7%	14.7%		
UT Peer Average	5.2%	8.4%	7.9%	CPI+6% p.a. over rolling 3 years Prudential Variable Equity Category	2.37%*
Old Mutual Balanced Fund	5.5%	8.4%	7.9%		
Optimised Balanced Fund	4.0%	7.3%	7.3%		
Target	11.4%	10.7%	12.7%	CPI+4% p.a. over rolling 3 years Prudential Low Equity Category	2.20%*
Old Mutual Stable Growth Fund	6.4%	8.7%	N/A		
Optimised Defensive Fund	6.3%	8.2%	8.4%		
Target	9.4%	8.7%	10.7%	CPI+3% p.a. over rolling 3 years	1.38%
Old Mutual Real Income Fund	7.0%	10.7%	9.4%		
Target	8.4%	7.7%	9.7%		
CPI	5.4%	4.7%	6.7%		

*TER as at 30 June 2011

¹ Three fund currently overweight international due to market movements

Sources: Morningstar and OMIGSA

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

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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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