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YIELD IS KEY TO LONG-TERM RETURNS

“The most realistic distinction between the investor and the speculator is found in their attitude towards stock-market movements. The speculator’s primary interest lies in anticipating and profiting from market fluctuations. The investor’s primary interest lies in acquiring and holding suitable securities at suitable prices.” Benjamin Graham

One of the crucial differences between investing and speculating is the time horizon. Investing is buying and holding a valuable asset with a realistic expectation of the long-term return; a speculator trades, and hopes to sell at a higher price. A speculator’s aspiration for returns is driven by price movements, generated by potentially selling on to a “greater fool”.

For instance, a speculator who bought bonds last month would have made a 3.5% return but, over a period of two weeks in September would have lost 3.2%, predominantly made up of price movement. However, an investor holding a bond to maturity will make all of their returns from yield. This thinking applies to equities too. As tabled below, the impact of reinvested dividends is significant, representing 25% of the total return on equities in the last 50 years. And if expressed relative to real returns, more than half. Very simply, the longer your investment time horizon, the more of your return will be made from yield and less from volatile price action

The last 50 years:	% p.a.
Total return on FTSE/JSE All Share Index (ALSI) incl dividends	17.7
Return on ALSI excluding dividends	12.5
Inflation	8.6
Real returns on ALSI	9.1
Impact of reinvesting dividends	5.2
Average dividend yield	4.4

Sources: OMIGSA and I-Net

Long-term returns

Our philosophy is to use a five-year investment time horizon when investing our clients’ money, which helps enormously to reduce the noise in markets. Long-time readers of Macro Solutions will be aware that we publish our expected five-year real return expectations (www.omigsa/msi).

For bonds, current yields are a good indication of what future nominal returns are going to be, although we do not know what inflation will be (refer table below). However, this month US 10-year inflation-linked bonds traded at -5 basis points (bps)! Although it was negative just on that day, this is a startling phenomenon as it shows investors are prepared to accept no real return (below inflation returns!) over 10 years, purely to protect their capital. At time of writing, 21 September, these bonds were trading at real yields of just 2bps.

	10-year bond yields 21/09/2011	July 2011 Inflation
US	1.9%	3.6%
Japan	1.0%	0.5%
Germany	1.8%	2.5%
UK	2.4%	4.5%
South Africa	8.5%	5.3%

Source: Inet

Cash is trash

The reason investors will accept flat returns is because they know they will actually go backwards in real terms if they remain in cash. This is due to the lethal combination of low interest rates and higher inflation. This is unlikely to change as developed economy central banks are taking increasingly desperate measures to ensure negative real interest rates.

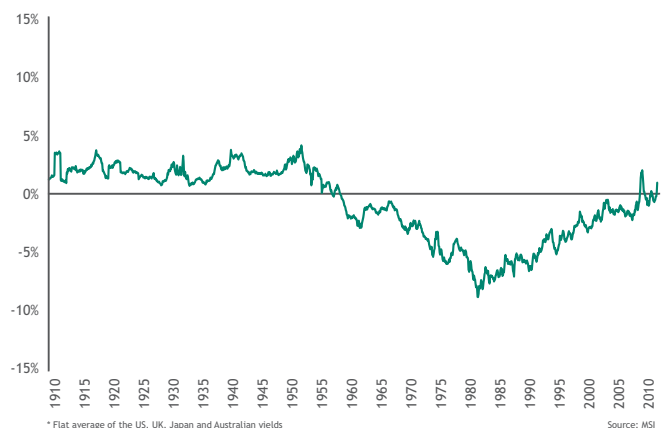
For instance, Ben Bernanke of the US Federal Reserve has committed to “exceptionally low levels for the federal funds rate, at least through mid-2013”. The Swiss National Bank “is prepared to buy foreign currency in unlimited quantities” to ensure the franc weakens against the euro.

The big picture

Once you remove cash and bonds, developed market investors are running out of investment options. Commodities (e.g. gold and silver) produce no yield and have already increased materially in real returns. This leaves equity and property as the best-yielding asset classes. This is an unusual situation, as shown by the 100-year graph below: *for the first time in more than 50 years dividend yields are greater than bond yields.*

We have used historic dividend yield, so a future collapse in earnings, and hence dividends, could reduce the attractiveness of equity. However, while not impossible it is not likely, as many companies in our investable universe are in excellent financial condition and are already retaining two-thirds of income, so we expect dividends will be safe. In fact, we expect additional returns on capital through special dividends, buy-backs and corporate action.

**Relative valuation:
Dividend yield minus bond yield***



This perspective gives us a high degree of conviction that equities will outperform bonds and cash over the next decade. The worst case scenario: growth is very soggy, markets move sideways and investors only receive their dividends. However, this will still be better than cash and bonds.

If inflation comes through strongly, equities will protect investors and bonds will underperform very badly. Therefore, whatever picture emerges, we favour equity in what we still expect will be a low return world.

How does this view reflect in your funds?

Within our funds we took advantage of the increased allowance to international assets. However, within this international allocation we have no exposure to offshore government bonds and are predominantly invested in equity. We also took a longer-term view and increased our equity exposure in the recent market turmoil.



Market Commentary

Global equity markets saw quite sharp moves in August on the back of weak economic data, uncertainty about a sustainable solution to Europe's sovereign debt issues, and a surprise downgrade of the US debt rating. While equity markets were generally weaker for the month, there was a wide spread of returns: Germany's DAX plunged 19% for the month, while the JSE/FTSE All Share Index (ALSI) declined by less than one percent over the same time period.

Despite the ratings downgrade, US bond yields fell sharply on fears of a recession and the South African bond market produced a return of 3.5% for the month. Inflation-linked bonds and listed property also performed well. Locally, interest rate hike expectations have experienced a significant shift. Previously expectations were for hikes later this year to early next year; this has now been pushed out further, with some analysts now seeing a rate cut as probable.

Fund performance and commentary

Old Mutual Flexible Fund and Optimised Aggressive Fund

The funds held 20% in cash, including a protective structure ahead of the current correction. However, this was not enough to protect them from a decline in August. Despite the weakness of the rand their international equity holdings still fell in local currency terms.

The good news is that the market decline resulted in cheaper share prices and the funds took advantage of this opportunity. They increased equity exposure using cash, and cash levels have now fallen to 10% of the portfolio. The funds can go to 100% in equity, so there is still some firepower for further purchases, but they are now strongly positioned for equities to outperform in the next couple of years.

Old Mutual Balanced Fund and Optimised Balanced Fund

The funds were positioned more defensively in April in response to the rising global uncertainty. They hold inflation-linked bonds and listed property, and these asset classes performed well during the global market sell-off in August. While it is likely that markets will remain jittery in the short-term, the environment for adding attractively valued shares to the portfolio has improved. As long-term investors, valuations remain the key underpin for returns, and we anticipate that equities will provide good real returns over the next five years, in both absolute and relative terms.

Old Mutual Stable Growth Fund and Optimised Defensive Fund

The funds handled the uncertainty in August well due to their diversified nature and the protection that was placed on roughly one third of the South African equity portion of the portfolio.

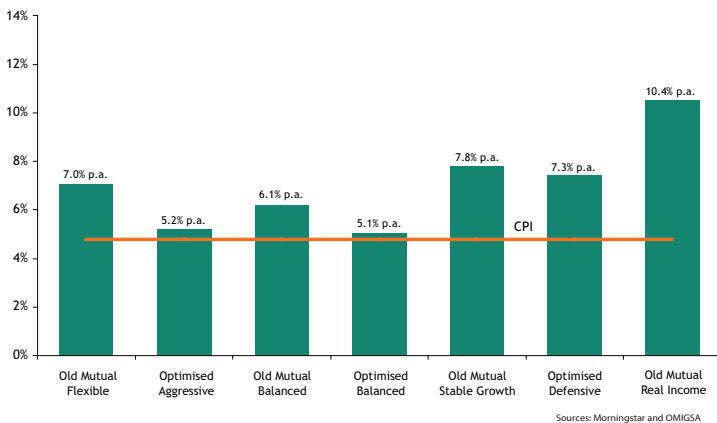
The strong returns from bonds and weak returns from equities have meant equities now offer substantially better returns than bonds. As a result, we have increased their investment in shares and decreased the bond holdings. We have also removed the protective structure. This will enable the funds to deliver better real returns into the future. However, the environment is still risky and, as a result, we have not increased equity exposure to the sector limit of 40%.

Old Mutual Real Income Fund

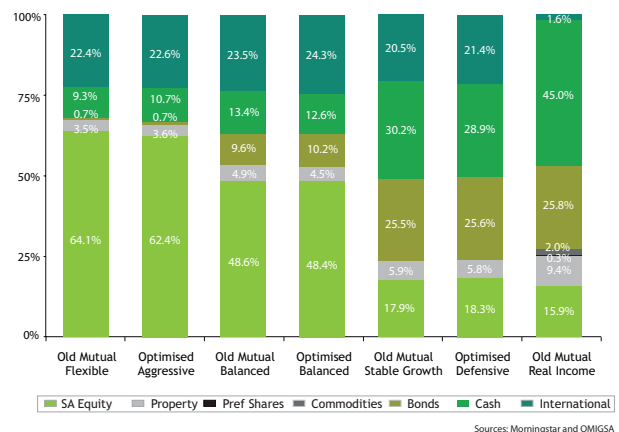
The fund enjoyed another positive month despite the massive volatility in global equity markets. This is because it is primarily invested in income-producing assets that performed well. However, the change in rate expectations and the lower yields available create a problem for retired investors. Lower income and higher inflation is a double-edged sword that cuts into real spending power.

As a result, we invested some of the fund's cash in equities during the recent sell-off, as these company dividends will provide real spending power into the future. We also took advantage of a new property listing, Dipula, which provides a very secure yield of 9.25%, to build a position for our investors.

3-year performance to 31 August 2011



Asset analysis as at 31 August 2011



Performance to 31 August 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	11.2%	7.0%	9.6%	CPI+8% p.a. over rolling 3 years Flexible Category	2.36%*
Optimised Aggressive Fund	10.2%	5.2%	8.4%		
Target	14.1%	12.9%	14.9%		
UT Peer Average	11.2%	6.5%	8.4%	CPI+6% p.a. over rolling 3 years Prudential Variable Equity Category	2.37%*
Old Mutual Balanced Fund	12.2%	6.1%	8.5%		
Optimised Balanced Fund	9.6%	5.1%	7.8%		
Target	12.1%	10.9%	12.9%	CPI+4% p.a. over rolling 3 years Prudential Low Equity Category	1.39%
UT Peer Average	9.4%	6.3%	8.0%		
Old Mutual Stable Growth Fund	8.9%	7.8%	N/A		
Optimised Defensive Fund	8.3%	7.3%	8.6%	CPI+3% p.a. over rolling 3 years	1.39%
Target	10.1%	8.9%	10.9%		
UT Peer Average	7.6%	6.9%	7.8%		
Old Mutual Real Income Fund	9.7%	10.4%	9.7%		
Target	9.1%	7.9%	9.9%		
CPI	6.1%	4.9%	6.9%		

*TER as at 30 June 2011

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.