GRAYISSUE
LONG TERM COMMENTARY

5 November 2003
Issue no. 27

The Equity Fund turns 5!

Allan Gray's first unit trust, the Allan Gray Equity Fund celebrated its fifth birthday on 1 October this year. The Fund, with assets under management of R3.456 billion (at 30 September 2003) is a hair's breath away from becoming the largest fund in the general equity sector.

The aim of the fund is to earn a higher total rate of return than that of the average of the South African equity market as represented by the FTSE/JSE All Share index, including income, without assuming greater risk. It has achieved this objective, and more. An investment in the Fund at the outset would have achieved a total return of 441% over the 5 years, roughly four times better than the FTSE/JSE All Share Index. The Fund has consistently been in the top quartile of the domestic general equity unit trust category, with an 84.61% return over three years and 18.45% over one year.

Allan Gray adopts a 'value' approach to investing, which means that it invests in assets that it believes offer superior fundamental value. Investing based on this 'value' approach not only offers above average returns over the long-term, but also less risk of loss. In addition, it takes a long-term approach towards investing, which means that it is willing to buy shares with a three- to five-year holding period in mind.

In line with this long-term investment approach, the Equity Fund is positioned as a long-term investment vehicle. Allan Gray targets investors seeking long-term wealth creation, and investors with an investment horizon of less than three to five years are unlikely to get the true benefit of the long-term philosophy. As returns generated by the stockmarket tend to be very volatile over short periods of time, clients' returns have also been volatile in the short-term. There is a difference in returns of 153.8% between Allan Gray's best and worst 12 months.

Unlike the majority of its peers, Allan Gray has only one equity fund. To begin with, Allan Gray believes in providing a simple product range that is easy for its clients to understand. The proliferation of investment products, particularly unit trusts, in recent years has confused most investors and resulted in unfortunate investment behaviour such as frequent switching into the latest trend fund, and thereby destroying value. By offering investors a range of different equity funds to choose from, asset managers are effectively asking their clients to make their own investment decisions. Most consumers are simply not equipped to choose between, for example, sector-specific funds and funds that purport to focus on 'growth' or 'value' shares. Nor should they have to. (An example follows in the next paragraph.) Allan Gray believes that it is their job to make the investment decisions, not that of their clients.

Example: During the 20-year period of 1982-2002, the annual rate of return of the average US equity fund was 10%, compared to 13.1% for the S&P 500 Index, a shortfall of 3.1 percentage points, largely accounted for by the high levels of fund operating and transaction costs. Thus, the average actively managed fund delivered just 76% of the market's annual return. What's more, according to recent estimates, the average fund investor earned just 2% per year over the same period. Shareholders pay heavy *timing* penalties, investing too little of their savings in equity funds when shares represent good value and vice-versa. There is also a *selection* penalty: most investors were pouring money into the 'new economy' shares and withdrawing from the 'old' during the bubble, proving to be at precisely the wrong moment.

Allan Gray believes that the best investment decisions are made by individuals, specialising in a specific asset class, and not by committees or teams. Therefore, the assets under management are notionally pooled and then managed by dedicated equity, fixed interest and property portfolio managers supported by a team of specialist analysts. Clients' portfolios therefore reflect the best investment ideas of a select group of portfolio managers and not a house view or those of any particular individual. While individualism is encouraged, it is acknowledged that this has to take place within a system of checks and balances and full accountability.

Commentary by Johan de Lange, Director Allan Gray Unit Trust Management Limited