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ASSET MANAGEMENT

**Client Letter** 18 October 2002

**Quarter End: 30th September 2002** 

Dear Investor

For the past few years we have been warning of the overvaluation of US (in particular) and global stockmarkets. While they have fallen substantially, these markets are now at best slightly overpriced and are certainly still not cheap. Just as markets overshot on the upside, so too can they overcorrect on the downside. We are very aware that we may sound like a songbird that knows only one song, which is why our analysis has been ever more rigorous before reiterating this view. Market volatility will be with us for some time yet.

In the past quarter the JSE fell by over 11% while our clients' portfolios ended the period largely unchanged. Over the past six months the JSE has fallen near 14% and our clients' portfolios have increased in value. Over the past year the JSE has delivered a return of 16% and our clients' portfolios have returned more than double that.

Just as global market valuations are unappetizing, many South African companies are attractively priced. Over the past few years the JSE has been weighed down by negative sentiment which led to local shares trading at a fraction of the ratings of our international peers. The bubble that was allowed to develop in the US, and some other stockmarkets, is now being deflated and is bringing associated pain to bear in those markets.

Our investment strategy has allowed us to weather the turbulence of current market conditions and to return superior capital gains to our clients. Although market conditions are expected to remain challenging, we continue to find intriguing investment opportunities that we believe will offer attractive long-term returns.

Yours sincerely

Alexander Otten

**Alexander Otten**

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5 Year chart of UK, US, German and Japanese market's returns


So far this year, the US stockmarket has surrendered 32% for the S&P index and 43% for the Nasdaq, while in Europe it has been no better. The UK market has lost 28%, the French 40% and the German market's whopping 52% fall this year is its biggest in forty years. The Japanese market retreated to levels last seen in August of 1983; nineteen year lows.

The uncertainty generated from corporate scandals seems to have been overtaken by the uncertainty over the anemic global economic recovery and the specter of war in Iraq.

While these markets are technically oversold, they are still not cheap. International investors still expect a major recovery in earnings next year. A slow global economy will not help realizing these.

As a sign of the times the German Stock Exchange will, at the end of 2003, shut its equivalent of the US Nasdaq. The German Neuer Markt stockmarket has now fallen over 95% from its peak.

US Investors withdrew $45bn from mutual funds in the past quarter. Once again, the sad truth on display is the private investor's habit of buying high and selling low. Internationally, heavy redemptions have continued after the quarter-end putting further pressure on financial markets.

US stock option accounting and pension funds are areas of concern. Applying accepted accounting practices to US stock options would reduce reported earnings in the US by around ten percent, further undermining equity valuations. Many global companies have huge holes in their pension schemes. The declines in the markets accentuate these. Many companies suspended pension contributions when they thought schemes were in surplus, and will now have to divert substantial earnings (from shareholders) to make up the shortfalls in their schemes. Pension liabilities will be the asbestos of the next decade.

In the heady 1990's companies were under constant pressure to improve their return on equity. More than a few companies took to devious accounting. More widespread was the use of debt to buy back shares in the stockmarket. This created a (false) demand for the companies' shares, enhanced the returns on the outstanding shares and increased the riskiness of the company.

Now that US share prices have fallen by 40%, this form of financial engineering appears less than brilliant. The debt doesn't go away and now threatens the future of many companies as the ratio of debt to equity has rocketed as share prices fell. The lowest interest rates in forty years are not enough to bail them out, as margins and earnings have collapsed and their ability to service the debt remains stretched.

A year ago we anticipated that companies would choose to restore the integrity of their balance sheets; now they have no choice. The emphasis is no longer on ever increasing returns but rather on survival and the paring down of the debt which ballooned in the past decade.

And the US is not alone. In Europe the largest 150 companies have, in the last three years, increased debt levels by 118%. As company risk increases it undermines banks which have lent money and which may have to take large hits on loan defaults.

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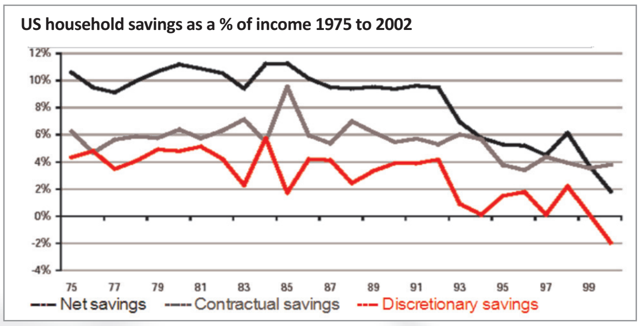



The economy is supported by the US consumer, who in turn is dependent on a massive increase in debt (mortgage refinancing). This will be a longer term problem. With low inflation these debts will not be monetized and will be around for a long time to come.

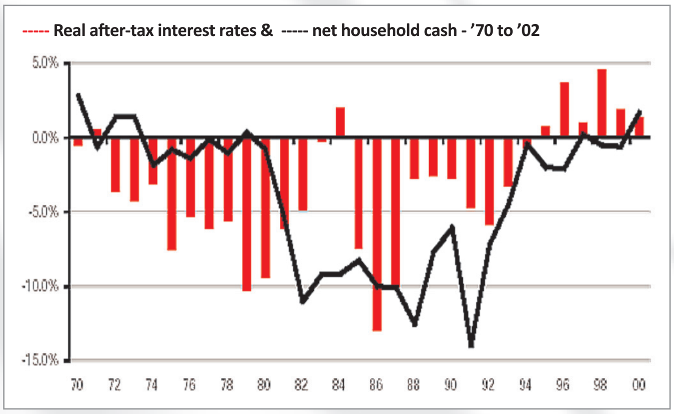
Low interest rates and six years of no real return from equities mean that saving levels need to rise. This could lead to a postponement of consumption by US households and will affect corporate profits as margins are cut as companies compete for revenue. Deflation seems now not so impossible a prospect.

It is not all doom and gloom. The South African economy continues to perform well with second quarter GDP growth reported at 3.1%. Many South African industrial companies have reported excellent results.

The fall in the Rand late last year has put considerable pressure on inflation and we continue to see it feeding into the economy.

In November, we expect SARB to increase interest rates to 14.5%. This will still not enable the Reserve Bank to meet its 3%-6% inflation target next year. The imminent hike has been well telegraphed to the markets and should bring little reaction.

Real household consumption expenditure will continue rising. Consumer resilience may have its roots back in 1998, when a sharp rise in local interest rates caught households off-guard. The reduction in household debt levels relative to disposable income improves their repayment capacity, and has probably made them less sensitive to the recent series of interest rate hikes than was the case in 1998. Tax reductions and a lower debt ratio put households in a better position to sustain the steady expenditure growth during the rest of 2002 and to respond to improving economic conditions during 2003.




In the prevailing volatile market conditions we apply disciplined active management to our clients' portfolios in order to protect capital from loss and to exploit opportunity for gain. Now, more than ever, returns are dependant on asset managers' ability in skillful share selection.

The most significant contributor to our portfolios' recent performance, in the face of a weak stockmarket, has been the strong results reported by a number of companies whose shares we hold. We believe that this trend will continue in the months ahead and that, given the low rating placed on many of these shares, this bodes well for expected returns.