ALLAN GRAY

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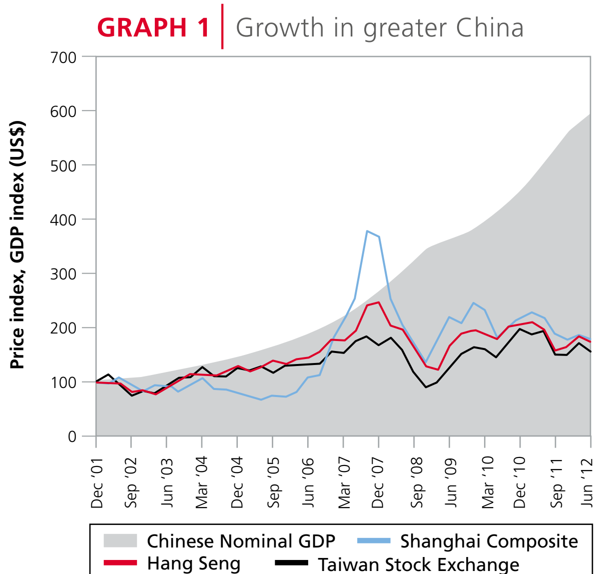
Rob Dower

Comments from the Chief Operating Officer

We have made the point many times in this magazine and on other platforms that the best investment opportunities are often not to be found in industries or countries that are growing fast or that are performing most strongly. For example, patient investors in the Shanghai Composite Index would have seen about a 5% p.a. nominal increase in the index over the last decade. Those investing at the peak in 2007 would have lost more than half of their money in the five years since then. Of course, an investor seeking index exposure to greater China could have taken positions in the Taiwan and Hong Kong indices, each at close to the same scale as the Shanghai exchange and similarly exposed to China's economic opportunities. But these have been no better, each going up between 4% and 5% p.a. in nominal terms since the beginning of 2002 (see **Graph 1**).

There are two reasons why the total return from listed shares may not match an increase in economic activity. Firstly, opportunity attracts competition and therefore each company makes less profit than would be expected, despite industry growth across all firms. Secondly, investors become over-excited about the future profits of companies in high growth industries or countries and pay more for these shares up front. If reality does not live up to these expectations prices fall, sometimes to reflect an overdose of pessimism about the same companies.

GRAPH 1 | Growth in greater China



Source: World Bank, Datastream, I-Net Bridge

In the previous Quarterly Commentary Ian Liddle wrote about the prospects for the South African economy and in this issue Sandy McGregor explains how the world's obsession with Europe and America is distracting attention from what may prove to be the most important current investment issue: the slowdown in growth in the emerging markets. Both of these may be classed as economic commentary. Why do these things matter if market returns are so poorly correlated with economic performance?

The answer is obvious, but it bears articulating: in any market, diligent analysis of individual shares reveals some opportunities to invest and some pitfalls to avoid. We make investment decisions about individual companies and not markets, but these companies benefit or suffer under different economic conditions. Stock analysis has to include an understanding of the drivers of each company's performance – a simple example would be that the demand for steel in emerging markets has an impact on the prices of coal and iron ore sold by JSE-listed resources companies.

Responsible investing

Since this firm's inception in 1974 we have steadfastly adhered to the same investment philosophy and guiding principles. While longstanding clients will have hopefully seen us putting these principles into practice over the years, in support of an industry-wide initiative, the introduction of the Code for Responsible Investing in South Africa ('CRISA'), we have now made public our responsible investing policies. I encourage you to read our *Policy on Ownership Responsibilities*, introduced by Ian Liddle and Mahesh Cooper in the first of our articles this quarter. This and our other responsible investing documents are available on www.allangray.co.za, along with a record of our voting recommendations for shareholder meetings.

I hope you enjoy this quarter's pieces. Thank you for your continued support.

Kind regards

Rob Dower

Ian Liddle

Mahesh Cooper

Responsible investing

EXECUTIVE SUMMARY: The Code for Responsible Investing in South Africa ('CRISA') was introduced in 2011 as an industry-wide initiative. Allan Gray supports CRISA's principles and, in line with its recommendations, we have documented our responsible investing policies. Hopefully, longstanding clients will have observed us putting these principles into practice over the years. The process of documenting these policies has served as a useful reminder to us of the ideals we strive towards. You can access these policies by clicking the 'Responsible Investing' button on our home page www.allangray.co.za. Here you will also find a record of our voting recommendations for shareholder meetings, which is a further initiative to improve transparency.

While these policies provide guidance for a wide array of possible scenarios, we will continue to subject all our actions to the critical question: 'what is in our clients' best interests?'

In the Quarterly Commentary we often write about our investment philosophy and how we consider the valuations of companies that we buy or hold on behalf of our clients. But accepting responsibility for managing our clients' investment portfolios entails more than seeking out undervalued shares. A vital element of our service to clients includes assisting you in exercising your ownership rights and responsibilities. Indeed, we believe that assisting our clients to exercise their shareholder rights in a judicious manner can enhance long-term investment returns. We hope that our *Policy on Ownership Responsibilities* is sufficiently clear and comprehensive to accurately reflect the principles we apply daily in managing your portfolios; the full text of this policy follows below.

"We believe that we can assist investors to diligently exercise their ownership responsibilities."

Allan Gray Group Policy on Ownership Responsibilities

Allan Gray manages investment portfolios for its clients. The full economic benefit of the assets in all of these portfolios belongs to our clients, not to us. Our clients pay us a fee for our services. In the terminology of CRISA, Allan Gray is a service provider.

We believe that we can assist investors to diligently exercise their ownership responsibilities. This assistance is an important component of the overall service we provide to our clients. This assistance is not motivated by a 'tick-box' mentality. We believe that by providing this service, we can enhance our clients' long-term investment returns.

The two primary ways in which we seek to assist our clients in exercising their ownership responsibilities are:

- engaging, on their behalf, with company directors; and
- recommending how they should vote their shares at shareholder meetings.

Engagement

Our aim in engaging with a company's directors is to further the best interests of our clients holding shares in the company by encouraging the directors to act in a way which enhances or preserves shareholder value. We aim at all times to engage constructively with company directors, as we believe that constructive engagement is more likely to succeed than hostile engagement.

Company executives regularly ask to meet with us. These meetings typically follow the announcement of the company's financial results. We use these meetings primarily to improve our understanding of the business of the company. We believe that the responsibility for the day-to-day operations of the company rests with the executives, and that we probably have limited value to add in this regard. From time to time, we may believe that we can contribute to

a company's deliberations over its broad strategy, particularly with regard to capital allocation. When offering our views, we try to do so with humility.

The chairman or non-executive directors of a company may request meetings with us from time to time. These meetings are usually arranged by the non-executive directors to elicit feedback from shareholders on matters such as the company's broad strategy, remuneration policy, the performance of executives, or any other matters. When offered these opportunities, we aim to speak candidly and make our views clear.

Unless it would be contrary to the best interests of our clients to do so, we aim to inform a company's representatives prior to a shareholders' meeting if our clients, in aggregate, hold a material shareholding in the company and we intend recommending votes against any of the resolutions. Often this creates an opportunity to explain to the company's directors why we believe a certain resolution is not in the shareholders' best interests.

Our portfolio managers are responsible for identifying strategic, sustainability or governance concerns with companies held in the portfolios under their management. This is consistent with our objective to hold our portfolio managers individually accountable for the performance of the portfolios under their management. Portfolio managers will rely on many sources, including the press, to identify such concerns. When evaluating such concerns, we will take into account the King Code and other widely accepted guidelines considered relevant by the portfolio manager at the time and both current and proposed law and regulations. Guidelines, which allow for deviations if explained, will not override our own common sense and judgement as to what is in our clients' best interests in any given circumstances.

"We aim at all times to engage constructively with company directors, as we believe that constructive engagement is more likely to succeed than hostile engagement."

If we identify such concerns, and we do not expect to have an opportunity to communicate these concerns to the company within a reasonable period, we may contact either the company's executive or non-executive directors in order to communicate our concerns. We may communicate verbally and/or in writing, if we wish for our concerns to be placed on the record.

On rare occasions, our efforts at constructive engagement and persuasion may fail. If our efforts at constructive engagement fail, and we continue to harbour material concerns about the strategy, sustainability or governance of a company, we may begin to engage with the company's directors in a more forceful manner, including to:

- recommend that our clients vote against certain resolutions at shareholder meetings (including the election of directors); and/or
- attend a shareholder meeting on our clients' behalf and voice our concerns; and/or
- request the company's directors to add a new independent director to the board (this new director may or may not be nominated by us); and/or
- call for a general meeting of the shareholders of the company in terms of section 61 of the Companies Act of 2008 (provided that we are able to do so); and/or
- report our concerns to the relevant authorities, if appropriate; and/or
- institute legal action to enforce shareholder rights.

Before deciding to embark on any one or more of the more forceful actions listed above, we consider whether:

- our clients have a reasonable prospect for success;
- the proposed action may impede our ability to further effectively manage our clients' investment in the company concerned;
- there are potential conflicts of interest between any of our clients or between our clients and Allan Gray in the matter;
- the time and effort required to pursue the forceful action is commensurate with the potential benefit for our clients if we succeed; and
- the nature of the planned action is appropriate in the circumstances.

We will not act in a forceful manner merely to assert ourselves or to generate publicity. If our concerns regarding a company's strategy, sustainability or governance cause us to lower our estimate of the company's intrinsic value, we may sell the company's shares.

From time to time, companies may request to share information, which they regard as material and price sensitive,

because it is not yet in the public domain. Provided that this information will either be made public or lose its relevance within a period of a few weeks, we believe that it may be in our clients' best interests, depending on the specific circumstances at the time, to agree to become party to this information. If we do so, we follow the procedures outlined in our *Inside Information Policy* (which cover applicable legal requirements), including placing an immediate ban on trading in the relevant share(s) and ensuring immediate isolation of the information. In deciding on whether to become party to this information, we weigh up the benefit of engaging with the company and potentially influencing a significant event in the life of the company, against the opportunity cost of not being able to trade in the share for the duration of the trade ban.

Our policy with regard to material, price-sensitive information is different to practice recommendation 7 of CRISA, which recommends that service providers implement controls to prevent the receipt of such information under all circumstances. In certain circumstances, becoming party to material, price-sensitive information in a strictly controlled manner and for a limited period, affords us the opportunity to engage with company directors and influence their thinking on potential events of significant importance for the company for the benefit of our clients. Indeed, companies are sometimes unwilling to publicly announce potential transactions without first hearing the opinions of representatives of their major shareholders. Thus, we believe that it is in our clients' best interests to deviate from practice recommendation 7 of CRISA.

"We recommend votes that we believe to be in the best interests of our clients holding the share, regardless of whether our view falls into the majority or minority."

We expect all company executives and representatives to be aware that we never wish to be made party to material, price-sensitive information without them first formally inviting us to become party to such information and offering us the opportunity to either accept or decline their invitation. On rare occasions, a company representative may inadvertently say something to us, which could be regarded as material, price-sensitive information. In such circumstances, there is clearly nothing we can do to prevent the receipt of such information once it has already been received, and we will follow the procedures outlined in our *Inside Information Policy*.

Voting at shareholder meetings

We recommend to clients how we believe they should vote their shares at shareholder meetings of all companies in which either:

- the value of our clients' aggregated holding exceeds 1% of the total value of South African equities under our management at the time; or
- our clients' aggregated holding exceeds 4% of that company's shares in issue at the time.

We may make recommendations for shareholder meetings of companies which fall below these thresholds if we believe that special circumstances warrant such action.

The analyst in our investment team who is responsible for researching the company considers the proposed resolutions, and recommends votes to the portfolio manager primarily responsible for the share. This portfolio manager is responsible for reviewing the proposed resolutions and writing letters to our clients containing our voting recommendations. If the company concerned accounts for more than 2.5% of the total value of South African equities under our management at the time, then a second portfolio manager is required to review and approve the voting recommendation.

We believe that it is preferable to impose this responsibility on the relevant portfolio manager, as opposed to delegating it to a compliance department, as the portfolio manager will have a thorough knowledge of the company concerned, and the portfolio manager is aligned with our clients in seeking the maximum long-term value from our clients' investments. Furthermore, we believe that this reinforces the individual accountability of our portfolio managers for the performance of the funds under their management.

We recognise that just as there is scope for differences of opinion over a company's intrinsic value, there is scope for differences of opinion over whether a resolution proposed to shareholders is in their best interests. Of course, that is why companies seek a vote from all shareholders, but only require the approval of a majority (or 75% in some cases) of shareholders for a resolution to be passed. We recognise that from time to time we may hold a minority view. While

we may try to persuade the company's directors of our view, we expect them to act in accordance with the wishes of the majority of the company's shareholders.

Nevertheless, we believe that it is important for minority views to be expressed at shareholder meetings. We do not reserve our recommendations to vote against resolutions only for occasions when we sense a groundswell of shareholder opinion that conforms with our view. We recommend votes that we believe to be in the best interests of our clients holding the share, regardless of whether our view falls into the majority or minority.

Sometimes we may be called upon to make a judgement on the appropriate voting recommendation based on our subjective assessment of the balance of probabilities at the time. We recognise that we may make errors of judgement from time to time, but we will always make voting recommendations which we believe at the time to be in the best interests of our clients holding the share.

From time to time, companies may, prior to a shareholder meeting, request us to undertake that we will recommend to our clients that they vote their shares in a certain manner. We will only do so if we believe the relevant resolutions to be in the best interests of our clients holding the shares, and if by doing so, we materially increase the probability of the relevant resolution being proposed and supported. Of course, we cannot bind our clients to vote in a certain way, and in this case as in all others our clients are free to disagree with our voting recommendations and vote in the manner they see fit.

The portfolios under our management can be classified as:

- Segregated Portfolios
- Unit Trust Portfolios (managed by Allan Gray Unit Trust Management)
- Pooled Portfolios (administered by Allan Gray Life)

The ultimate ownership responsibility for the shares held in the Segregated Portfolios and Unit Trust Portfolios rests with our clients' appointed trustees. For the Segregated Portfolios, this is the trustees of the relevant client (typically a large pension fund). For the Unit Trust Portfolios, this is the trustee of the unit trust scheme appointed in terms of section 68 of the Collective Investment Schemes Control Act of 2002 and approved by the Registrar of Collective Investment Schemes (presently FirstRand Bank Limited Trustees). In exercising their ownership responsibilities our clients' appointed trustees will consider our voting recommendations, but they hold and control the voting rights at all times. From time to time, our clients' appointed trustees disagree with our voting recommendations, in which case the relevant trustees instruct us or their custodians as to how they wish their shares to be voted.

Although the full economic benefit of the Pooled Portfolios belongs to the clients (policyholders) of Allan Gray Life, the assets in these Pooled Portfolios are included together with a matching policyholder liability on Allan Gray Life's balance sheet. The directors of Allan Gray Life thus assume an ownership responsibility and control the voting rights in respect of the shares held in these Pooled Portfolios. Allan Gray thus fulfils the role of both a service provider and an institutional investor (as defined by CRISA) in respect of the Pooled Portfolios.

"We disclose our voting recommendations, together with the outcome of the shareholders' vote on each relevant resolution, on the Allan Gray website."

We disclose our voting recommendations, together with the outcome of the shareholders' vote on each relevant resolution, on the Allan Gray website.

Companies' annual general meetings (AGMs) typically require shareholders to vote on three matters of substance in addition to the usual 'house-keeping' resolutions. These matters are:

- Appointment or re-election of directors;
- Remuneration policy;
- Permission for the issue or repurchase of the company's shares.

We consider these matters on a company by company basis taking into account the special circumstances which may be affecting a company at the time. In forming our view on the appropriate voting recommendation, we typically consider the following factors:

1. Appointment or re-election of directors

If we have concerns that the election of an individual director may not be in the best interests of all shareholders, we may recommend abstaining from voting on that director's election or voting against the election of that director. We are not privy to what happens in company boardrooms, which

makes it very difficult for us to determine whether an individual director is making a positive, negligible or negative contribution. Thus, we do not require conclusive evidence to recommend voting against a director. If we believe on a balance of probabilities that shareholders could be better served by another director, then we may recommend voting against the re-election of the incumbent director. In forming these assessments we may consider the director's performance on other companies' boards and the overall performance and composition of the board of the company in question. If the overall performance of a company's board is disappointing, or we believe that there are too many directors on a company's board, we may recommend voting against one or a number of directors.

2. Remuneration policy

Companies are now putting forward non-binding resolutions on their remuneration policy at their AGMs. We view this as a positive development. While the shareholders' vote on remuneration policy is not binding on the company, it does present opportunities for engagement with the company's remuneration committee.

Remuneration practices and policies are evolving. Many of today's remuneration schemes are vast improvements on the simple share option schemes which were common a decade ago. We expect that they will continue to evolve and improve as companies compete for the best executives, and as the matter receives more attention from shareholders.

"We believe that we can play a constructive role in the continued improvement of companies' remuneration policies by recommending voting against remuneration policies which have fallen materially behind current best practice."

We believe that we can play a constructive role in the continued improvement of companies' remuneration policies by recommending voting against remuneration policies which have fallen materially behind current best practice. A vote against a company's remuneration policy normally leads to discussions with the company's remuneration committee as to how we believe the current policy could be improved. By recommending a vote against a company's remuneration policy we are not necessarily suggesting that we lack confidence in the company's executive directors.

We believe that a company's remuneration policy should aim to attract and retain competent executives, reward these executives fairly in a way that is consistent with their performance, and align the incentives for these executives with the best interests of shareholders. This is easy to say, but can be difficult to implement in practice. The perfect remuneration policy probably does not exist. We remain mindful of this when considering our voting recommendations on remuneration policies. We also remain mindful that the value which key executives can add (or subtract) for a company can dwarf their remuneration, and that companies compete to employ competent executives.

The key criteria we consider when evaluating a company's remuneration policy include scale, linkage, median-performance reward and alignment. We may recommend voting in favour of a company's remuneration policy if it is sufficiently close to current best practice, even if it does not conform in every respect with our views on the criteria below.

2.1 Scale

The base pay for an executive should not materially exceed the median base pay for comparable roles in comparable companies. The potential performance-based pay for an executive should not materially exceed that offered to executives in comparable roles in comparable companies. Potential performance-based pay should be capped unless the executive is willing to bear unlimited downside risk to match unlimited upside potential. We remain mindful of the risk of executive pay spiralling upwards as listed companies continuously upgrade pay packages to match those of their peers.

2.2 Linkage

There should be a clear link between performance-based pay and the actual performance of the executive. The measurement of the executive's performance may include a range of factors, but the most significant should be long-term total shareholder return. The performance metrics should be compared against appropriate benchmarks, so that as far as possible, the executive is rewarded for performance in areas which are under the executive's control. Performance-based pay should, as far as possible, not be affected by exogenous factors outside the executive's control. Exogenous factors should be provided for by, for example, comparing the total shareholder return of the company to that of other comparable companies, which are affected by similar exogenous factors. An executive should not receive performance-based pay purely on the basis of a cyclical

upswing in an industry. Similarly, an executive who performs much better than his peers in a struggling industry should be rewarded for his performance.

We recognise that there will probably always be some element of chance in share-based or performance-based remuneration. Companies should attempt to control this element of chance as far as is reasonably possible in an elegant manner.

2.3 Median-performance reward

Median or average performance should earn minimal performance-based pay. Base pay should not be disguised as performance-based pay. It should not be possible for all executives in an industry to be simultaneously receiving performance-based pay. If they are all being rewarded for performance above the mean, whose performance was below average?

2.4 Alignment

Performance-based pay should be weighted towards long-term (3 – 5 years) performance and rewards. Executives benefitting from share-based performance rewards should be required to build a minimum shareholding in the company over a defined period.

3. Permission for the issue or repurchase of the company's shares

The value of the shares held by our clients derives from their scarcity. We typically recommend voting against resolutions which grant the company's directors general authority to issue new shares (even if only in limited quantities), because such a general authority diminishes the scarcity value of the shares held by our clients. Even if the resolution is restricted to the issuance of new shares required for employee incentive schemes, we prefer to recommend voting against such resolutions. Unless there are regulatory or tax considerations which complicate matters, we prefer companies to repurchase the shares which are required to fulfil their obligations under employee incentive schemes. This generally makes the cost of such schemes more explicit.

If the directors wish to issue new shares for the purpose of an acquisition or some other form of corporate transaction, we prefer to consider their proposal on its merits and, if we agree, to recommend to our clients voting for a resolution which grants them a specific authority to issue the shares required just prior to the finalisation of the transaction. We believe that this approach reduces the risk of the value of our clients' shares being diluted by an ill-advised issue of new shares by the company's directors.

Provided that our estimate of a company's intrinsic value is accurate, then our clients' portfolios should be invested predominantly in shares which are trading at a discount to their intrinsic value. By repurchasing its own shares at a discount to their intrinsic value, a company increases the intrinsic value of each remaining share. We believe that this is in our clients' best interests. Thus, we typically recommend supporting a resolution which grants a company a general authority to repurchase its own shares. In unusual circumstances where a share in our clients' portfolios is trading at a premium to our estimate of its intrinsic value, we believe that it is still in our clients' best interest to recommend supporting such a resolution, as the company's buying will increase market demand for the share, and improve the probability of us being able to exit our clients' holding at a premium to its intrinsic value.

Glossary

Allan Gray / Allan Gray Group: Allan Gray Group Proprietary Limited and its subsidiaries, which includes Allan Gray Proprietary Limited

Allan Gray Unit Trust Management: Allan Gray Unit Trust Management (RF) Proprietary Limited, a wholly-owned subsidiary of Allan Gray Proprietary Limited

Allan Gray Life: Allan Gray Life Limited, a wholly-owned subsidiary of Allan Gray Proprietary Limited

CRISA: Code for Responsible Investing in South Africa

Ian is our chief investment officer, with overall responsibility for the investment team and portfolio management. He joined Allan Gray in 2001 after several years as a management consultant.

Mahesh is a director of Allan Gray and heads up the Institutional Client Servicing team. He joined Allan Gray in 2003, having had previous experience in investment and healthcare consulting.

Sandy McGregor

The slowdown in emerging markets

EXECUTIVE SUMMARY: Since the northern hemisphere Spring earlier this year global business and economic conditions have been weak. The US recovery has failed to gain traction and the euro crisis is pushing Europe into recession. The disintegration of the euro system has become the source of macabre fascination for journalists and market participants. It is like watching a shipwreck in slow motion. Sandy McGregor explains how this obsession with Europe and America is distracting attention from what could prove to be the most important current investment issue: the slowdown in growth in the emerging markets. Emerging markets account for half the world economy and for the majority of the year-by-year increment in the global output of goods and services. Problems in emerging markets can have a profound effect on business conditions everywhere.

Emerging market booms and busts

Market crises in developing countries are a recurrent theme in economic history. In the 19th century when the United States was an emerging market, its cycle of boom and bust had on occasion dramatic effects in Europe. A long series of financial disasters included state governments defaulting in the 1840s and major railway bankruptcies between 1873 and 1893. Argentina's crisis in 1891 left Baring Brothers, the second largest investment house in London, effectively bankrupt. It had to be bailed out by the Bank of England.

The two most recent examples of widespread financial distress in emerging markets were in 1982 and 1996-98. In 1982 problems developed in Latin America, particularly in Brazil and Mexico. The previous decade had seen profligate lending by US banks to these countries. When the 1980-82 recession was triggered by high oil prices, the borrowing countries were unable to service their debts. It took almost a decade for the banks involved to recover from the balance sheet damage they suffered as a result. It took just as long for the heavily indebted countries to restore their credit ratings.

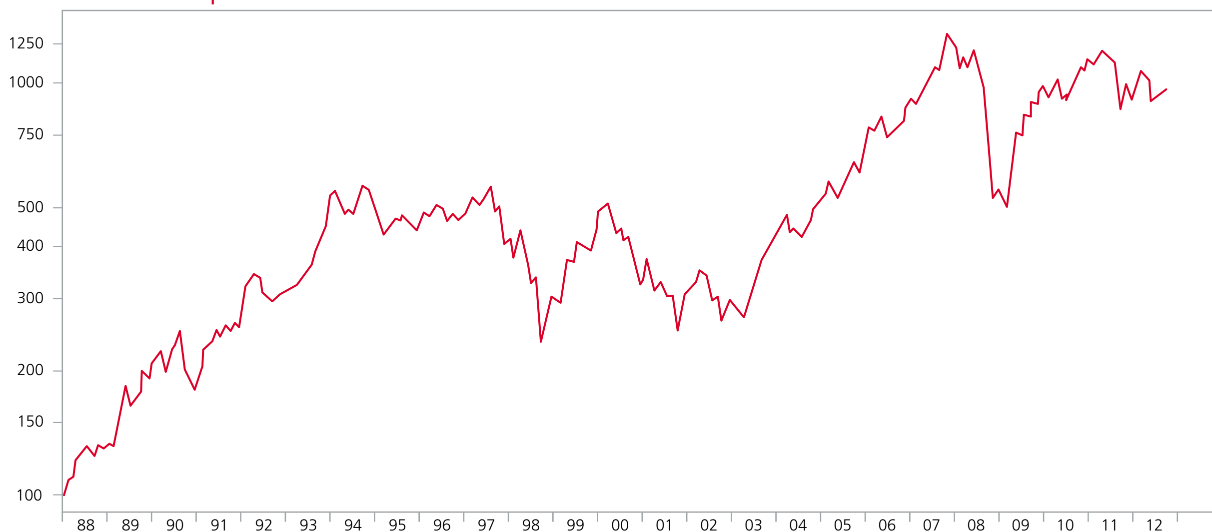
The 1996-98 crises were focused in Asia, where again developing countries such as South Korea, Thailand and Indonesia became dependent on short-term foreign borrowings. Massive domestic investment that generated strong economic growth was financed by borrowing heavily abroad. When the lenders became nervous and some tried to withdraw their capital the borrowers' currencies collapsed. The problem started in Thailand in August 1996 and rapidly spread elsewhere. The final blow-up occurred in 1998 when Russia defaulted on its government debt. This brought down the Long Term Capital Group (LTC) in New York. The US monetary authorities had to orchestrate a bailout of LTC similar to the rescue of Barings a century earlier.

"...increasingly, developments in emerging markets have a profound effect on the developed economies."

The detailed causes of these crises differ from case to case, but all of them have similar macroeconomic characteristics. Over long periods of prosperity the allocation of capital in an economy becomes increasingly inefficient. Strong growth masks these problems and allows excessive debt to build up in the system. Finally, mounting inefficiencies cause growth to slow. Often this becomes manifest through rising inflation, which requires increased interest rates. Ultimately what is not sustainable collapses. Apart from resource bonanzas, in the long run economic growth depends on improving efficiency and productivity. Recessions are periods in which the economy contracts, eliminating inefficiencies and forming a new base from which growth can resume. They play an essential role in achieving sustainable growth over the longer term.

Share market indices provide the simplest picture of the changing fortunes of these economies. **Graph 1** shows the aggregate index for all emerging markets. The five-fold rise in prices between 1988 and 1993 was followed by a five-year decline from 1997 and 2002. The tremendous surge in

GRAPH 1 | MSCI EM Emerging Markets – US$



Source: I-Net Bridge

equity prices in Brazil and India after 2002 reflects their recent economic booms (see **Graphs 2** and **3** on page 10). China offers a more nuanced picture, experiencing an asset bubble between 2006 and 2007, which was choked off by government intervention (see **Graph 4** on page 11).

The expansion of emerging markets after the 1982 meltdown lasted 12 to 14 years. We are now in the 14th year since the nadir of 1998. Given previous experience, we are close to or at the point where after a decade of astonishing growth, emerging markets should enter a period of adjustment. The current slowdown in China, India, Brazil and other emerging markets must be viewed within this context.

China

In 2009, in response to the world financial crisis, China pumped huge sums of money, equivalent to more than 30% of its GDP, into state-owned enterprises and regional governments to boost infrastructural investment. The state-controlled banking system was instructed to open the lending taps, leading to a rapid recovery of China's economy, and counteracting the adverse consequences of a collapse in world trade. The problem was that the programme worked too well, creating an overheated property market and rising inflation. Since 2010 the Chinese government has been battling to regain control of an overheated economy. Direct measures, such as restricting the growth of credit, are starting to work and growth has slowed towards the government's longer-term target of 7%. However, increasingly the normal symptoms of an over-indebted society are becoming visible. When debt levels are too high investment slows because the focus of the borrower shifts from business expansion to repairing balance sheets.

As the Chinese economy has become larger and more complex and sophisticated, the ability of its government to manage the economy has waned. It is no longer able to switch growth on and off with commands from the centre. Its economy is developing a life and will of its own, evolving from being investment driven to consumption driven. The current slowdown is part of this process. While it may be possible to use the old techniques to inject one last growth surge, the secular trend will be towards growth at a more moderate pace.

India, Brazil and the rest

India has also been growing unsustainably, the consequences of which are seen in a deteriorating current account, a declining rupee and rising inflation. Inevitably markets are forcing adjustments to rebalance the economy to create greater financial stability. Growth is slowing. The story in Brazil and other emerging markets is similar.

GRAPH 2 | India Index – US$

Source: I-Net Bridge

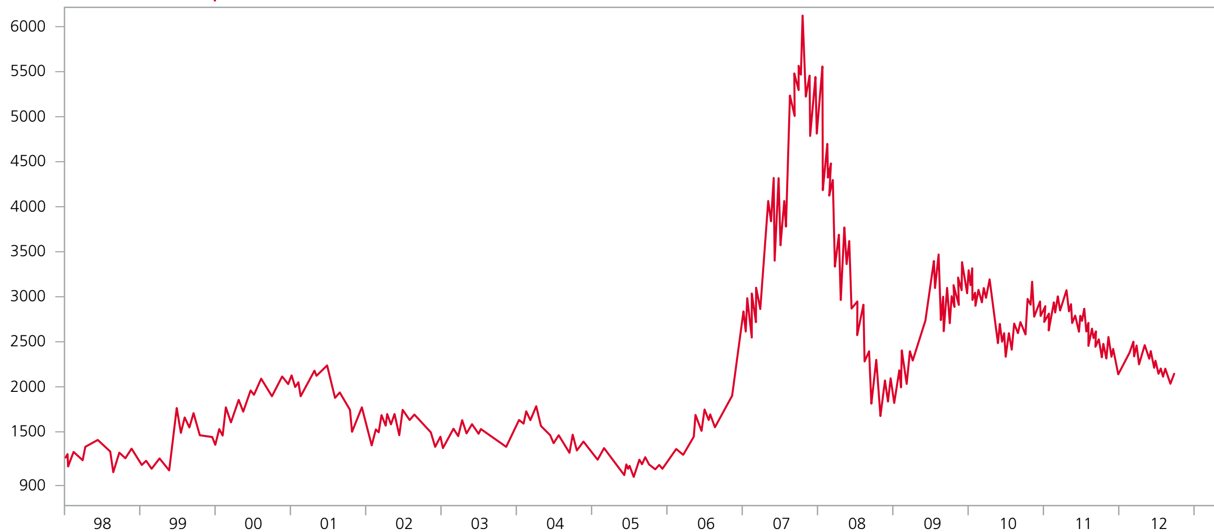
The impact of lower commodity prices

Among the casualties of slower emerging market growth have been the commodities markets. It increasingly looks as if we have seen the peak of the great commodity boom which commenced in 2002 and was driven by a rapid increase in demand in developing economies, especially China. Rising export prices have rewarded commodity

GRAPH 3 | Brazil Index – US$

Source: I-Net Bridge

GRAPH 4 | China Shanghai Composite Index



Source: I-Net Bridge

exporters such as Australia, Chile and South Africa with a decade of prosperity. Now what has been favourable is becoming adverse. No longer will these countries be able to sit back complacently and allow the rising tide of prices to carry them ever forward to increasing prosperity. The prospects for South Africa are particularly worrying. While Chile and Australia have a strong skills set which will enable them to reinvent themselves and change their focus to compensate for shrinking mining revenues, South Africa probably lacks the skills and market flexibility to do this. This is the biggest challenge our country faces because it impacts directly on all our other problems. How will the economy grow after the end of the commodity boom?

Global interdependence

Since 1990 globalisation of trade has created one world market. What happens in Europe and North America has long affected what happens in Brazil or India. Now, increasingly, developments in emerging markets have a profound effect on the developed economies. For example, the eurozone has become dependent on the prosperity of Germany, but Germany has become significantly reliant on exports to China. Emerging markets account for most of the world's growth. The principal reason why their economies are slowing is internal and has nothing to do with Europe, America or Japan. Slower growth in Asia is one of the main causes of deteriorating global business conditions.

The success of the big monetary stimulus injected into the financial system after the Lehman collapse in September 2008 may have given rise to a prevalent illusion that the emerging markets can bounce back rapidly to their previous growth rates. Previous experience suggests otherwise and that a slowdown such as we are currently experiencing can continue for a number of years.

However, in time all things pass. The upward secular growth trend of the developing half of the world remains intact. After a period, which may last years rather than months, growth will start accelerating again. A global slowdown can create investment opportunities for those patient enough to wait for them.

Sandy joined Allan Gray in October 1991. His current responsibilities include the management of fixed interest and individual client portfolios. Previously he was employed by Gold Fields of South Africa Limited for 22 years where much of his experience was focused on investment-related activities.

Seema Dala

Tamryn Lamb

A healthy approach

EXECUTIVE SUMMARY: Broadly speaking, one could think about building a portfolio in two key ways. Investors with a 'top-down' approach start with a wide view of the world and make decisions about which countries or sectors look the most attractive at any given time. Once these allocations are made, they flesh out their portfolios by investing in the shares they consider to be most attractive in each area. On the other hand, investors who adopt a 'bottom-up' approach, like Orbis and Allan Gray, start by searching for undervalued stocks. Our analysts regularly perform in-depth research on a wide range of companies, seeking to understand their underlying value based on long-term fundamentals. We then step back and ask ourselves which shares appear to offer the greatest dislocations between the market price and our assessment of their value. With this in mind, we seek to position our portfolios in the most attractive opportunities at any given time. Seema Dala and Tamryn Lamb discuss how, ultimately, our funds' overall positioning is driven by our analysts' views on individual companies, rather than 'the big picture'. But they also illustrate how 'clusters of ideas' can arise, using the Orbis Global Equity Fund's exposure to US healthcare shares as an example.

The healthcare story

Orbis often sees very significant exposures or key areas of concentration emerge at the portfolio level as a result of bottom-up stock selection decisions, which may appear as taking a view on a particular sector. This is not the case; rather, and to borrow a mining analogy used in an Orbis quarterly report late last year, the discovery of one nugget often leads to a rich vein of similar ideas, which tend to be clustered around specific industries or countries.

In the Orbis Global Equity Fund, five areas currently account for more than half of the portfolio's net asset value. These include North American Technology, Oil & Gas and Healthcare, Asia ex-Japan Technology, and Japanese Consumer Services. Collectively, these areas make up less than a quarter of the FTSE World Index. The North American Healthcare exposure is dominated by three significant stock positions, in WellPoint, Humana and Aetna. These health insurers comprise 8% of the Fund, compared with a less than 1% weighting in the World Index.

> "...the discovery of one nugget often leads to a rich vein of similar ideas..."

WellPoint is the largest holding within this sector, and was 4% of the Orbis Global Equity Fund at the end of September 2012. WellPoint is the largest commercial health insurer in the US, serving approximately 35 million members. It is a clear leader, operating in 14 US states with a number one share in all of its markets.

Orbis first bought WellPoint in October 2008, at a time when the US health insurance sector was deeply out of favour with investors. WellPoint shares had lost more than half of their value after hitting an all-time peak in January of the same year. The rapidly deteriorating economy threatened to decrease WellPoint's membership base, and profit margins were being squeezed by rising medical loss ratios (MLRs) – defined as the percentage of premiums spent by the insurers on medical costs. There was also an overwhelming sense of fear and uncertainty about what an Obama victory might mean for the implementation of healthcare reform. Some investors even feared a fully nationalised healthcare system. More importantly, it was unclear what impact such reforms would have on the healthcare insurers' business models and overall levels of profitability.

Orbis believed that the market's outlook was far too pessimistic. The major US insurance providers would ultimately be part of almost any healthcare reform solution,

with an opportunity to cover millions of previously uninsured Americans. Approximately 16% of the US population – or nearly 50 million people – are uninsured. Yet WellPoint's valuation of just seven times earnings, which was about half its long-term historical average, was effectively pricing in a scenario in which growth would never return, medical costs would fail to normalise, and margins would remain at about half their historical norms. Orbis believed that the odds of this bearish scenario playing out were very low.

Discovering additional nuggets

Orbis' research on WellPoint prompted a look at other companies in the sector, including health insurers Aetna and Humana.

At the time Aetna was purchased in the Orbis Global Equity Fund in late 2009, the implications of reform remained uncertain and investors continued to avoid the sector. Weakness in the US economy also continued to weigh on membership growth. When healthcare reform was finally signed into law in March 2010, the business impact was nowhere near as bad as many had feared. Still, both WellPoint and Aetna shares remained weak for much of 2010 as concerns shifted to the details of how the reforms would be implemented. With the underlying long-term fundamentals unchanged, and the theses intact, Orbis Global increased its position in both shares.

Against this backdrop, the Humana opportunity was also identified. The investment thesis for Humana, which now accounts for 2.4% of the Fund, is predicated on the view that Humana will continue to deliver earnings growth as a key provider of government-funded healthcare services. By way of background, the US government pays for the healthcare of individuals over the age of 65 through the Medicare programme. These participants have the option of having those benefits delivered via Medicare Advantage (MA), a privately administered programme managed by insurance companies such as Humana. MA plans generally offer simplified paperwork, better coordination of benefits across multiple healthcare providers, and ancillary benefits (e.g. fitness memberships) that traditional Medicare coverage does not provide. As a result, MA plans have become increasingly popular. More than 25% of eligible participants opt for MA plans and Humana is the second-largest provider.

Humana stands to benefit from the massive wave of baby boomers joining the Medicare rolls in the years to come. More than 25 million seniors are expected to 'age into' the Medicare programme over the next 15 years. By 2030 Medicare enrolees are expected to account for about 20% of the US population. The MA segment of the market is growing even faster. Given Humana's strong market position and the popularity of the programme, Orbis estimates that the company could capture over 5% membership growth for many years to come.

The market remains less convinced for two reasons: First, the MA programme is potentially facing billions of dollars in cuts as a source of financing for the healthcare reform package. Secondly, the market expects operating margins to drop as a result of reform. Orbis believes these fears are overblown. The company has successfully navigated the MA marketplace for many years and even in the face of lower reimbursement rates from the government, Humana appears well placed to deliver 10% p.a. earnings growth over a five-year horizon. On the cost side, the margin pressure has been expected for some time, and Humana has been preparing and adjusting its operating structure accordingly. Neither of these positive factors was captured in the valuation.

Where do we stand today?

Today, all three companies trade at roughly half their historic levels, with free cash flows per share equivalent to 13% of their share prices. When compared to their healthcare peers, the insurers trade at a discount to the average pharmaceutical share on 12 times earnings, despite superior growth prospects (see **Table 1**). For a more detailed comparison of the healthcare insurers versus pharmaceutical shares, please refer to the Orbis quarterly reports available via www.orbisfunds.com

TABLE 1 Orbis Global health insurers – key metrics

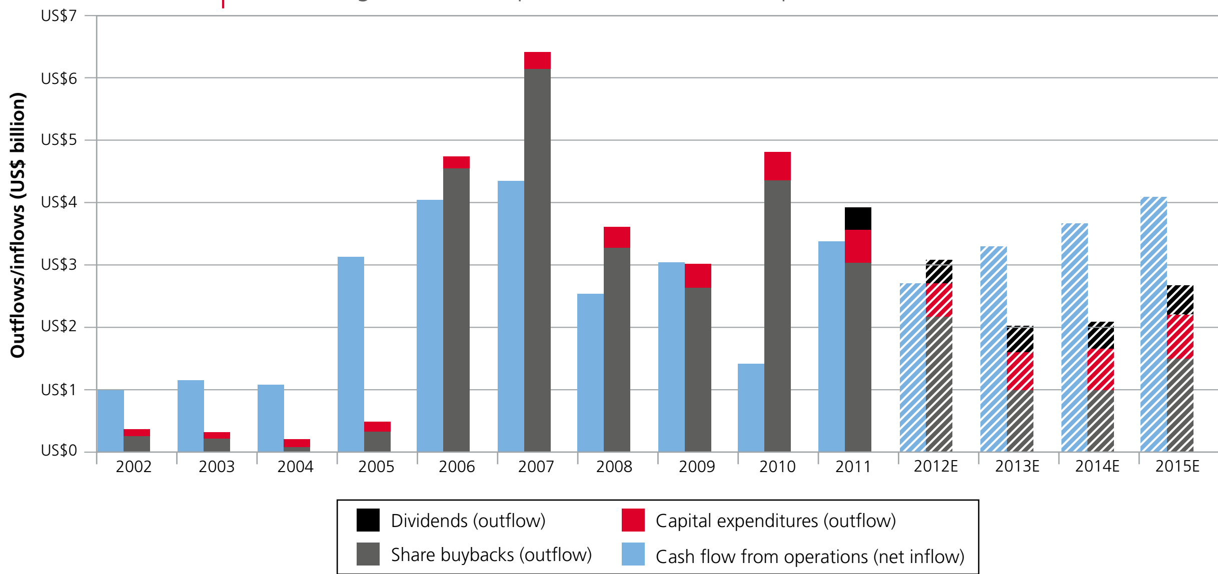
Company	Expected '12 - '15 EPS CAGR*	2012 P/E**	2013 P/E**	Free cash flow yield	Dividend yield
Aetna	15.6%	7.4x	6.3x	16.2%	1.8%
WellPoint	10.8%	7.6x	6.9x	11.5%	1.9%
Humana	15.0%	9.7x	7.9x	11.5%	1.5%
Average	13.8%	8.2x	7.1x	13.1%	1.7%

Sources: Orbis Research, FactSet

* Expected compound annual growth rate of earnings per share from 2012-2015.
** Price to earnings ratio.

All three insurers offer an opportunity to invest in a business with a solid franchise and competitive positioning generating

GRAPH 1 | WellPoint generates ample cash and return capital to shareholders

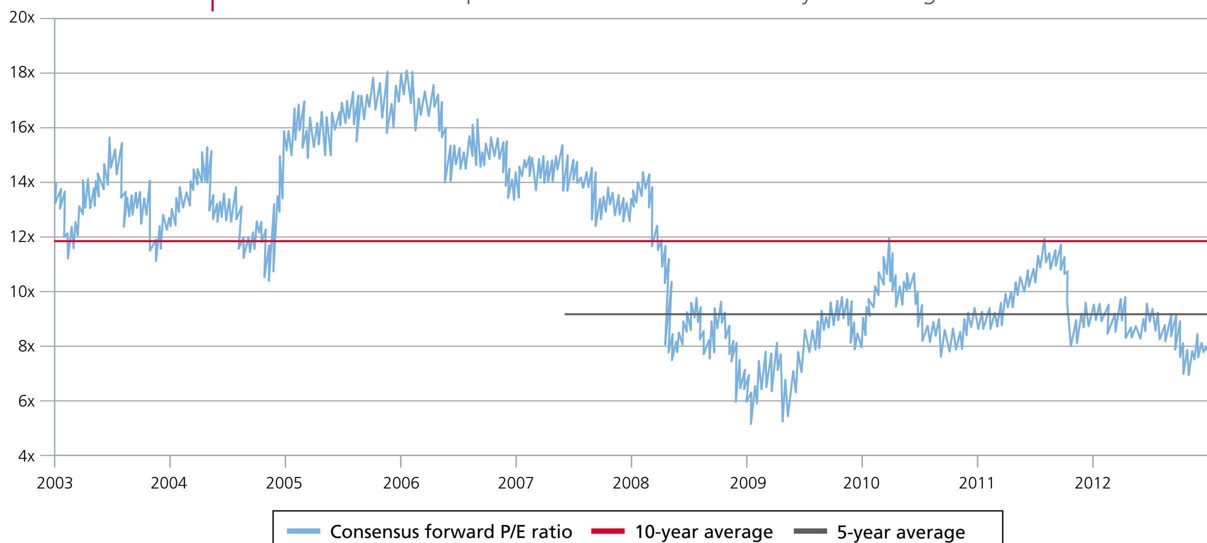


Source: Orbis Research

substantial free cash flow. WellPoint, for example, has demonstrated its willingness to return this cash to shareholders in the form of share buybacks and dividends (as seen in **Graph 1**) – arguably an attractive characteristic in a capital-starved environment.

The market, however, believes that the business should be priced at around eight times future earnings, not far from the levels seen during the darkest days of the healthcare reform when the stock was first purchased. This is lower than the five- and 10-year historic averages (see **Graph 2**).

GRAPH 2 | WellPoint's P/E multiple is below its five- and 10-year average



Source: FactSet

Orbis' long-term view

In 2010-2011, these three healthcare stocks each contributed positively to Global's relative performance. Having been extremely conservative with pricing in the face of great uncertainty, insurers were in a position to deliver a string of quarterly results that easily beat earnings estimates. In 2012, however, although the insurers managed to exceed consensus forecasts in the first two quarters of the year, it was not enough to satisfy the market's lofty expectations which, compounded with a few self-inflicted execution mistakes, caused the stocks to underperform.

The healthcare reform debate is on investors' minds once again as the November US presidential election approaches, and few investors are willing to touch these shares ahead of that time. Orbis sees it differently. If Mitt Romney is elected, the stocks are likely to rally on the prospect of a repeal of 'Obamacare' or significant changes to the healthcare law. If Obama is re-elected, the industry can proceed as it has been planning for the past two years. Either way, Orbis believes investors will have much greater visibility on the sector over the next six to 18 months.

What is clear is that sentiment in this space is more volatile than earnings and, with the sentiment pendulum shifted strongly to the bearish camp over recent months, the resultant share price weakness has given Orbis the opportunity to increase the Fund's position. There appears to be a sizeable gap between Orbis' assessment of intrinsic value and what is being reflected in current share prices. Over the long term, Orbis believes the exposure to the healthcare cluster represents attractive value and a compelling risk-adjusted opportunity.

Seema is a member of the Institutional Client Servicing team and is responsible for Orbis client servicing in South Africa. She joined Allan Gray in 2007 as an investment analyst and is a qualified CA (SA).

Tamryn is a member of the Orbis Investment Counsellor Group, with a specific focus on global consultants. She joined Orbis in 2006 as an investment analyst and spent four years researching European equities. She is a CA (SA) and a CFA charter holder.

Richard Carter

Planning for income post retirement

EXECUTIVE SUMMARY: If you are knocking at 60's door and fall into the small minority of South Africans who have saved enough to retire comfortably, you may be planning your retirement party. Whether or not you are part of this select group, you need to carefully consider the options available to you, with the help of your independent financial adviser. Richard Carter sheds some light on these options, illustrating how using a combination of products may help to increase the longevity of your retirement savings and your standard of living.

While your personal circumstances dictate the options you have at retirement, it is probably fair to say that most retirees share the same key objective: to receive an income on which they can survive, and which will sustain them for the rest of their lives. But what are your options?

When you retire from a pension fund or retirement annuity fund, you are allowed to take one-third of your retirement capital in cash. With the rest of the money you are legally obligated to buy an annuity. If you are retiring from a provident fund, depending on the rules of your fund, you may be allowed to take a full cash payout. You could then invest the lump sum as you wish, with one option being to buy an annuity. Investors often feel they need to choose between a guaranteed annuity and a living annuity, but your financial adviser can help you understand how you can use both products to combat the key risks faced by retirees: the risk of outliving your money and the risk of inflation eroding the buying power of your monthly income over time.

Guaranteed for life

As the name suggests, a guaranteed life annuity in its simplest form will pay you a pre-determined guaranteed income for as long as you live, effectively insuring you against the risk of living too long. The rate you receive is influenced by your age and the current interest rate. The older you are and the shorter your life expectancy, the higher the income you are likely to receive.

In return for taking on the risk that you will live for a long time, and guaranteeing to pay you an income for life, the insurer takes ownership of your capital and your beneficiaries have no claim to this money when you die. Just as the insurer cannot ask you to pay in more money if you live longer than expected, your family cannot ask for a refund if you die sooner than anticipated. These are the normal principles of insurance. You can protect against this to some extent by adding an initial guarantee period to your annuity. If you die before this period is over, your loved ones will receive the benefit until the end of this period. However, if you select this option, you will receive a lower income to pay for it.

There are different variations of the guaranteed life annuity. You need to shop around for the best income rate and select the type of annuity that will best provide for your needs (see **text box**). You also need to understand the effects of inflation on your investment before you commit to a

Guaranteed annuities: different options available

- **Level annuity:** Your income remains the same for as long as you live. Important to consider is that your income will therefore not keep pace with inflation, meaning the purchasing power of your annuity weakens as you get older.
- **Inflation-linked annuity:** Your income increases every year in line with inflation. While you will start on a lower income than you would with a level annuity, at least your income still means something years down the line.
- **Escalating annuity:** Your income increases by a fixed and pre-determined amount every year. Depending on the percentage increase you agreed on when you bought the annuity, this may or may not keep pace with inflation. Again, your income in the early years will be lower than that of a level annuity.

product. Inflation erodes the purchasing power of your income. If you lock into payments which increase at too low a rate, or worse, payments which do not increase at all, you run the risk of not being able to maintain your standard of living.

Once you have bought your annuity you do not need to make any further decisions about the product as your terms are set for the rest of your life. If, however, you want flexibility, choice and more investment upside, along with the option of leaving your retirement capital to your loved ones, you should consider the benefits of a living annuity (see **Table 1**, which compares the benefits of living and life annuities).

Living annuities give you flexibility

Living annuities have been around in South Africa since 1993 and were first offered in response to the limited flexibility of guaranteed annuities. A living annuity is also known as a 'linked annuity' as the income from the annuity is not guaranteed, but is dependent on ('linked' to) the performance of the underlying investments. Living annuities give investors flexibility. However, with flexibility comes risk, in particular market risk and longevity risk. If you go the living annuity route you should consider using an independent financial adviser to assist you with your key decisions to make sure there is no disconnect between your expectations, the way you construct your portfolios and the amount of income you draw down.

> "…it may make sense to use both a living annuity and a guaranteed life annuity."

As living annuities need to provide an income for life, careful asset allocation is your first big decision – particularly as it will influence how long your investment will last and what standard of living you will be able to afford. Before you begin, you should consider how much growth you need to sustain your investment and how much risk you can afford to take. You need to look for assets that offer long-term growth potential, and allocate capital to these assets based on your risk appetite and ability to handle decreases in income.

Asset classes with the potential for greater returns come at the expense of increased risk of capital loss as well as increased short-term volatility. Therefore, if you want to enjoy the benefit of a greater lifetime income, you must be prepared to tolerate both these risks.

Your next big decision is how much income to draw, within the 2.5%-17.5% range stipulated by legislation. There is some flexibility here as you have the opportunity to change your income level once a year. It is crucial that you withdraw a sustainable level of income – in other words, a level of income which can realistically be supported by your investments and still provide for inflationary increases and last for the rest of your life. Obviously there are lots of unknowns in this, such as what your real investment returns will be, the rate of inflation and how long you will need the income to last. To combat these unknowns you need to make reasonable assumptions, withdraw a reasonable level of income, and adjust your income when things do not go according to plan.

The hybrid approach

There is a misconception among retirees that retiring means the end of the investing cycle. Actually, although you are retiring, you may still have a considerable number of years ahead to live, and many of those years need to be used to generate investment returns, even while drawing an income. Bearing this in mind, rather than choosing between products, it may make sense to use both a living annuity and a guaranteed life annuity.

TABLE 1 Benefits of pension products

Living annuity	Guaranteed annuity
Allows you to take less income now, so that your capital can grow and fund more income later in life, and leave capital behind for others	Allows you to buy protection from yourself against drawing too much or living too long
Flexibility of income drawn	Predictability
Flexibility of investment choice	You do not need to make investment decisions
Investment upside	No risk of reduced income due to volatile markets

Source: Allan Gray Research

The value that insurers offer gets better as you get older. Although the value might not seem that attractive at retirement, by the time you reach 70 or 75, this situation changes. This is because your risk profile is linked to that of your peers. As the mortality rate of your group increases, the income you would be offered on purchase increases as well. For this reason, retirees could opt for a phased approach, initially taking a living annuity, and transferring to a guaranteed product when it becomes apparent that they will get a better level of income. With this approach, you get flexibility and enhanced return potential in the early years, and then have guaranteed income in your sunset years.

Retirees who prefer the relative security of the guaranteed product from the outset, but do not want to miss out on potential returns, might prefer to divide their retirement savings at retirement, investing partly in a living annuity and partly in the guaranteed product, and potentially transferring the full investment to the guaranteed product later in life. It is important to note that you can transfer from a living annuity to a guaranteed annuity at any point, but the reverse is not allowed.

At the end of the day, with an increasing number of people spending as much time in retirement as they spend in the workforce, it is crucial that retirement is not seen as the endpoint of financial planning; rather it should be the next stage of your financial plan.

Richard is part of the Institutional Client Servicing team. He joined Allan Gray in 2007 after working for several years in financial services in the UK. He completed his B Bus Sc degree at UCT and is a qualified actuary.

Wanita Isaacs

Investing for education

EXECUTIVE SUMMARY: As Wanita Isaacs joins the ranks of parents investigating ways to afford the best possible education for their children, she learns that, although long-term thinking and early sacrifices certainly pay off, thankfully there are also options available for those of us who are late starters. While there is plenty of reading material that covers this subject matter, her analysis shows that the growth you earn on an investment significantly lowers the impact of education costs on your budget, even if you miss the opportunity of starting your investment at the birth of your baby.

Take the time to plan

With the cost of education soaring, comfortably affording our children's school and tertiary education fees requires careful budgeting. As with any investment plan, the sooner we start putting money aside, the longer we will have for our money to work for us. However, if, like my child, yours has already started school, do not be disheartened, investing can still ease the burden of the more expensive later years of education.

There are various ways to pay school fees and your options will naturally be influenced by your circumstances. Rather than paying all the fees from your salary, or taking out a loan, you could consider putting a plan in place which allows you to either:

- Invest from the birth of your child and pay for all fees from the investment, or
- Invest for later education (high school and tertiary education) and pay for the early years from your salary

To illustrate the differences between these options we analysed the cost of financing education for a single child. We assumed an inflation rate of 6% per year and, in the investment examples, contributions escalating with inflation each year. The fees used in our analysis are notional estimates for a suburban 'Model C' school and tertiary education at a major university.

Paying fees from your salary may not be the best option

Over the last 15 years, education inflation (the rate at which the cost of education increases each year) has been almost 10%, according to Statistics South Africa – about 4% higher than the general inflation rate. This means that, unless your salary increases by at least 10% per year as well, as time goes by it will get increasingly harder to make space in your budget for school fees. While fees vary, they tend to escalate at a similar rate: **Table 1** is intended to give a sense of what you would be in for.

Table 1 shows the fees for our example schools and tertiary education today compared with what it could cost, in real terms, at the time the child attends each stage of school, assuming fee increases remain at the current rate of 4% ahead of general inflation each year.

TABLE 1 Annual school fees in real terms now and in the future

	Today	At the time of attending
Pre-school	R20 000	R23 720
Primary school	R30 000	R38 318
High school	R45 000	R74 490
Tertiary	R35 000	R63 725

Source: Allan Gray Research

Weigh up greater savings versus the impact on your budget

When you invest, the returns you earn lessen the total financial impact of school fees on your budget. Our analysis indicated that if our illustrative parent paid all school and tertiary fees from her salary, the total cost could end up being almost R2.4 million.

If instead the parent in our example started investing R3 500 per month at the birth of her baby, and used the investment to fund *all fees*, and assuming a real return on her investment of 3%, the impact on her budget would be 29% lower. Although going this route requires contributing a meaningful percentage of your salary at a time when you may have many other financial pressures, tight budgeting upfront allows for predictability and cost saving in the future.

Table 2 highlights the fact that the longer you have to invest, the more you can benefit, since saving from birth for the later years and paying for pre- and primary school from your salary, can decrease the impact on your budget by even more.

Being a disciplined saver has another obvious benefit, in that the impact of lumpy costs like education is spread over many years. This means that, on top of the benefit of investing the money, parents who save can send their children to schools they may otherwise not be able to afford.

Table 2 also shows that the growth you earn on an investment for the later schooling years significantly lowers the impact of education costs on your budget, even if you miss the opportunity of starting your investment at the birth of your baby. Even if our illustrative parent started her investment after her child had started school, and her investment only earned enough return to keep up with inflation, investing would lower the impact on her budget by 13%.

Credit: avoid it if you can

The repercussions of not planning may be that you are forced to use a loan to finance education. Although the power of compound interest works in your favour when you invest, the same mechanism works against you when you borrow and makes credit the most expensive option – especially if you are making use of an unsecured personal loan. It is scary to think that the cost of credit to fund later schooling can work out to almost four times more than your total education costs if you had invested for these schooling levels from birth and paid for the early schooling years from your salary.

Research the investment options available

If you decide to invest for education, there are many investment products available that may suit your needs, including various specialised education policies. Allan Gray offers a range of unit trusts that you can invest in directly or via an endowment product wrapper. Please visit our website www.allangray.co.za for more information on these options. It is important to research the various options available, comparing costs, restrictions, expected returns and other product features and benefits.

At Allan Gray we do not offer financial advice, however, we believe in the merits of using an independent financial adviser to help you make these complex investment decisions. An independent adviser can help you to assess your current and future financial situation and recommend the most suitable course of action. He or she can help you make investment choices such as how much to save, which product and which underlying investments are right for you.

TABLE 2 | Lower impact on your budget through investing for the later schooling years

	Investment performance	Child's age at start of investment						
		0	1	2	3	4	5	6
Lower impact on your budget compared to paying fees from your salary	3% above inflation	31%	29%	28%	25%	24%	22%	20%
	At inflation	21%	20%	18%	18%	16%	14%	13%

Source: Allan Gray Research

Wanita is a business analyst in the Product Development team. She is a medical doctor and a UCT graduate and has been with Allan Gray since 2008.

Notes

Investment track record - share returns

Allan Gray Proprietary Limited global mandate share returns vs. JSE All Share Index

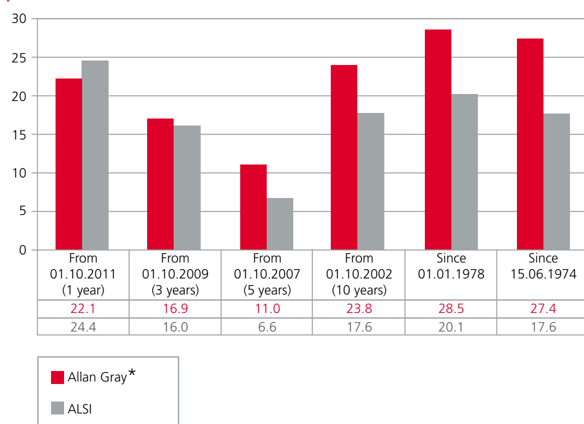
Period	Allan Gray*	JSE All Share Index	Out/ underperformance
1974 (from 15.06)	-0.8	-0.8	0.0
1975	23.7	-18.9	42.6
1976	2.7	-10.9	13.6
1977	38.2	20.6	17.6
1978	36.9	37.2	-0.3
1979	86.9	94.4	-7.5
1980	53.7	40.9	12.8
1981	23.2	0.8	22.4
1982	34.0	38.4	-4.4
1983	41.0	14.4	26.6
1984	10.9	9.4	1.5
1985	59.2	42.0	17.2
1986	59.5	55.9	3.6
1987	9.1	-4.3	13.4
1988	36.2	14.8	21.4
1989	58.1	55.7	2.4
1990	4.5	-5.1	9.6
1991	30.0	31.1	-1.1
1992	-13.0	-2.0	-11.0
1993	57.5	54.7	2.8
1994	40.8	22.7	18.1
1995	16.2	8.8	7.4
1996	18.1	9.4	8.7
1997	-17.4	-4.5	-12.9
1998	1.5	-10.0	11.5
1999	122.4	61.4	61.0
2000	13.2	0.0	13.2
2001	38.1	29.3	8.8
2002	25.6	-8.1	33.7
2003	29.4	16.1	13.3
2004	31.8	25.4	6.4
2005	56.5	47.3	9.2
2006	49.7	41.2	8.5
2007	17.6	19.2	-1.6
2008	-12.6	-23.2	10.6
2009	28.8	32.1	-3.3
2010	20.9	19.0	1.9
2011	7.1	2.6	4.5
2012 (to 30.09)	12.4	14.8	-2.4

Investment track record - balanced returns

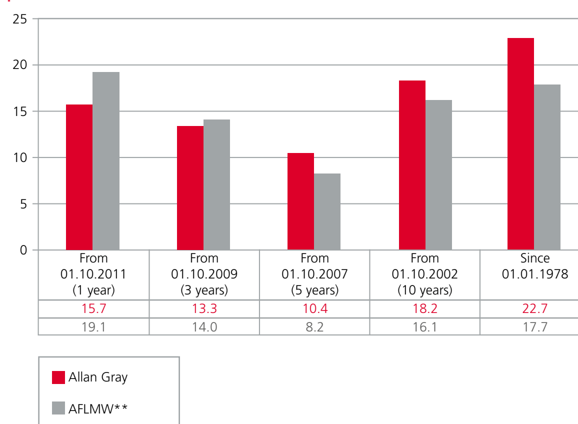
Allan Gray Proprietary Limited global mandate total returns vs. Alexander Forbes Global Manager Watch

Period	Allan Gray*	AFLMW**	Out/ underperformance
1974	-	-	-
1975	-	-	-
1976	-	-	-
1977	-	-	-
1978	34.5	28.0	6.5
1979	40.4	35.7	4.7
1980	36.2	15.4	20.8
1981	15.7	9.5	6.2
1982	25.3	26.2	-0.9
1983	24.1	10.6	13.5
1984	9.9	6.3	3.6
1985	38.2	28.4	9.8
1986	40.3	39.9	0.4
1987	11.9	6.6	5.3
1988	22.7	19.4	3.3
1989	39.2	38.2	1.0
1990	11.6	8.0	3.6
1991	22.8	28.3	-5.5
1992	1.2	7.6	-6.4
1993	41.9	34.3	7.6
1994	27.5	18.8	8.7
1995	18.2	16.9	1.3
1996	13.5	10.3	3.2
1997	-1.8	9.5	-11.3
1998	6.9	-1.0	7.9
1999	80.0	46.8	33.1
2000	21.7	7.6	14.1
2001	44.0	23.5	20.5
2002	13.4	-3.6	17.1
2003	21.5	17.8	3.7
2004	21.8	28.1	-6.3
2005	40.0	31.9	8.1
2006	35.6	31.7	3.9
2007	14.5	15.1	-0.6
2008	-1.1	-12.3	11.2
2009	15.6	20.3	-4.7
2010	11.7	14.5	-2.8
2011	12.6	8.8	3.8
2012 (to 30.09)	10.2	12.5	-2.3

Returns annualised to 30.09.2012



Returns annualised to 30.09.2012



* Allan Gray commenced managing pension funds on 1 January 1978. The returns prior to 1 January 1978 are of individuals managed by Allan Gray, and these returns exclude income.

Note: Listed property included from 1 July 2002.

An investment of R10 000 made with Allan Gray on 15 June 1974 would have grown to **R107 105 638** by 30 September 2012. By comparison, the returns generated by the JSE All Share Index over the same period would have grown a similar investment to **R5 003 535**.

** Consulting Actuaries Survey returns used up to December 1997.

The return from 1 April 2010 is the average of the non-investable Alexander Forbes Large Manager Watch. The return for September 2012 is an estimate.

An investment of R10 000 made with Allan Gray on 1 January 1978 would have grown to **R12 156 550** by 30 september 2012. The average total performance of global mandates of Large Managers over the same period would have grown a similar investment to **R2 869 434**.

Allan Gray Balanced and Stable Fund asset allocation as at 30 September 2012

	Balanced Fund % of portfolio			Stable Fund % of portfolio		
	Total	**SA**	**Foreign***	**Total**	**SA**	**Foreign***
Net equities	54.6	43.1	11.4	15.1	8.7	6.5
Hedged SA equities	12.6	2.9	9.7	30.4	16.2	14.2
Property	0.7	0.6	0.1	0.5	0.3	0.0
Commodities (new gold)	2.8	2.8	0.0	3.0	3.0	0.0
Bonds	9.6	9.6	0.0	6.7	6.7	0.0
Money market and bank deposits	19.8	15.7	4.1	44.4	39.4	5.0
Total	**100.0**	**74.6**	**25.4****	**100.0**	**74.3**	**25.7****

NOTE: There might be slight discrepancies in the totals due to rounding.

* The Fund is above its foreign exposure limit due to market value movement.
** This includes African ex-SA assets.

Allan Gray Equity Fund net assets as at 30 September 2012

Security (ranked by sector)	Market value (R million)	% of fund	JSE ALSI weight (%)
Equities	**29 401**	**95.8**	
Resources	**8 685**	**28.3**	**31.9**
Sasol	3 126	10.2	
Anglo American*	1 369	4.5	
Anglogold Ashanti	998	3.3	
Impala Platinum	876	2.9	
BHP Billiton	868	2.8	
Gold Fields	422	1.4	
Harmony Gold Mining	299	1.0	
Positions less than 1%	729	2.4	
Financials	**6 378**	**20.8**	**47.2**
Standard Bank	1 385	4.5	
Sanlam	1 323	4.3	
Reinet Investments	987	3.2	
Old Mutual	737	2.4	
Investec	509	1.7	
MMI Holdings	318	1.0	
Positions less than 1%	1 119	3.7	
Industrials	**14 130**	**46.0**	**20.9**
British American Tobacco	2 833	9.2	
SABMiller	2 411	7.9	
Remgro	2 241	7.3	
Mondi	1 019	3.3	
Tongaat-Hulett	616	2.0	
Nampak	586	1.9	
Netcare	522	1.7	
Sappi	409	1.3	
Datatec	400	1.3	
Illovo Sugar	371	1.2	
Positions less than 1%	2 721	8.9	
Other securities	**208**	**0.7**	
Money market and call deposits	**1 291**	**4.2**	
Totals	**30 693**	**100.0**	

* Including positions in Anglo American Plc stub certificates.

Allan Gray Unit Trusts annualised performance in percentage per annum to 30 September 2012

	QTR (unannualised)	1 YEAR	3 YEARS	5 YEARS	10 YEARS	SINCE INCEPTION	ASSETS UNDER MANAGEMENT (R million)	INCEPTION DATE
UNIT TRUSTS [1]								
High net equity exposure (100%)								
ALLAN GRAY EQUITY FUND (AGEF)	[3]	19.4	15.1	8.5	20.3	27.2	30 692.8	01.10.98
FTSE/JSE All Share Index		24.4	16.0	6.6	17.6	18.3		
ALLAN GRAY-ORBIS GLOBAL EQUITY FEEDER FUND (AGOE)	[3]	22.1	6.6	3.5	-	10.3	5 858.9	01.04.05
FTSE World Index (Rands)		24.8	11.1	2.4	-	9.1		
Medium net equity exposure (40% - 75%)								
ALLAN GRAY BALANCED FUND (AGBF)	[3]	14.3	12.1	9.1	17.3	19.5	57 807.6	01.10.99
Average of both Prudential Medium Equity category and Prudential Variable Equity category (excl. AGBF)		16.7	11.8	6.9	14.5	13.8		
ALLAN GRAY-ORBIS GLOBAL FUND OF FUNDS (AGGF)	[3]	10.0	3.5	6.1	-	7.5	6 892.2	03.02.04
60% of the FTSE World Index and 40% of the JP Morgan Government Bond Index Global (Rands)		17.2	10.3	6.3	-	8.2		
Low net equity exposure (20% - 40%)								
ALLAN GRAY STABLE FUND (AGSF) - (NET OF TAX)	[3]	6.6	7.2	8.2	11.6	12.4	29 175.8	01.07.00
Call deposits plus two percentage points (Net of tax)		4.9	5.3	6.7	7.0	7.3		
ALLAN GRAY STABLE FUND (AGSF) - (GROSS OF TAX)	[3]	7.1	7.8	9.1	12.6	13.6	29 175.8	01.07.00
Call deposits plus two percentage points (Gross of tax)		6.6	7.1	9.0	9.4	9.8		
Very low net equity exposure (0% - 20%)								
ALLAN GRAY OPTIMAL FUND (AGOF)	[3]	2.8	4.4	6.7	8.2	8.2	1 181.8	01.10.02
Daily call rate of FirstRand Bank Ltd		4.5	5.0	6.9	7.2	7.2		
ALLAN GRAY-ORBIS GLOBAL OPTIMAL FUND OF FUNDS (AGOO)	[3]	5.0	-	-	-	3.8	708.3	02.03.10
Average of US$ Bank Deposits and Euro Bank deposits		0.8	-	-	-	2.7		
No equity exposure								
ALLAN GRAY BOND FUND (AGBD)	[3]	13.8	11.7	10.8	-	10.1	757.7	01.10.04
BEASSA All Bond Index (total return)		17.0	12.7	10.6	-	10.0		
ALLAN GRAY MONEY MARKET FUND (AGMF)	[3]	5.6	6.3	8.2	8.5	8.7	7 857.6	03.07.01
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index [9]		5.6	6.2	8.0	8.4	8.6		

Total Expense Ratios (TERs)

	Equity Fund	Global Equity Feeder Fund	Balanced Fund	Global Fund of Funds	Stable Fund	Optimal Fund	Global Optimal Fund of Funds	Bond Fund	Money Market Fund
Performance component	0.94%	0.30%	0.20%	0.25%	0.38%	0.00%	0.00%	0.19%	0.00%
Fee at benchmark	1.71%	1.49%	1.16%	1.23%	1.15%	1.14%	0.99%	0.29%	0.29%
Total fees*	2.65%	1.79%	1.36%	1.48%	1.53%	1.14%	0.99%	0.48%	0.29%
Trading costs	0.09%	0.12%	0.08%	0.15%	0.06%	0.18%	0.17%	0.00%	0.00%
Other expenses	0.01%	0.06%	0.02%	0.07%	0.02%	0.01%	0.06%	0.03%	0.01%
Total Expense Ratio (TER)	2.75%	1.97%	1.46%	1.70%	1.61%	1.33%	1.22%	0.51%	0.30%
Annualised fee* rate for latest quarter	2.15%	1.80%	1.27%	1.40%	1.58%	1.14%	0.99%	0.29%	0.29%

** Including underlying Orbis Fund fees.*

A Total Expense Ratio (TER) of a portfolio is a measure of the portfolio's assets that were relinquished as a payment of services rendered in the management of the portfolio. The total operating expenses are expressed as a percentage of the average value of the portfolio, calculated for the year to 30 June 2012. Included in the TER is the proportion of costs incurred by the performance component, fee at benchmark and other expenses. These are disclosed separately as percentages of the net asset value. Trading costs (including brokerage, VAT, STT, STRATE, levy and insider trading levy) are included in the TER. A high TER will not necessarily imply a poor return nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TERs.

Orbis Funds annualised performance in percentage per annum to 30 September 2012

	QTR (unannualised)	1 YEAR	3 YEARS	5 YEARS	10 YEARS	SINCE INCEPTION	INCEPTION DATE
ORBIS FUNDS (RANDS) REGISTERED FOR MARKETING IN SOUTH AFRICA [1, 6]							
ORBIS GLOBAL EQUITY FUND (RANDS)	8.4	22.5	6.5	3.3	8.6	17.6	01.01.90
FTSE World Index (Rands)	8.0	25.2	11.0	2.2	6.6	11.9	
ORBIS JAPAN EQUITY (YEN) FUND (RANDS)	4.1	4.7	6.3	5.9	5.0	13.1	01.01.98
Tokyo Stock Price Index (Rands)	0.0	0.8	2.9	-2.1	1.4	5.4	
ORBIS ASIA EX-JAPAN EQUITY FUND (RANDS)	10.1	30.4	8.6	7.3	-	14.7	01.01.06
MSCI Asia Ex-Japan (Rands)	10.3	22.7	10.1	2.6	-	13.0	
ORBIS OPTIMAL SA FUND-US$ CLASS (RANDS)	3.8	6.6	2.3	6.4	-	9.1	01.01.05
US$ Bank Deposits (Rands)	0.9	2.8	3.2	4.8	-	7.4	
ORBIS OPTIMAL SA FUND-EURO CLASS (RANDS)	4.6	2.0	-1.3	4.7	-	7.8	01.01.05
Euro Bank Deposits (Rands)	2.2	-1.1	-0.7	3.3	-	6.4	

Segregated and life pooled portfolios annualised performance in percentage per annum to 30 September 2012

	QTR (unannualised)	1 YEAR	3 YEARS	5 YEARS	10 YEARS	SINCE INCEPTION	ASSETS UNDER MANAGEMENT (R million)	INCEPTION DATE
SEGREGATED PORTFOLIOS [5]								
GLOBAL BALANCED COMPOSITE	4.7	15.7	13.3	10.4	18.2	22.7	38 329.4	01.01.78
Mean of Alexander Forbes Global Large Manager Watch [2,4]	5.3	19.1	14.0	8.2	16.1	17.7		
DOMESTIC BALANCED COMPOSITE	4.2	16.5	14.6	11.1	20.7	23.3	21 502.4	01.01.78
Mean of Alexander Forbes Domestic Manager Watch [2,7]	4.9	20.0	15.1	9.4	18.3	18.2		
DOMESTIC EQUITY COMPOSITE	5.2	20.3	16.4	10.8	23.4	21.8	53 924.9	01.01.90
FTSE/JSE All Share Index	7.3	24.4	16.0	6.6	17.6	14.8		
GLOBAL BALANCED NAMIBIAN HIGH FOREIGN COMPOSITE	4.7	15.0	11.6	10.1	17.8	19.4	6 954.6	01.01.94
Mean of Alexander Forbes Namibia Average Manager [2]	5.4	18.8	12.9	8.6	16.1	14.4		
RELATIVE DOMESTIC COMPOSITE	6.4	22.3	15.9	8.8	20.2	20.9	5 130.4	19.04.00
Weighted average of client specific benchmarks [2]	7.1	25.4	16.6	7.5	18.3	16.3		
FOREIGN BEST VIEW (RANDS) COMPOSITE [8]	5.0	9.6	3.1	5.5	6.0	13.3	6 046.7	23.05.96
60% of the MSCI and 40% of the JP Morgan Government Bond Index Global (Rands)	6.2	17.3	10.2	6.1	6.0	10.5		
LIFE POOLED PORTFOLIOS								
GLOBAL BALANCED PORTFOLIO	4.9	16.0	13.6	10.6	18.4	20.0	21 536.4	01.09.00
Mean of Alexander Forbes Global Large Manager Watch [2,7]	5.3	19.1	14.0	8.2	16.1	15.0		
DOMESTIC BALANCED PORTFOLIO	4.6	17.5	15.2	11.4	21.0	20.7	6 840.1	01.09.01
Mean of Alexander Forbes Domestic Manager Watch [2,7]	4.9	20.0	15.1	9.4	18.3	17.0		
DOMESTIC EQUITY PORTFOLIO	5.4	20.4	16.7	10.8	23.5	23.8	7 451.1	01.02.01
FTSE/JSE All Share Index	7.3	24.4	16.0	6.6	17.6	15.9		
DOMESTIC ABSOLUTE PORTFOLIO	0.9	6.7	10.6	13.1	21.0	22.4	1 099.4	06.07.01
Mean of Alexander Forbes Domestic Manager Watch [7]	4.9	20.0	15.1	9.4	18.3	16.7		
DOMESTIC STABLE PORTFOLIO	2.1	8.2	9.3	10.2	15.0	15.2	1 830.3	01.12.01
Alexander Forbes Three-Month Deposit Index plus 2%	1.8	7.6	8.1	9.9	10.5	10.7		
DOMESTIC OPTIMAL PORTFOLIO [1]	0.4	3.5	5.4	7.7	-	8.6	365.6	04.12.02
Daily Call Rate of Nedcor Bank Limited	1.1	4.8	5.3	7.2	-	7.4		
GLOBAL ABSOLUTE PORTFOLIO	2.0	7.4	10.0	12.7	-	18.2	3 068.4	01.03.04
Mean of Alexander Forbes Global Large Manager Watch [2,7]	5.3	19.1	14.0	8.2	-	16.4		
DOMESTIC STABLE MEDICAL SCHEME PORTFOLIO	2.1	8.5	9.3	10.3	-	13.7	1 513.0	01.05.04
Consumer Price Index plus 3% p.a. [2]	1.6	8.0	7.7	9.5	-	9.0		
GLOBAL STABLE PORTFOLIO	2.6	8.3	8.8	10.0	-	13.8	3 501.7	15.07.04
Alexander Forbes Three-Month Deposit Index plus 2%	1.8	7.6	8.1	9.9	-	9.9		
RELATIVE DOMESTIC EQUITY PORTFOLIO	6.1	19.8	15.0	8.3	-	22.8	373.2	05.05.03
FTSE/JSE CAPI Index	7.3	24.4	16.3	7.5	-	21.8		
MONEY MARKET PORTFOLIO [1]	1.4	5.7	6.5	8.4	8.8	9.1	499.1	21.09.00
Alexander Forbes Three-Month Deposit Index	1.3	5.5	6.0	7.8	8.3	8.7		
FOREIGN PORTFOLIO [1]	5.0	9.3	3.0	5.4	6.0	5.0	1 400.9	23.01.02
60% of the MSCI Index and 40% JP Morgan Government Bond Index Global (Rands)	6.2	17.3	10.2	6.1	6.0	3.7		
ORBIS GLOBAL EQUITY PORTFOLIO [1]	8.4	22.5	6.5	3.4	-	10.4	4 873.9	18.05.04
FTSE World Index (Rands)	8.0	25.2	11.0	2.2	-	9.2		
HEDGED DOMESTIC EQUITY PORTFOLIO	5.0	19.4	15.8	-	-	10.5	985.3	01.06.08
FTSE/JSE CAPI Index	7.3	24.4	16.3	-	-	7.0		

PERFORMANCE AS CALCULATED BY ALLAN GRAY

1 The fund returns are net of investment management fees
2 The return for the quarter ending 30 September 2012 is an estimate as the relevant survey results have not yet been released
3 Unable to disclose due to ASISA regulations
4 Consulting Actuaries Survey returns used to 31 December 1997. Alexander Forbes Global Large Manager Watch used from 1 January 1998. Alexander Forbes Non-Investable Large Manager Watch used from 1 April 2010
5 The composite assets under management figures shown include the assets invested in the pooled portfolios above where appropriate
6 Amounts invested by the Allan Gray client portfolios in the Orbis funds are included in the assets under management figures in the table above
7 The mean returns of the Alexander Forbes Non-Investable Large Manager Watch used from 1 April 2010
8 The foreign carve-out returns of the Global Balanced Composite used from 23.05.96 to 31.08.01. The Foreign Balanced Composite returns are used from 01.09.01
9 Alexander Forbes Three-Month Deposit Index from 3 July 2001 to 31 March 2003. As from 1 April 2003, the benchmark is the simple average of the Domestic Fixed Interest Money Market Unit Trust Sector excluding Allan Gray Money Market Fund. The benchmark from 1 November 2011 is the Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index

Unit trusts	A unit trust is a savings vehicle for investors who want to grow their money and may want to access it before they retire. Unit trusts allow investors to pool their money with other investors who have similar investment objectives. Unit trusts are also known as 'portfolios of collective investment schemes' or 'funds'. Allan Gray has nine funds in its stable: Equity, Balanced, Stable, Optimal, Money Market, Bond, Global Equity Feeder, Global Fund of Funds and Global Optimal Fund of Funds.
Retirement Annuity*	The Allan Gray Retirement Annuity Fund (RA) is a savings vehicle for investors looking for a flexible, tax-efficient way to save for retirement. Investors can only access their money when they retire. Individually owned RAs can be managed on a group basis, offering employers a flexible solution to the challenge of retirement funding for their staff.
Preservation funds*	The Allan Gray Pension Preservation and Provident Preservation funds are savings vehicles for investors looking for a tax-efficient way to preserve existing retirement benefits when they leave a pension or provident fund, either as a result of a change in employment (e.g. retrenchment or resignation), or when they transfer from another preservation fund.
Endowment*	The Allan Gray Endowment Policy is a savings policy for investors who want a tax-efficient way to save, and wish to create liquidity in their estate.
Living Annuity*	The Allan Gray Living Annuity gives investors flexibility, within certain regulatory limits, to select an annuity best suited to their income needs after retirement. A living annuity provides investors with a regular income which is not guaranteed, and which is funded by growth on capital and income from interest and dividends.
Offshore funds	Through our partnership with Orbis we offer you a cost-effective way to diversify your portfolio by investing offshore. There are two options for investing offshore through Allan Gray: invest in rand-denominated offshore funds without the need to use your offshore investment allowance, or use your offshore investment allowance to invest in foreign funds.
Platform – local and offshore	Our investment platform provides you with access to all of our products, as well as a focused range of unit trusts from other fund providers. The platform enables you to buy, sell and switch – usually at no charge – between the funds as your needs and objectives change. South African investors who wish to diversify their portfolios can also access funds from certain other offshore fund providers via the same platform.
Life pooled portfolios	The minimum investment per client is R20 million. Mandates include risk-profiled pooled portfolios: Stable Portfolio, Balanced Portfolio and Absolute Portfolio; asset class pooled portfolios: Money Market, Equity and Foreign, and finally an Optimal Portfolio. Institutional investments are currently restricted to existing investors only (except for foreign mandates).
Segregated portfolios	The minimum portfolio size is R500 million. Mandates are of a balanced or asset class specific nature. Portfolios can be managed on an absolute or relative risk basis. Institutional investments are currently restricted to existing investors only (except for foreign mandates).
Botswana	Allan Gray Botswana manages institutional portfolios on a segregated basis, and offers our range of nine South African unit trusts to individual investors.
Namibia	Allan Gray Namibia manages institutional portfolios on a segregated basis and the Allan Gray Namibia Investment Trust provides investment management for Namibian retirement funds in a pooled vehicle.
Swaziland	Allan Gray Swaziland manages institutional portfolios on a segregated basis.
Allan Gray Orbis Foundation	Allan Gray Orbis Foundation is a non-profit organisation that was established in 2005 as an education and development catalyst. It seeks to foster a next generation of high-impact leaders and entrepreneurs for the ultimate purpose of increased job creation in Southern Africa. The Foundation focuses on educational and experiential methods at the secondary and tertiary levels to realise the potential of bright young minds. Through its highly researched learning programmes, it intends equipping talented young individuals with the skills, attitudes and motivation to have significant future impact.
E^2	E^2 stands for 'excellence in entrepreneurship' and as a long-term capital fund its purpose is to provide substantial financing to entrepreneurs who are graduates of the Allan Gray Fellowship Programme. In addition, E^2 provides financing for social entrepreneurs who demonstrate exceptional leadership and creative initiative in the not-for-profit sectors.

* This product has unit trusts as its underlying investment option.

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