

MEDIA RELEASE

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CORPORATE BONDS TO OFFER SUPERIOR RETURNS

With interest rates expected to remain near their current low levels for an extended period of time and the outlook for government bonds discouraging, corporate bonds are expected to remain an attractive sub-asset class over the medium-term for investors looking for income, according to Wikus Furstenberg, a portfolio manager at Futuregrowth Asset Management, South Africa's largest fixed income asset manager and a boutique in Old Mutual Investment Group SA (OMIGSA).

Speaking at a press conference on Tuesday, Furstenberg said that, considering the various income-producing asset classes, yields from top-rated SA corporate bonds were currently very attractive, having risen roughly 100 basis points on average versus government bonds in the last two years as a result of the global credit crisis.

"Although some investor risk appetite has returned to the bond market now that conditions have improved, corporate bond spreads versus government bonds are offering attractive yields on a historic basis," he pointed out. "For example, an AA-rated corporate bond from Bidvest (BID01) is offering 11.1% (or 2.5% over the comparable government R201 bond) currently, compared to 10.0% (or 1.4% over the R201) at the end of 2007."

Compare this to money markets, which are likely to return around 7.5% per year for the next 18 months or so. This is barely above inflation, currently at 6.4% y/y (as of August) and expected to average 5.5% y/y in 2010, he said.

At the same time, government bonds have a gloomy outlook: a sharp rise in new supply is already having a negative impact as the National Treasury is required to borrow more to meet the higher-than-expected government budget deficit for the current and following fiscal years. "We estimate government's net new long-term bond issuance for fiscal 2009/10 at between R100bn and R120bn, which is equivalent to about 11%-15% of our total listed bond market, and almost double the R61bn in new issuance estimated by the Minister of Finance in February this year.

"Although the market has started factoring in this large increase, it is hard to tell at exactly what price the additional net new issuance is going to clear, especially if inflation does not surprise on the downside during the next few months." As a result, Furstenberg said, he expects government bond prices to be driven down and

yields to rise more in the coming months, especially for paper with a term to maturity of five-years and beyond.

“This creates a significant risk of high volatility of returns from pure bond funds over the medium-term. And with money market returns low, very conservative funds that must hold significant levels of cash are also at risk of delivering low real returns. So retail investors who require income should consider more flexible income funds, like the Old Mutual Enhanced Income Fund, that are allowed a great deal of flexibility in terms of allocation within the fixed income market. This would allow them to benefit from exposure to higher corporate bond yields, plus gain some protection against possible higher interest rate risk should market conditions require it.”

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