

22nd September 2008

Hi all

Crisis! What Which Crisis?

In the current volatile environment (economically and politically), a quick extraordinary note is warranted. I am sure you have been overwhelmed by media commentary on the current state of the world economy, as well as the political juggling within the ANC. AJM thought it may be prudent to put it in perspective to you as an investor.

Market sentiment, or the degree of confidence investors have in the markets, compounds the impact of news flow. When confidence abounds, bad news or risky strategies are ignored. Conversely, during negative sentiment, markets crash on any bad news, and hover on exceptional news. The US government has over the last 5 years shown its willingness to manage "situations", which has created excesses in various sectors, in this case borrowing, or more specifically mortgages. The sudden collapse of these excesses has redefined pessimism. The confident-boosting actions of the US Fed and Government of "we will fix" has thrown confidence into the midst of adversity, which is creating some confusion amongst investors.

That global central banks and governments have reacted as strongly as they have to prevent a complete collapse of the financial system generates a huge amount of confidence going forward. However, confusion results from not knowing what value we should be placing on a stock (the quantum of losses they still may incur as a result of the mortgage crisis). In addition, the sophisticated credit instruments seem to have affected more than just the financial sector, compounding this confusion.

On the political front, normal democratic process is not designed to be consistent, and thus uncertainty is already built into our emerging market environment. Activities leading up to our election in 2009 will only heighten uncertainty. However, as long as our Constitution is not in threat, normal political activity will remain robust, which is healthy.

Analytical Review

In this current financial crisis, it is worth reminding ourselves of the typical investor psychology that grips us when stock-markets decline. I have revisited this graphic (Chart 1) courtesy of Momentum Multi-Managers. It was originally produced in 2003 (when the stock market dropped 21% from Jan to 31 March). It shows the emotions investors go through as the markets change in cycle. We would all like to think that we are far smarter than the average, but investor psychology is sampled from the very brightest of the population (those that have vast amounts of money to invest). Investor psychology is backed up by statistics showing where money flows and when, and the consistent errors long-term-investors make confirm that irrational investment management is alive and well.

It is also very important to note that short-term directions of equity markets confuse the strategy of long-term investors. In a long-term slide in markets (remember the Didata share price), there are many supporters that believe the bottom has arrived at various levels along the way down. The Didata share price rallied from R44 – R57 and then again from R 31 - R40 on its way down from R 70 to R1.

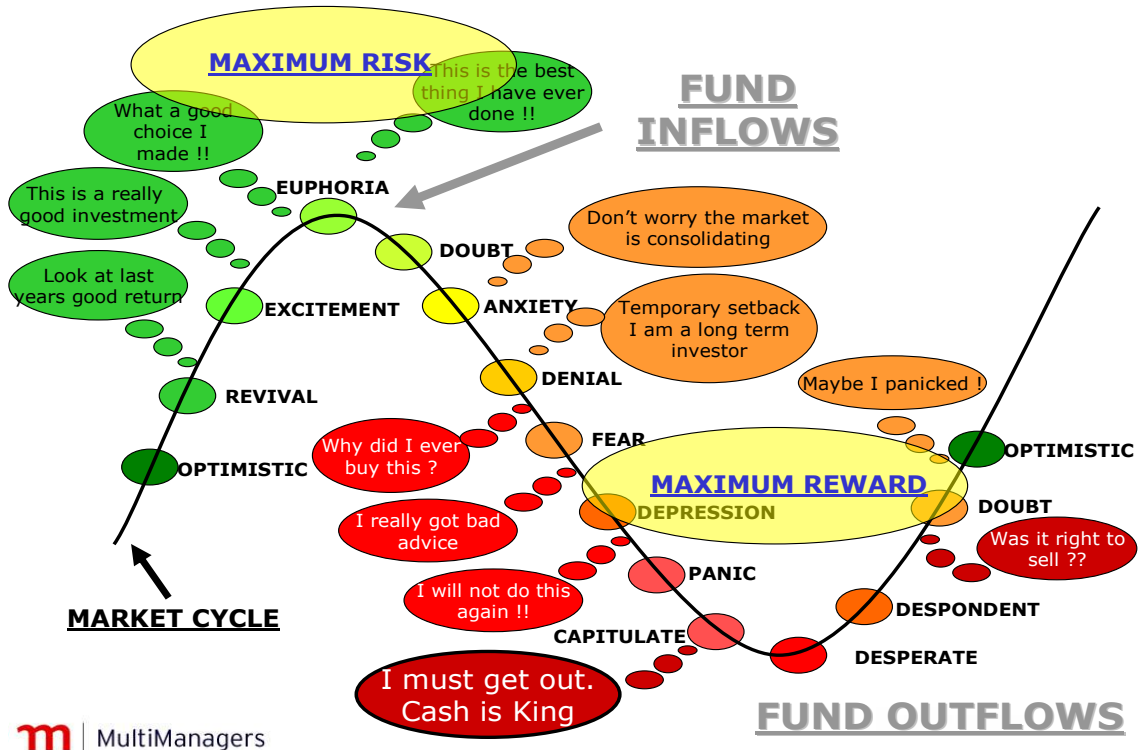


Chart 1. Investor emotions during equity cycles

Whether we are in the denial or desperate part of the economic cycle, it is very important to understand how we feel when the markets are as volatile as they are at present. When first world economies show daily changes of 5% (in differing directions, all in the same week), only prudent investors who understand their investment strategies make sensible investment decisions.

I would not like to hazard a guess as to where we are in this economic cycle. The facts are:

1. There is significant panic in the markets creating adverse short-term volatility
2. There is uncertainty as to the value of many companies (not being able to gauge the true exposure to the credit crisis, or whether companies can generate the profits they expect)
3. Credit has dried up completely (don't try borrowing money globally)
4. The housing market is still in a decline in most economies
5. There are still creatively packaged debt structures that need to be tested (structures with rebalancing interest rates)
6. Many company valuations are extremely attractive (low values to the earnings they are producing and are likely to produce in future)
7. Asian, Indian and African populations (those that do not borrow, but have increased earnings substantially as a result of the economic boom we have seen since 2003) are spending
8. Excesses have created other shortfalls, particularly in some commodities

Investment Strategy

Investors should understand the risk they are taking on their portfolio.

If you are taking an above-average risk in your portfolio (more than 70% in equity/high emerging markets/very overweight in one economy or sector), then you must accept that your portfolio could get worse before it gets better. If you are uncomfortable with this, you should be reviewing your portfolio to ensure that you are taking the appropriate amount of risk for your tolerance. This may require minor adjustments to asset allocation. It will be vital to review and learn from investment decision you made during 2006/07.

If you have a moderate risk strategy and are concerned about sustaining more losses, it may be unwise to reduce equity exposure at the moment. It may be prudent to ensure that your equity exposure is diverse. If it is, leave as is, and trust your investment time horizon. If not, it may be worthwhile to review investment decisions made during 2006/07 to assist in making better decisions in the future.

If you have a low risk strategy (less than 40% in equity), you may wish to rebalance your portfolio slightly (increase equity exposure up to your benchmark), but as a conservative investor it is more than likely that the best strategy would be to wait for more clarity on the end of the financial crisis (when housing prices start to stabilise and rise again).

If you are an investor who reduced exposure when equities were expensive, it may be a very good time to start rebalancing your portfolio to your target asset allocation. You would however need to confirm that you are a long-term investor and that further equity slides will only create more buying opportunities.

In my next review, I will discuss the indicators that I weight more heavily to determine the risk in markets. Suffice to say that the current indicators do not suggest an imminent return to optimism. However, with many indicators at record lows, it does suggest that there is only a moderate risk of further significant losses.

As always, please contact me if you would like to discuss your portfolio, especially if you are uncertain as to the risk you are taking with your investments. There is no copyright on these reports, so you are most welcome to forward this document to friends and family.

Kind regards

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