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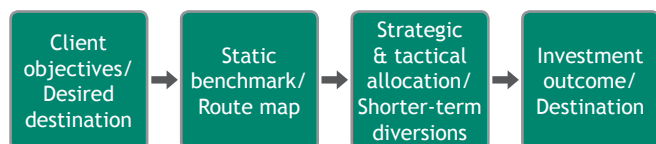
## TRAVELLING TO YOUR INVESTMENT DESTINATION: HOW MUCH OFFSHORE?

When you travel, planning the route you will take greatly improves the likelihood of arriving at your destination. Sounds obvious, doesn't it? Now let's look at the same principle in investment terms. What should your asset allocation be if your objective is to consistently deliver a return of inflation + 6%? At Macro Strategy Investments (MSI) we think this question is an excellent starting point. This is because, in terms of our philosophy, we recognise that the correct long-term asset allocation (what we call the static benchmark) is of vital importance when investing towards great real returns (returns in excess of inflation).

While your objectives (in this case inflation + 6%) represent your desired destination, the static benchmark allocation is the planned route that will get you safely there. During the journey there may be deviations from this planned route, but these are carefully considered decisions that should either shorten the journey, or make it less stressful or even more fruitful.

### What could cause a fundamental reroute?

A reroute could arise due to significant changes in the legislative and regulatory environment. For example, the relaxation in exchange controls late last year could make it worthwhile in some cases to consider the merits of re-plotting the route, i.e. changing the static exposure. Such fundamental changes are different to the adjustments arising from our use of strategic and tactical allocation decisions, as they represent our ACTIVE asset allocation and are in play to take advantage of medium- to shorter-term opportunities. Amending the static benchmark for a portfolio represents a shift in our long-term view which applies to a 20 year + investment horizon.



Source: OMIGSA; Macro Strategy Investments

**Static allocation:** A timeframe of around 20 years; long-term asset allocation in respect of mandated risk/return requirements.

**Strategic allocation:** A timeframe of around five years; buy and sell decisions based on the analysis of macroeconomic conditions to identify themes that will drive the markets and affect asset class behaviour.

**Tactical allocation:** A timeframe of six months to one year; short-term outperformance through exploiting mispricing opportunities in the market

In January 2011 we wrote that there were compelling reasons to diversify into offshore assets. These reasons were:

- (i) the overvalued nature of the rand,
- (ii) the attractiveness of offshore equity relative to SA equity, and
- (iii) the risk reduction (diversification) offered by offshore assets.

Point (iii) talks to a criterion that we would consider when determining the route or static benchmark, while points (i) and (ii) represent strong arguments to deviate from that route and to gain additional exposure to offshore assets – i.e. tactical and strategic allocation considerations.

Is it a no-brainer that your portfolio alters its route such that you take full advantage of 25% invested in offshore assets? In a nutshell, the answer is unfortunately: It depends. Our analysis shows that the higher your real return objectives and risk tolerance, the higher your allocation to offshore assets ought to be.

Figure 1 below shows the risk and returns associated with the major asset classes over the last 41 years. Each asset class has delivered positive real returns over the period. Offshore asset classes have been heavily influenced by the depreciation of the rand over the period, which accounts for approximately 40% of their returns. In contrast to this positive, the rand's negative impact is its contribution to the increased volatility of returns, i.e. risk. Adjusting for the higher risk, we observe that the real returns per percentage point of risk are more attractive for the local asset classes relative to their offshore counterparts.

**Figure 1: Annualised risk and return across asset classes (Rands)**  
31/12/1969 - 31/12/2010



Source: OMIGSA; Macro Strategy Investments

The correlation between asset classes is also an important consideration. For example, an investor has not been compensated for the additional risk observed in gold bullion. However, the asset has been reasonably uncorrelated to the other asset classes over the period. This means that the inclusion of gold, an intrinsically volatile asset, would, counter-intuitively, have lowered the volatility of the portfolio.

**Positive correlation:** When asset classes respond similarly to events/data.

**Negative correlation:** When asset classes respond in an opposite manner to events/data – they move in opposite directions.

**Uncorrelated:** The behaviour of the asset classes has no relation, i.e. they are not affected by the same events/data.

### Changing the route to stay on course

We employ several risk and return criteria when determining the appropriate static benchmark for a client. Our analysis shows that increasing the static allocation to offshore assets (primarily equity) is a must for clients with a moderate risk mandate, and other analyses have shown that the optimal weight is closer to 35%. Therefore, even a move to the maximum of 25% offshore can still be considered an underweight offshore stance. (Note: We are constrained by current exchange controls as determined by legislation.)

For more conservative portfolios (i.e. lower return expectations and less tolerance for risk), amending the static benchmark to 25% offshore is not requisite in our view. This is because local assets have delivered attractive returns relative to the lower real return objective of these portfolios, and with much less risk. Also, the additional risk of the offshore assets outweighs the additional returns attributable to the rand. We maintain that a more appropriate static exposure to offshore assets for these portfolios is between 15% and 20%.

### A flexible plan

Planning your investment route is as important as planning your travel route or your career path. Our view is that you should have significant exposure to offshore assets in order to achieve your investment objectives over the long term. The size of that exposure depends on your return and risk profile. However, there may be deft detours along the way as opportunities arise, or circumstances change.

## Market Commentary

The FTSE/JSE All Share Index (ALSI) gained 2.8% in February, despite the political unrest in the Middle East and North Africa. Fears that the unrest would impact oil production in the region caused oil prices to spike, with Brent Crude oil gaining 13% for the month. As a result, oil & gas was the best-performing sector on the (ALSI), gaining 9.8% for the month. Despite the geo-political developments, the rand strengthened in February, up 3% against the US dollar on the back of a growth-friendly Budget and no further relaxation of exchange controls. The currency was also rebounding after selling off sharply in January. The All Bond Index (ALBI) was flat over the month, and inflation-linked bonds gained 1%, as a wider-than-expected budget deficit of 5.3% of gross domestic product (GDP) is now expected for the coming year. Domestic growth for the fourth quarter of 2010 came in at 4.4%, with the full year's growth at 2.8%. Inflation drifted up to 3.7% for January and, as with commodity prices, is likely to rise through the rest of the year. Generally, the mood (in SA, but also globally) on monetary policy has become more hawkish.

levels, it has performed exceptionally well over that period. In 2010, listed property was the best-performing asset class, delivering a 29% return. As a result the sector no longer justifies a large overweight position, and we have reduced our exposure in recent months. However, from a yield perspective property continues to look more attractive than cash, and therefore we will continue to maintain a smaller position, somewhat closer to the benchmark.

The year has certainly begun with a focus on geo-political events, and much commentary on their implications for markets, commodity prices, etc. has been generated. The simple answer is that such things cannot be forecast, and much less how they will end. We would like to remind our investors that these funds are long-term investments, and that it may be wise to avoid getting caught up with the current massive media focus and speculation. We are pleased to report that the funds are now first quartile when measured against the unit trust Domestic-Asset Allocation-Prudential Variable Equity category over one and two years.

### Old Mutual Stable Growth Fund and Optimised Defensive Fund

The funds remain very well-balanced investments, with roughly an even third split between equity, cash and bonds. However, in the medium term we are concerned about lower real returns from cash as inflation accelerates and cash yields are slow to rise. Therefore, as opportunity presents itself, we will invest some of the cash.

### Old Mutual Real Income Fund

The gradual increase in inflation is bad news for investors, as it silently erodes spending power. It also means that capital gains on bonds and listed property are less likely in 2011, and we will have to make do with the income generated by those investments. However, bond yields are now well above cash yields, and for yield-orientated investors the extra 3% is worth taking on additional risk. On the equity front, the funds' two largest holdings, British American Tobacco plc (BAT) and Sasol, both did exceptionally well in February, gaining 7% and 9.8% respectively. However, many of the fund's higher-yielding shares are in the small and mid-capitalisation areas, both of which fell during the month.

## Fund performance and commentary

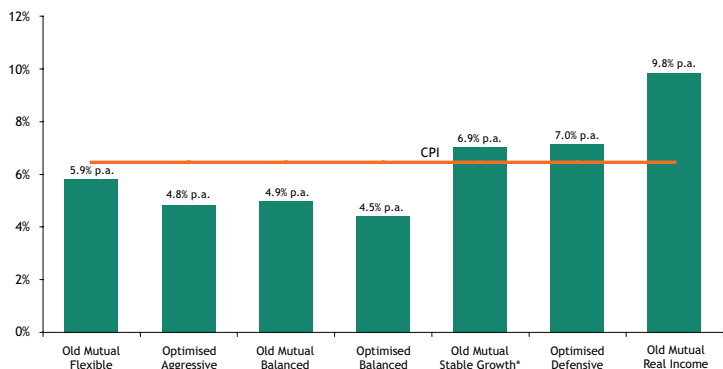
### Old Mutual Flexible Fund and Optimised Aggressive Fund

The strong equity market resulted in another positive month for the funds, bringing their 12-month returns to 15.9%. However, there is a much more uncertain market outlook due to the political strife in North Africa and the Middle East, and the resultant higher oil prices. For instance, large capitalisation shares were up, but mid- and small capitalisation shares fell in the month. Internationally, Japan performed well and emerging markets fell. As part of the funds' increased international exposure they had increased their Japanese exposure by 3%.

### Old Mutual Balanced Fund and Optimised Balanced Fund

During the past decade, the funds have held an overweight position in property for much of the time. And, while the asset class started off at very depressed

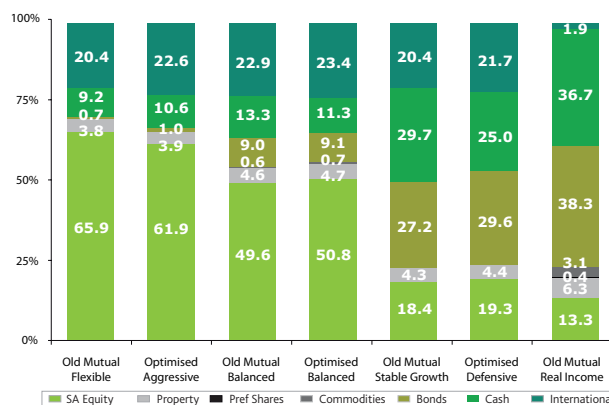
3-year performance to 28 February 2011



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

Sources: Morningstar and OMIUSA

Asset analysis as at 28 February 2011



Sources: Morningstar and OMIUSA

Performance to 28 February 2011	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	15.9%	5.9%	11.0%	CPI + 8% p.a. over rolling 3 years Flexible Category	2.63%
Optimised Aggressive Fund	14.3%	4.8%	10.0%		
Target	11.5%	14.4%	14.7%		
UT Peer Average	13.5%	5.0%	9.3%		
Old Mutual Balanced Fund	14.2%	4.9%	9.9%	CPI + 6% p.a. over rolling 3 years Prudential Variable Equity Category	2.52%
Optimised Balanced Fund	12.6%	4.5%	9.0%		
Target	9.5%	12.4%	12.7%		
UT Peer Average	11.3%	5.4%	8.9%		
Old Mutual Stable Growth Fund	9.7%	6.9%	N/A	Launched June 2007	2.21%
Optimised Defensive Fund	9.8%	7.0%	9.0%	CPI + 4% p.a. over rolling 3 years Prudential Low Equity Category	1.38%
Target	7.5%	10.4%	10.7%		
UT Peer Average	9.3%	6.6%	8.1%		
Old Mutual Real Income Fund	11.4%	9.8%	N/A	Launched April 2006	
Target	6.5%	9.4%	9.7%	CPI + 3% p.a. over rolling 3 years	
<b>CPI</b>	<b>3.5%</b>	<b>6.4%</b>	<b>6.7%</b>		

Sources: Morningstar and OMIUSA

For more information, visit [www.omigsa.com/msi](http://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 OMIUSA. 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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