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ASSET MANAGEMENT

Client Letter 14 July 2011

Quarter End: 30th June 2011

Dear Investor

The surest way to turn a great company into a bad investment is to overpay for it. This is why we concentrate our efforts on trying to assess the intrinsic value of a company which could also be said to be the price a reasonable person would pay were they to buy the entire company. Our objective is to have our clients invest in companies whose shares trade at a discount to their intrinsic value, as this provides a margin of safety by ensuring that investments made are backed by inherent value.

We expect the intrinsic value of a company to increase over time and should the discount at which our clients invested narrow, or be eliminated, it is then that our clients enjoy additional market-risk free returns. This is also the point at which we sell our clients' investment positions and recycle the gains into another company whose shares are trading at a discount to that company's intrinsic value.

Intrinsic value is based on what the value of a business would be under normal conditions. Just as one would not be expected to pay more for an outdoor restaurant on a sunny day than on a rainy one, in summer than in winter, so too should the price of a business, for a long term investor / buyer, not materially change at different times through the economic cycle. But it often does. Investors are guided as much by the emotions of fear and greed, as they are by reason.

On stripping out seasonal, cyclical or other distortions we arrive at normalised values and are able to estimate a starting point of what a business is intrinsically worth. Industrial commodity markets are experiencing a once in a generation boom caused by China's growing demand for raw materials. Unsurprisingly, the earnings and profits of many commodity companies are at record levels. However, these prices too will normalise as the best remedy to high prices, is high prices.

The big five base metal mining companies have indicated that they will be investing over $70 billion of retained earnings, in 2011 alone, to increase production capacity. Although output volumes will increase, the additional supply will ensure that commodity prices normalise and margins will come under pressure as these companies compete away their super-profits. Consequently, unlike earlier in the cycle, when they really were cheap, our clients currently have very little exposure to base metal and commodity producing companies.

The exception being Sasol, to which our clients have significant exposure. The company has long-life assets, a low cost base and an attractive valuation of less than 10 times normalised earnings. Moreover, unlike most commodities, only around 10% of the world's oil is presently consumed by China. This may be contrasted with the 60% of all seaborne iron ore which is shipped to that country. The largest new car market in the world is China, with over 1 million cars being sold there every month. Given these scenarios, we believe that, on a normalised basis, the price effect of China's long-term oil demand is far more positive than are the supply/demand dynamics for the base metals markets.

Commodities aside, in these uncertain times, our clients' portfolios continue to be skewed towards businesses with strong free cash-flows and which have highly predictable, transparent and robust future earnings. Moreover, where we have managed to acquire these investments at a discount to their intrinsic value, the soundness of our clients' portfolios is further underpinned. An example of one such investment opportunity is detailed in our attached Market Report.

Yours sincerely

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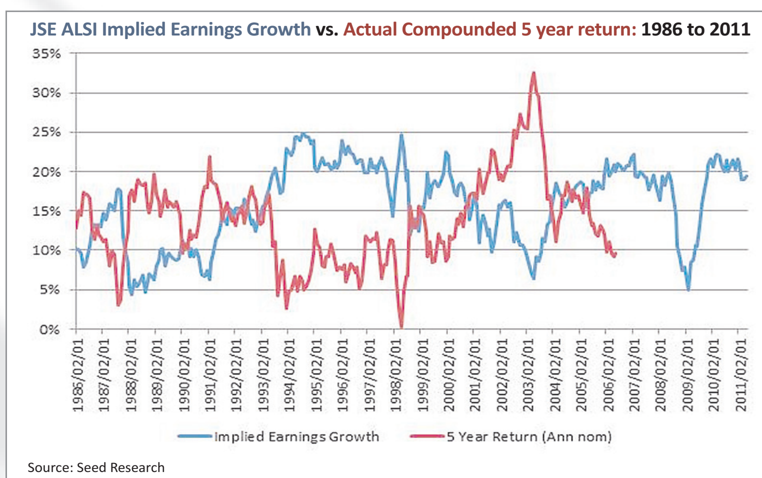
In our investment analysis, and client correspondence, we place little value on economic forecasting. We have low confidence in our, or anyone else's, ability to consistently or reliably predict economic outcomes. Forecasting suffers from at least two problems.

In the first instance, forecasting of uncertain events has a low degree of probability. And secondly, even if one were to correctly forecast certain factors such as the oil price for an oil company or the input cost of maize for a poultry producer, these have a surprisingly low correlation with investment performance.

In our fundamental company analysis we prefer to use normalised values for these variable inputs into our models that evaluate a company's potential investment performance. Be they the oil price, maize cost or margins and volume growth of a retailer etc.

Experience and results have confirmed that normalised input values, which are part of a big picture mean reversion thesis, are substantially more dependable for constructing valuation models than are 'expert' predictions.



Source: Seed Research

Indeed, so unpredictable is the current investment climate that analysts' future earnings predictions for US companies has never, in any reporting period on record, been less accurate than in the most recent reporting season. We do live in an interesting time.

Consensus forecasts are the bedrock on which most analysts build company valuations and offer investment recommendations. But when these have little accuracy, so too do all the models which are built on them.

Ironically, the more analysts forecast a view which differs from the normalised values, the more they can be relied on as contra-indicators. At times when analysts and investors become most optimistic / pessimistic about a company's future prospects, the greater their conviction to bake that into today's share price. And the greater the mean reverting correction required if they are wrong. High expectations lead to lower returns and vice-versa.

This somewhat heretical view is confirmed when we test implied earnings growth with actual compounded returns over a rolling 5 year period. Implied earnings can be calculated for the Johannesburg All Securities Exchange (JSE) All Share Index (ALSI) as a whole, or for individual company shares. They are based on the market (share) price, price earnings ratio and the risk-free government bond yield. The higher the implied earnings growth, the higher the expected investment reward, and vice versa.

As is self-evident there is an inverse correlation between the predicted / implied earnings growth and actual compounded five year returns subsequently achieved by investors. Not unexpectedly, expectations of future earnings growth collapsed, along with the markets, in late 2008. Plainly investor optimism swept back into the markets as prices recovered in 2009 and now these are once more being moderated.

Rather than experience the volatility most investors experience when using analyst forecast and their self-reinforcing exaggeration of expectations, we prefer the self-correcting and self-moderating mean reverting normalisation approach. It leads to a better night's sleep.

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Over the past quarter we have begun to build a position in our clients' portfolios in MMI Holdings. MMI was created when FirstRand unbundled and merged its entire stake in Metropolitan Insurance with Momentum Insurance, to form MMI. The merged entity was listed on the Johannesburg Securities Exchange (JSE) in December of 2010 and is the third largest of the six life insurers listed on the JSE.

Rand Merchant Bank's (RMB) subsidiary, Rand Merchant Insurance (RMI) is MMI's largest single shareholder holding ~25% of the company. As the prime motivation for the unbundling and merger was improved efficiencies, we expect meaningful savings to result from the company's number one priority: cost management.

These will be achieved over time, not least on account of the SA Competitions Tribunal making a precondition for approval of the merger that no staff be laid off for the first two years after the deal.

To be frank, MMI is not a company which is going to shoot the investment lights out. However, it is an attractive investment opportunity and, by our analysis, will produce solid returns over the medium term.

One of our preferred investment strategies is where we can foresee inherent value being unlocked from an investment through corporate restructuring. Typically, such opportunities provide a superior margin of safety against downside risk and produce greater-than-market upside gain.

From our analysis, MMI presents just such an opportunity. The investment case is further enhanced by MMI's already generous dividend yield of 5.97% By our forecast, this is set to increase by 2013 to 9.5% of our target price for purchasing the shares on behalf of our clients. Not only is the present dividend yield double that of the overall market, but MMI's medium term dividend growth rate is also significantly greater than that projected for the market as a whole over the same period.

Crucially, as an insurance company, MMI's balance sheet reflects a capital adequacy ratio (CAR) 2.5 times covered and economic capital currently at 1.7 times the statutorily required CAR. Consequently, the merged company is sitting on surplus capital of around R4bn which could be returned to shareholders by way of dividends.

In terms of price paid versus value acquired, at our target price, our clients are paying a fair 15% discount to MMI's prevailing R30 billion embedded value.

So why is this seemingly low-hanging fruit neglected by the market? As with any merger, there are forecast risks to the synergies and savings that can, and will, be achieved. Some investors may prefer to stand back until these are realised, but by which time the share price would already be reflecting the company's improved profitability.

Secondly, companies of this nature are complex and fiendishly difficult to analyse, possibly encouraging investors to look elsewhere.

Thirdly, MMI operates in a very competitive environment in South Africa and industry margins are tight. This is somewhat offset by the increased domestic market share which the merged company is already carving out for itself, and is further offset in its more lucrative operations that present themselves in the less competitive markets of the 12 other African countries in which MMI is established.

Finally, it is a rather 'boring' investment opportunity and, as it will take some years to fully play out, MMI does little to excite the more short-term orientated investment herd.

All of which suits us perfectly. We are very comfortable with the fundamentals and the intrinsic value of MMI and, as our clients well know, it is always our preference to invest away from the 'herd'.

Unfortunately, the share price has recently increased and moved away from our initial target buying range. Notwithstanding, we will acquire further shares in this company, on behalf of our clients, should they fall back to, and hopefully below, our preferred entry price level.