Perspectives

January 2013

LOWER RETURNS IN 2013 FAVOUR EQUITIES AND STOCKPICKING

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A year ago we expressed our concerns around low expected returns amid the rampant macroeconomic fears. We strategically positioned our portfolios away from cash and towards growth assets, which we believed to offer the most potential for real returns in this environment. Since then, global macroeconomic risks have been receding somewhat from the high levels of 2012; ironically, however, the new year is not necessarily going to be a better one for investors. This is because we expect lower returns in 2013 across most asset classes versus the surprisingly high levels of 2012, as most good news has already been priced into both global and local equity markets and bond yields have very little room to fall further from their historic lows. On the plus side, our portfolios were ideally positioned for our investors to benefit from this return of market confidence.

2012 policies boosted markets

The extreme policy response that central banks undertook in 2012 (by cutting interest rates and buying bonds) to avoid a renewed global financial crisis lowered the cost of capital and resulted in record-low global bond yields and higher prices of local assets as well. Essentially, all of the bad news last year gave rise to market-boosting policies that, in the end, gave investors higher-than-expected returns. For example, the 50 basis point rate cut by the SA Reserve Bank (SARB) helped produce stellar returns from listed property (35.9%) and bonds (16.0%), with the SA government 10-year bond yield reaching 6.7% - a level not seen since 1970.

Equities also re-rated, with the FTSE/JSE SWIX index returning 29.1% last year from a combination of dividend growth (15%), strong earnings growth (50%) and higher price-earnings (P/E) ratios (35%). Forward P/E's moved higher following lower earnings expectations.

A quieter 2013

So in 2013, with the global macroeconomic outlook expected to improve as China and the US both recover to an extent and worries over a Euro break-up recede, we believe policymakers will have a quieter year as they maintain their current policies. This means the global cost of capital should stabilize – in fact, global bond yields are likely to have bottomed last year. So we can't see good real returns from global cash and bonds in 2013 – we are forecasting an average of -1.5% and -1.0% p.a., respectively (in US dollars), over the next five years.

Long-term asset allocation view

	Real return	View	Comment
SA	**p.a.**	**Neutral**	**Rand back to fair value**
Equity	6.5%	Neutral +	Getting expensive but best absolute return
Property	4.5%	Neutral	Good yield offset by negative reversion risk
Bonds	1.5%	Neutral –	Growing risk of capital loss
Cash	0.0%	–	Lower rates for longer means lower real returns
International*		**Neutral**	**Diversification is valuable**
Equity	6.0%	+	Will muddle through with dividends delivering the bulk of return
Bonds	-1.5%	–	Expensive with growing risk of capital loss
Cash	-1.0%	–	Cash is still unattractive

NB: These are long-term, real returns expected over the next five years, as at 8 January 2013.
* The international return expectations above are in US Dollar terms; any rand depreciation will add to returns in rands.

Global equities still attractive

Therefore, global equities still offer the best return prospects among offshore assets, primarily due to their higher yields relative to bonds and cash. We are forecasting a real return of 6.0% p.a. (in US dollars) over the next five years from this asset class. Investors should consider adding global equities to their portfolios in 2013 for their valuable diversification benefits, regardless of rand moves over the year.

We are also taking advantage of the pockets of higher yield to be found in emerging market debt, international property and higher-yielding international shares to enhance returns in our funds.

Looking at South African assets, the surprise SARB rate last year cut left cash investments delivering a below-inflation return of 5.6% for 2012. Looking forward, we think investors would be lucky to beat inflation over the medium term – we are expecting no real returns from cash over the next five years.

SA bond and property returns lower

After producing surprisingly strong returns in 2012, South African bonds and listed property are not likely to maintain this performance in 2013, we believe, largely since local interest rates are likely to remain on hold. We have lowered our five-year real return forecast for both by 50 basis points – for bonds to 1.5% p.a. and for listed property to 4.5% p.a. This does enhance our investment theme of a low-return world, and investors should temper their expectations for these asset classes in 2013.

SA equities preferred

The good news is that these conditions should be positive for equity returns, as investors continue to be forced to avoid negative real returns and chase the higher expected returns that equities offer. We expect the local equity market to grind higher in the absence of any exceptionally positive or negative global news. Our forecast is for a real return of 6.5% p.a. over the next five years in local equity. Although valuations are getting expensive, SA equities do offer the best absolute return prospects. Plus, positive economic surprises – such as faster-than-expected growth in China and the US – have the potential to lead to a broad investor rotation out of bonds and into equities, so it is important for investors to maintain their equity exposure.

We also believe that active equity managers should have an easier time in 2013 than last year. Both globally and locally, active managers struggled to outperform equity indices in 2012 due to the investor flight to safety – this created high correlations and momentum-driven markets as those shares that did well kept doing well, and those counters that did poorly continued to do poorly. Valuations played little role in share price moves, meaning active investors were unable to outperform the index.

The improved global outlook creates the potential for higher risk appetite among investors, so we expect some reversal of this trend. Stockpickers should be able to add more value under these conditions. Following from this, within international equity we are overweight in emerging markets (due to their higher growth prospects) and have a tactical overweight in Japan (to take advantage of the benefits of economic reflation in that country). Within South Africa equity we are underweight the expensive industrial shares and overweight selected resources and financial shares.

In summary, improving global macroeconomic conditions, ample liquidity and attractive relative valuations should be positive for equity investments in 2013. A lack of inflation-beating alternatives also favours equities, as does the potential for a broad rotation back into equities from bonds should any positive surprises materialise. These factors all suggest that investors should maintain their equity exposure this year, while continuing to diversify to both reduce risk and take advantage of select higher-yielding opportunities such as international property and emerging market debt.

So, despite the strong returns from most asset classes last year – except cash – we maintain that we are in a low-return world. Returns are likely to be lower across all asset classes in 2013, in the absence of further policy stimulation. Equities have more upside potential, but with company earnings growth likely to be lower than 2012, the chances of repeating last year's good equity returns are slim. So diversification and active asset allocation remain just as important this year.

Cutting our return expectations

(See chart previous page)

SA equity: We have left our return forecast unchanged at 6.5% p.a. Although valuations are expensive, equities still offer the best absolute returns versus other assets, plus the best upside potential given a possible broad rotation into equities globally should positive economic news emerge.

SA property: We have reduced our return forecast by 50 basis points following the SARB's interest rate cut last year. While yields remain attractive and the operating environment is relatively positive, the current high valuations in the sector versus historic levels following several years of strong performance mean risks are to the downside.

SA bonds: We have cut our return forecast by 50 basis points. The risk is to the downside in 2013 after such strong gains in 2012, but the market could remain well supported by foreign investors still looking for higher yields in emerging markets.

SA cash: We have reduced our return forecast by 50 basis points. We are expecting flat local interest rates in 2013, with risks to the downside should the central bank decide the economy needs a further boost.

The currency: The rand has reached fair value and the bulk of the real depreciation has already occurred. Over the longer-term we have a negative view due to the deteriorating terms of trade and negative productivity trends in South Africa. However, we are holding offshore assets for their diversification benefits rather than potential rand gains.

Offshore equity: Forecast returns are unchanged. We expect a similar return to SA equities, but international equities provide better risk-adjusted returns and diversification benefits; equities also have a 7.5% yield advantage over offshore bonds.

Offshore bonds: We have cut our expected returns by 50 basis points. We do not expect a sharp uptick in interest rates in 2103 due to continued central bank stimulus, but the longer-term risk of capital loss has risen. Avoid.

Offshore cash: With continuing expected negative real returns, cash remains unattractive as a longer-term investment option.

Market Commentary

The FTSE/JSE All Share Index (ALSI) had a very strong fourth quarter, gaining 10.3%, with returns of 26.7% for the 2012 calendar year. Listed property enjoyed another year of very strong returns, delivering 35.9% for the year. The All Bond Index and the Inflation-linked Bond Index gained 16% and 19.4%, respectively, for the year. Cash returned 5.5%. Globally, it was a good year for equities, with the MSCI ACWI up 16.8% measured in US dollars.

Emerging markets outperformed developed markets for the year, with strong relative performance in the last quarter. Commodity prices were generally higher for the year, with Brent Crude gaining 2.3%, copper up by 4.2% and gold 5.6% higher. The rand had a volatile year, losing 4.1% against the US dollar and 5.7% against the euro.

Old Mutual Flexible Fund

In line with the excellent returns from growth assets, the fund enjoyed an 18.2% return for the year. The fund benefited from exposure to both local and international property, an overweight position in emerging markets and the purchase of convertible bonds. However, with the benefit of hindsight, any cash holding was a mistake as that dragged on performance. During the year, the fund reduced exposure to certain shares which had run hard, which increased the cash allocation. Over the last decade, the fund has delivered an annual return of 16.4%, growing investor capital more than four-fold. We do not expect such good returns in the next decade, but the fund will strive to deliver decent real returns, enjoying the flexibility to invest across asset classes and markets.

Old Mutual Balanced Fund

The fund performed well in 2012 on an absolute return basis, relative to the other funds in its category and against its own performance objective of CPI + 6%. We have been overweight inflation-linked bonds for some time now and they performed exceptionally well last year. Despite this outperformance, we continue to hold these bonds as they offer inflation protection and we continue to see little scope for real returns from cash. The fund remains fully invested in offshore assets as we continue to find good value in international equities relative to other asset classes.

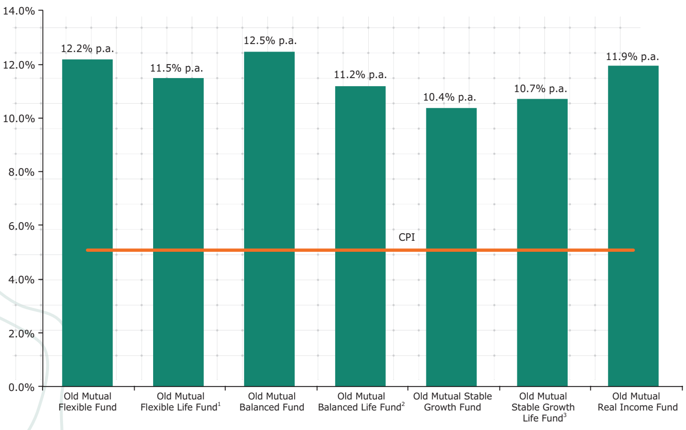
Old Mutual Stable Growth Fund

The fund finished 2012 with its annual performance well ahead of cash and inflation. The fund enjoyed exposure to the top-performing asset classes of the year, including SA listed property, domestic equity and inflation-linked bonds. Within equities, exposure to resource shares was a drag on performance, notwithstanding the selection of other excellent equity performers including Richemont, Old Mutual and Life Healthcare. During December, the fund bought holdings in ABSA and Lonmin, both of which we believe to be well-positioned for recovery in 2013. The fund increased its global exposure following a strong year in SA equities and property.

Old Mutual Real Income Fund

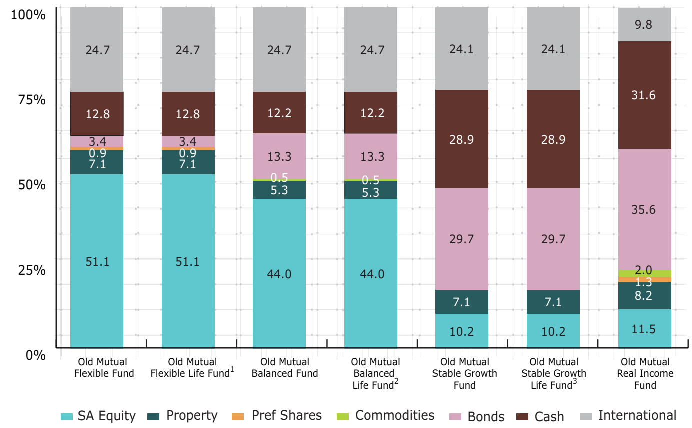
The good showing from bonds in December ensured that the fund ended the year strongly, delivering a return of 14.5% in 2012. This is an excellent real return and is particularly satisfying relative to cash. As would be expected, the fund's return lagged the equity market, but this is in line with its conservative mandate. The fund outperformed the Prudential Low Equity category average return, which is a surprise. Typically it would underperform when the share market runs strongly, as it has a lower equity holding. The fund holds just over 12% in listed shares, predominantly for their yield. Investments in listed property and active buying of bonds at the beginning of the year helped deliver the outperformance.

3-year performance to 31 December 2012



Sources: Morningstar and OMIGSA

Asset analysis as at 31 December 2012



Sources: Morningstar and OMIGSA

[1] Previously known as Optimised Aggressive Fund.
[2] Previously known as Optimised Balanced Fund.
[3] Previously known as Optimised Defensive Fund.

Performance to 31 December 2012	1 year	3 years (p.a.)	5 years (p.a.)	Description	TER
Old Mutual Flexible Fund	18.2%	12.2%	7.5%		1.33%
Old Mutual Flexible Life Fund	17.7%	11.5%	7.3%		
Target	13.7%	13.1%	14.4%	CPI+8% p.a. over rolling 3 years	
UT Peer Average	18.8%	12.6%	7.5%	Flexible Category	
Old Mutual Balanced Fund	18.1%	12.5%	7.6%		1.78%
Old Mutual Balanced Life Fund	16.8%	11.2%	7.0%		
Target	11.7%	11.1%	12.4%	CPI+6% p.a. over rolling 3 years	
UT Peer Average	15.6%	10.6%	7.4%	Prudential Variable Equity Category	
Old Mutual Stable Growth Fund	14.8%	10.4%	8.5%	Launched June 2007	1.86%
Old Mutual Stable Growth Life Fund	15.2%	10.7%	8.8%		
Target	9.7%	9.1%	10.4%	CPI+4% p.a. over rolling 3 years	
UT Peer Average	13.4%	9.7%	7.8%	Prudential Low Equity Category	
Old Mutual Real Income Fund	14.5%	11.9%	10.1%		1.37%
Target	8.7%	8.1%	9.4%	CPI+3% p.a. over rolling 3 years	
UT Peer Average	13.4%	9.7%	7.8%	Prudential Low Equity Category	
CPI	**5.7%**	**5.1%**	**6.4%**		

Sources: Morningstar and OMIGSA

For more information, visit www.macrosolutions.co.za

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