GRAYISSUE

# One of the keys to long-term wealth creation is preserving capital

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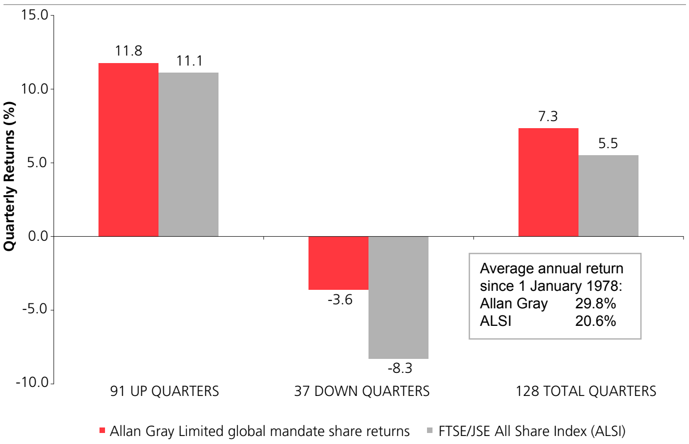
At Allan Gray we do not aim for short-term outperformance; our entire investment philosophy and process is centred on producing superior performance over the long term at lower-than-average risk of loss. Long-term performance is made up of a series of quarters, all adding up to produce the final return for a particular period. When looking at the investment performance of a fund, it is important to examine not only its performance during periods in which the stock market produced positive returns ('up quarters'), but also the extent to which it was able to preserve capital during periods in which the stock market produced negative returns ('down quarters'). Using Allan Gray's track record of share returns for institutional clients (which goes back to 1978, **Graph 1**) we see that our institutional clients earned an average quarterly return of 11.8% versus the FTSE/JSE All Share Index (ALSI) return of 11.1% during the 'up quarters'. In the 37 'down quarters' our clients suffered an average quarterly return of -3.6% versus the ALSI return of -8.3%. The net result for our clients has been an average annual equity return of 30% over 32 years, against the ALSI's annual return of 21%. Preserving capital in bear markets or 'down quarters' has been an essential contributor to our long-term performance track record.

**GRAPH 1** Average quarterly share returns for the Allan Gray Limited global mandate (before fees)




*Source: Allan Gray research*

## Putting short-term performance into perspective

These averages are useful to illustrate how relative performance is positively impacted by the ability to limit the declines during 'down quarters', but they hide the fact that during both up and down periods there are periods in which the portfolio outperforms or underperforms the market. Note that the portfolio did not outperform the ALSI for all of the 91 'up quarters', only on average. In fact it only beat the ALSI during 58 of the 91 'up quarters'. However, out of the 37 'down quarters' it outperformed the ALSI 29 times (i.e. the market declines were greater than those of the portfolio during 29 of these 'down quarters'). The implication is that in producing superior long-term performance, the portfolio experienced many quarters in which it underperformed the market, and those periods of relative underperformance were more likely to occur during periods in which the market was rising.

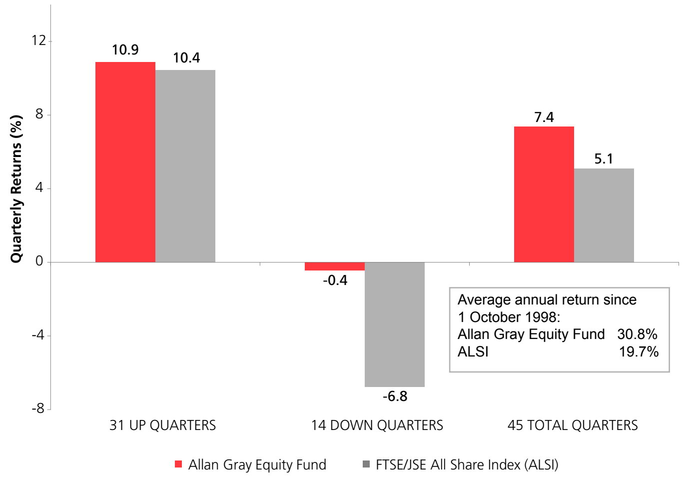
## The Allan Gray Equity Fund's returns tells a similar story

Looking back on the past 10 years, the Fund returned 22.1% per year for the decade, which amounts to a significant growth in the real purchasing power of investors' capital as the inflation rate averaged only about 6% per year over the same period. The Fund's benchmark, the ALSI returned 15.8%. However, over the last year the Fund returned 21.6% against the ALSI's 32.1%. In seeking the best relative value on the JSE, we often buy companies that are out of favour, and the composition of our portfolios may differ significantly from that of the benchmark index. Of course, this means that our short-term performance is likely to be different to that of the ALSI; and we will endure periods of underperformance. A recent example of this is the first two quarters of 2008, when we experienced underperformance, directly followed by three quarters of relative outperformance in a falling stock market.

## A track record of protecting capital

If we look at the long-term track record of the Fund, it is evident that a significant portion of its outperformance comes from protecting investors' capital during downturns in the market. As shown in **Graph 2**, the Fund has experienced 31 'up quarters' and 14 'down quarters' since inception to date. During the 31 'up quarters' it beat its benchmark 14 times (and underperformed it 17 times) resulting in an average quarterly performance of 10.9% against the ALSI's 10.4%. However, during the 14 'down quarters' it outperformed the ALSI for all 14 quarters with an average quarterly decline of only -0.4% against the ALSI's -6.8%.

**GRAPH 2** Average quarterly returns for the Allan Gray Equity Fund (after fees)




*Source: Allan Gray research*

## Contrarian approach

Investors are naturally concerned when they see their fund underperform the market in the short term. We would like to remind our investors that in pursuing long-term outperformance, we invest in stocks that are undervalued and which therefore offer the best prospects for long-term capital preservation. The resulting portfolio can differ markedly from the benchmark ALSI portfolio, which can lead to periods of short-term underperformance, such as for the 2009 calendar year, but we remain confident that it will translate into outperformance in the long term.

*Johan de Lange, Director Allan Gray Investor Services*

*Returns are calculated as at quarter-end 31 December 2009.*

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