GRAY ISSUE
LONG TERM COMMENTARY

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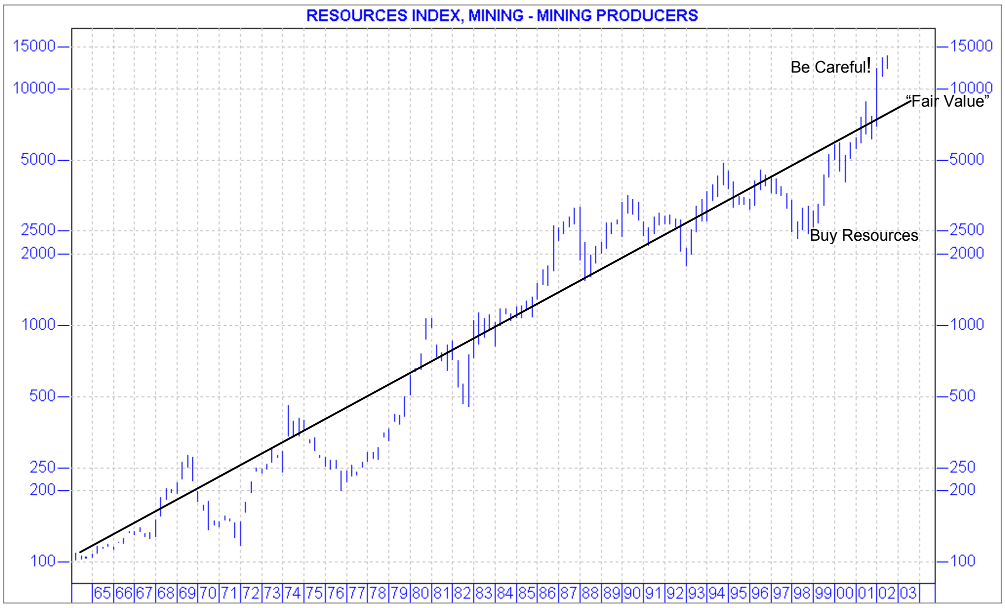
High risk should yield high reward. In investment markets, this is conventional wisdom. Experience over the past century supports this. Returns in the stockmarket have exceeded those in the money market by a substantial margin. The stockmarket investor did, however, experience the stockmarket crash of 1929 losing 89% of his/her capital, recovering only 30 years later; Japanese investors have lost 70% over the past 12 years.

Yet, we think that to simply equate high risk with high-expected return can be very misleading. During the Internet bubble of early 2000, many shares with no proven track record were trading at ten, twenty or more times their annual sales with no profit even on the distant horizon. At that point, the expectation of significant investment returns for a serious long-term investor was extremely low. The upside of even a best possible outcome was already discounted by the market. At the same time the downside, should there be any negative surprises, was enormous. The same was true about a large number of local "growth" shares in 1998.

On the other hand, at the same time De Beers, with its long proud track record, ownership of the world's best diamond mines, world-class brand and $4 billion of diamonds in the CSO vaults in London, was trading at less than the value of De Beers' investment in Anglo American shares. Anglo American itself traded at a 30% discount to its investments like Amplats, trading at R80 per share (currently R400). The upside for an investor at that point was huge given the potential for value unlocking through restructuring, large discounts and cheap prices of the underlying assets. And the risk was minimal given the underpin of the share price by assets other than diamonds.

So how does return and risk relate? The first viewpoint is correct that in order to get a return higher than that available in the money market, one has to accept some element of risk. That is why Allan Gray offers more than one fund. It gives our clients the ability to choose between various levels of short- to medium-term risk (of losing money) balanced by the opportunity of achieving long-term returns above those that are offered by riskless investments (money market).

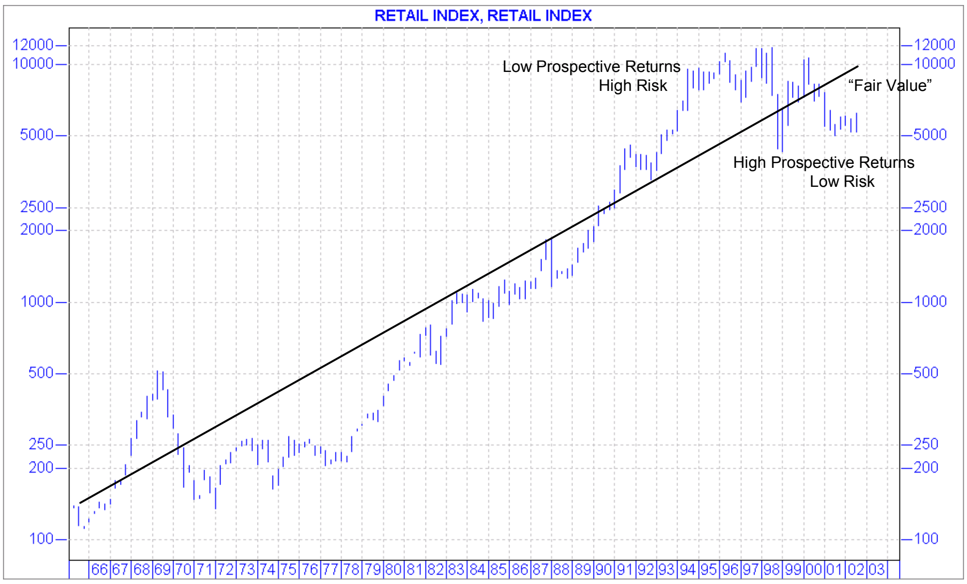


Source: I-Net Bridge

However, at the same time it is possible to achieve higher returns than the average, whilst taking less risk. The graph opposite shows the long-term history of the resources index. Note how the index always tends to come back towards its average or fair value as depicted by the line. Towards the latter half of the 1990's, resources were priced at a level where investors were exposed to very little downside, given the large gap to fair value. This was the period when De Beers offered the excellent value as discussed above. In addition, prospective returns were high given the scope for valuations to return to the average, plus the fact that dividend yields in the late 1990's were higher than most other investments. These were the returns experienced by resource investors (and your fund given our high historic resource weighting) over the past three years. But after the strong price rises, the resource market now offers relatively little value with significant risk.

On the other hand, the retail index offered investors high risk for poor prospective returns for most of the 1990's. At the moment, however, the price of retail shares is well below their true long-term value. The risk in these shares is now low given the fact that many trade below their tangible asset value, have a low Price/Earnings ratio and offer a high-income yield. Thus return prospects, if prices move back to fair value, are excellent. This explains our high level of investment in retail shares.

Commentary by Simon Marais, Chairman



Source: I-Net Bridge