



INVESTING FOR INDIVIDUALS

ALLAN GRAY

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# About Allan Gray

## What we do

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**We are an independent investment management company established to create long-term wealth for our investors**

Established in 1974, Allan Gray is a privately-owned Southern African investment management company. We focus on generating long-term wealth for our investors.

## Our approach to investment management

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**We take an integrated approach to managing investments**

We are an integrated investment company. We have a team of professionals performing investment management and research, trading, compliance, portfolio accounting, client service and investor administration within the same group.

## Our clients

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**We offer our services to both institutional and individual investors**

Our clients include individuals, retirement funds, insurance companies, trusts and foundations based throughout Southern Africa. In addition, many foreign institutions and individuals invest in Southern Africa through us.

## Independent financial advisers

Allan Gray is not authorised to and does not provide financial advice. However, we believe in the merits of independent impartial investment advice for those who lack the knowledge and skill to make their own investment decisions unaided. If investors are not comfortable making their own investment decisions, or do not have the time, we suggest they engage the services of an independent financial adviser (IFA).

### How we measure our success

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#### **Our success depends on how well we help you achieve your investment objectives**

The successful accomplishment of long-term wealth creation for our investors has led to us becoming South Africa's largest independent investment company. Our future success is dependent on our continuing ability to help you achieve your investment objectives.

### Our offices

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#### **We are Cape Town-based, but have a presence throughout South Africa**

We have offices in Johannesburg, Pretoria and Durban within South Africa. In addition there is an office in Windhoek, Namibia and Gaborone, Botswana.

### Access to a consistent global approach

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#### **We have an international partnership with the Bermuda-based Orbis Group**

Allan W B Gray founded both Allan Gray and Orbis. We share the same investment approach, commitment to long-term wealth creation and ethos. The relationship we have with Orbis extends to a sharing of global investment ideas, advice on and management of certain portfolios.

# What makes Allan Gray different?

## Our Guiding Principles

Since 1974 Allan Gray has adhered to a set of guiding principles, which may be categorised into two natural groups:

1. Those that guide our approach to investment: **Investment Guiding Principles**
2. Those that guide our business decisions: **Business Guiding Principles**

These principles have provided us with a consistent framework to help us to make the best decisions for our investors in a changing environment and over time.

## Investment guiding principles

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### We believe in active management

In the short term, share prices are affected by market psychology. Over the long term, we believe share prices are always determined by the economic progress of the underlying business. We believe that through discipline and patience we are able to exploit the investment opportunities this presents.

### We are committed to fundamental research

Our investment decisions are based on exhaustive, proprietary, fundamental research. We do not pay any attention to consensus opinions, our peer group or the investment benchmark when making investment decisions.

### Long-term orientation

We take a long-term investment view and do not try to forecast short-term events. We also do not believe in creating investment products that, in our opinion, hold little promise of long-term wealth creation.

### 'Bottom-up' investing

It is our experience that understanding companies and investing in them when they represent fundamental value is far more rewarding than trying to predict economic, political or share market trends. Fundamental value is the value a prudent businessman would place on a business. This involves detailed analysis of the business, its income, expenses, outlook, and positioning within its industry.

### Individual accountability

We believe that the best investment decisions are made by individuals and not by teams or committees.

### **Investment convictions always come before business considerations**

As an investment manager we focus on generating long-term performance, not on increasing our assets under management. We are also a fiercely independent private company, which means external factors, such as short-term shareholder interests, are minimised.

### **Total integrity**

Your trust in us is paramount. Trust is earned from unquestionable business ethics and honest, transparent communication – not promising what we cannot deliver.

### **Performance-driven**

Our business model and the way that we pay our team is designed to encourage excellence.

- Our performance-based investment management fees make our income more sensitive to long-term investment performance than the size of assets under management.
- Our senior executives are shareholders in the business. This aligns their long-term interests with yours.
- All other staff have a substantial portion of their remuneration in the form of performance-based bonuses.

### **Long-term orientation**

We try to establish long-term relationships with clients who believe in us and share our conviction in our investment approach. We offer an uncluttered range of products and services where we believe the application of our skills can add value and be enduring by nature.

# | What is our investment philosophy?

We try to buy businesses for less than they are worth

How do we determine how much a business is worth?

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**We focus on the value a prudent businessman would place on the business**

The intrinsic value is the value that a prudent businessman would pay for a business. We put ourselves in the shoes of a businessman who has to purchase 100% of the business and is unable to liquidate his investment on a daily basis on the stock market.

**This approach is different from just trading shares**

This mindset is very different from the average market participant buying a few shares in a business, hoping to sell these at a later date.

**The intrinsic value tells us whether a price of a share represents value for money**

We do not believe that the intrinsic value changes dramatically from one six-month period to the next. Rather, over time, value should increase by the steady growth of earnings, dividends and net assets. This focus equips us to evaluate whether the price of a share represents value for money.

**We look at business fundamentals such as sustainable profitability and long-term growth prospects**

The calculation looks at many factors. Any calculation of intrinsic value includes an estimate of a business' sustainable or normal profitability. In simple terms we ask ourselves whether the business is currently generating very high profits that it will be unable to sustain in less favourable conditions, or if profits are unsustainably low.

We then put this normal level of profits on an appropriate price earnings (PE) ratio given our view of the economics of the business. This would include an analysis of its competitive advantage, long-term growth prospects and management.

### The danger of basing investment decisions on market sentiment

In the listings boom of 1997-1998 small sized financial services companies (many with very short histories) were bid up to PE ratios of over 50.

The environment at the time was very beneficial to financial services companies, but the majority had no long-term sustainable competitive advantage and profitability was very high - ironically enough, partly because of the listings boom itself.

Yet sentiment at the time was very positive and the market justified the high ratings by extrapolating the recent earnings growth well into the future, no matter how ridiculous this seems with the benefit of hindsight.

### Share prices are driven by sentiment in the short term

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#### We pay little attention to short-term price movements

The price of a share at any given moment is a reflection of the attitude of all market participants towards its current and future prospects. Therefore, in the short term overly optimistic or overly pessimistic market participants can drive the price of a share away from its business value. For this reason, we pay little attention to short-term price movements.

#### The intrinsic value is often different to the share price of the business

This intrinsic value can (and often does) differ meaningfully from the value of the business as measured by its share price. It is important to realise that investing in a great company is no guarantee of great investment returns if the price paid is too high relative to the value of the business.

### The difference between long-term business value and the short-term share price creates investment opportunities

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#### The difference between the intrinsic value and the share price is what drives our investment decisions

Understanding the difference between the price the market places on a business and the long-term value of the business should drive all investment decisions. In other words we do not buy shares because we think they are going to go up - we try to buy businesses for less than they are worth.

**You pay more for what is popular**

Investing in popular shares or industries carries far less career or business risk for an asset manager. The result is that unpopular shares tend to outperform more 'popular' or 'sexy' shares over the long term. The popular shares of the time tend to command high prices relative to their business value. Owning them is also easier to justify to oneself and clients.

**Buying unpopular shares can be a lonely task**

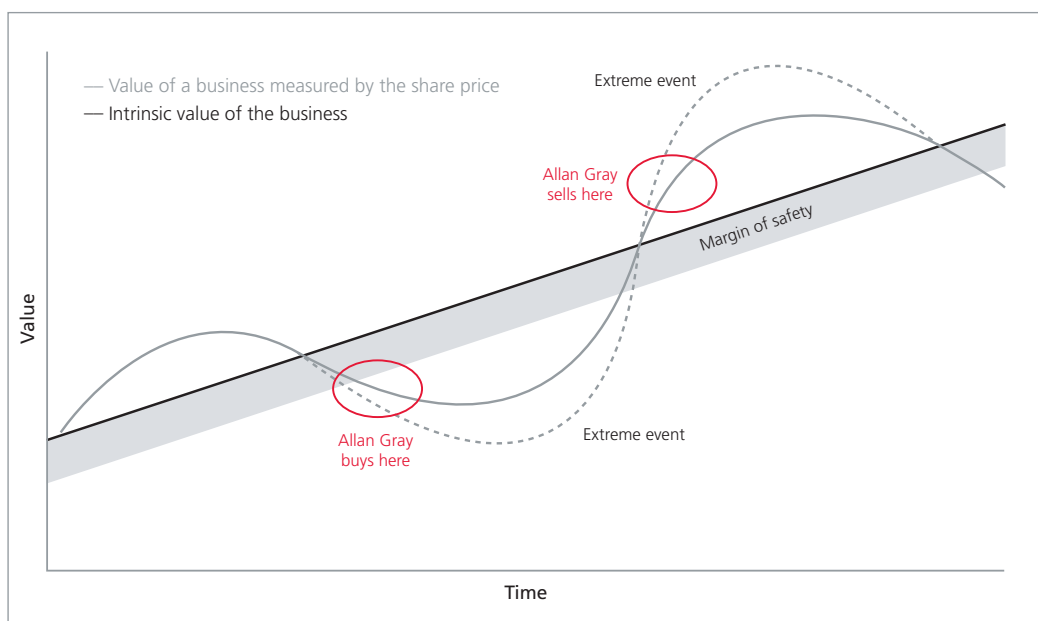
If a popular share turns out to be a poor investment it is comforting to point out that lots of other people owned the share too. Buying shares that are out of favour is often a very lonely task.

**The process is dynamic: we constantly value businesses and buy and sell shares**

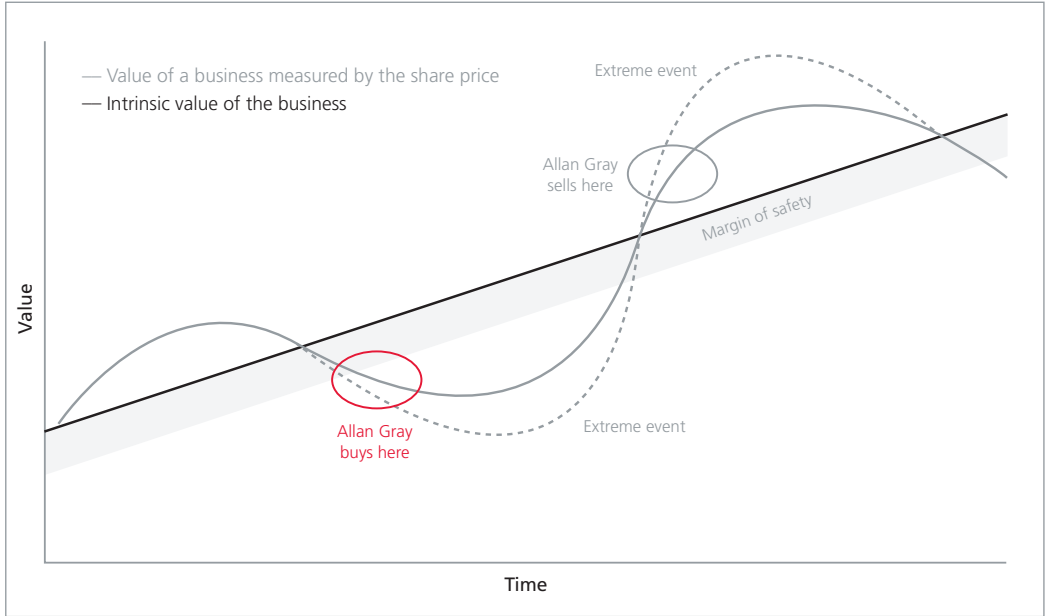
At any given point in time, different businesses will be trading at various discounts or premiums to intrinsic value. A typical Allan Gray portfolio in normal times will include shares that we are buying as the price declines and selling shares which are at or near intrinsic value.

## Our investment philosophy

At the core of our investment philosophy, we simply use our analysis of the fundamentals of a business to determine its intrinsic or underlying value or worth. We then compare this with the price the market places on this (the share price). If we can buy the shares of the business for a lower price than we believe they are worth, we will do so.



## When do we buy shares?



## We buy shares early

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### Buying shares early allows us to invest at an attractive price

When buying shares that are unfashionable one tends to buy 'early'. This is 'early' because the price may continue to decline. In other words we buy before the 'bottom'. This is good for the long-term investor. It allows us to buy shares at attractive prices from others who may be discouraged by the negative news at the time and who may want to get out of the share as soon as possible. Eventually, once all these shareholders have liquidated their positions, the share price starts to rise towards intrinsic business value. This happens as improvements in the fundamentals become more apparent to the market. At this point, once the value of the shares is more broadly recognised, it is more difficult to build an attractively priced position.

## We buy shares with a 'margin of safety' to help minimise capital loss

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### When the share price is well below intrinsic value a margin of safety exists

By investing in a business when its share price is well below its intrinsic value we are offered some protection should things turn out worse than we forecast (i.e. a 'margin of safety' exists).

### The margin of safety compensates for the uncertainty of the future

We try to always buy shares that offer us a margin of safety. We do this because any valuation of a business contains assumptions about the future. We do not have a crystal ball and so the future often does not work out the way we expected or wanted.

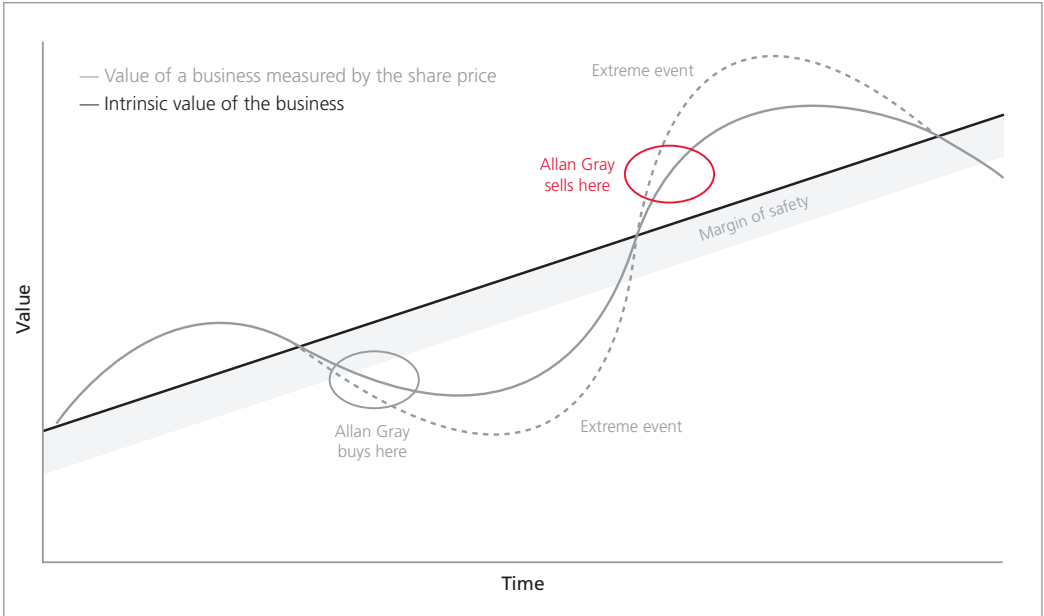
### The margin of safety helps minimise capital loss

Since we do not get it right every time, by purchasing with a margin of safety we would hope to minimise or avoid the loss of capital. The only loss suffered would be the missed opportunity to invest in shares whose intrinsic value continued to grow over the holding period.

### The benefits of buying shares with a margin of safety

A case study that demonstrates the benefit of having a margin of safety is our purchases of Comparex and African Merchant Bank that were both trading at what appeared to be very large discounts to intrinsic value with significant asset backing. The future turned out somewhat worse than what we had forecast but in both cases the entry price was low enough to get our investors' money back in nominal terms.

## When do we sell shares?



## We sell shares once they reach intrinsic value to reduce risk of capital loss

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### **We sell shares when the market price equals the business value**

We sell shares when the intrinsic or underlying value approximates the share price. At this stage, the market has recognised the business value and bid up the share price and the share performs in line with its fundamentals.

### **We avoid the risk of capital loss involved in speculative momentum investing**

Positive sentiment and momentum often inflate the share price well in excess of business value. Whilst sometimes it is tempting to ride this momentum, we view this as speculation not investment. Market participants are buying a share for more than it is worth in the hope of selling it to someone else at a higher price. This strategy can be successful, sometimes spectacularly so, but sooner or later the share prices fall back to the underlying business value resulting in a permanent loss of capital.

### **We aim to sell at fair value – which may cause short-term relative underperformance**

By selling the share at fair value we do not expose our investors to risk of permanent capital loss that can often occur. We would rather reinvest the proceeds from the sale in another share trading at a discount to business value. This implies that it is possible that we will periodically underperform in the short term.

### **Selling shares once they reach intrinsic value reduces risk of capital loss**

The significant price rise in IT shares such as Dimension Data from 1998 to 2000 caused a period of short-term relative underperformance on our portfolios as we did not own them. The subsequent sharp decline in price to business value took place as estimated. We managed to prevent capital loss for our investors, at the expense of short-term performance.

## When is Allan Gray likely to underperform?

When prices move to extremes this may cause short-term underperformance

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### **Allan Gray is likely to underperform when prices are extreme**

When the market is irrational and share prices move to extremes, shares that appear attractive continue to fall in price and expensive shares continue to rise. Our history shows that Allan Gray is likely to underperform over the short term during these periods as prices move to extremes.

### **Selling shares that are rising in price while buying shares that are falling in price is rational, but difficult to implement**

This makes sense, as we would be simultaneously selling shares that are rising in price and buying those that are falling. Whilst this appears to be a rational strategy it is psychologically very difficult to implement. Investors are often more comfortable buying shares when prices are high and rising and selling when prices are low and falling.

### **Remaining disciplined during market extremes positions us well for future long-term performance**

It is difficult to own unpopular shares that continue to fall in price in sympathy with unfavourable short-term prospects. This is however, when we get most excited as we know we are able to accumulate shares that are being sold at prices that will deliver exceptional future returns.

## The benefits of a long-term view

Over time, prices correct and revert to fair value

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### **Long-term returns are rarely generated in a straight line**

When we analyse a possible investment we look at the return we expect the investment to generate over a four-year period, and compare that to other alternatives, such as the returns on putting the money in the bank. If the expected return is attractive we will buy the share without trying to time the entry point by attempting to predict the short-term movements in the share price. The expected return thus rarely comes in a straight consistent line.

### **The inefficiency of the market in the short term creates long-term opportunities**

If we have done our work correctly, the long-term return should be attractive. In other words, we believe the market is not efficient at pricing shares in the short term, but that over the long term the share price will reflect the underlying business value.

# The importance of investment discipline

It is crucial to stick to one's investment philosophy, to create wealth over the long term

In 2000 and 2001 domestically-focused industrial businesses had dropped to valuations that, in hindsight, were probably a once-in-a-decade buying opportunity. The market was extremely pessimistic about the domestic economic outlook at the time. The rand had weakened significantly to over 13 to the dollar and interest rates had been raised in response.

The weak rand boosted sentiment towards rand hedges, in particular commodity shares, as this was expected to boost future earnings. At the same time, sentiment was against local industrial companies due to the poor short-term earnings outlook, partly driven by the (in hindsight once-off) perceived impact of new industries such as casinos, cell phones and the impact of AIDS on profitability.

Our analysis at the time indicated that profitability for industrial companies such as Foschini, Edgars and Tiger Brands was unsustainably low and that on a normalised basis the intrinsic value of the shares was well above the level that the share prices were trading. We purchased many shares in many of these companies for our investors' portfolios and continued to avoid most of the large resource shares that we believed were trading well above their intrinsic value.

The shares' prices continued to move towards relative extremes, with Anglo American and Billiton both rising over 70% in the last three months of 2001. Consumer shares continued to decline or were at best flat. Amazingly enough, companies with strong consumer franchises such as Woolworths, Foschini and Edgars eventually traded near or below the value of their debtors' book and the net cash on their balance sheet. The market was placing very little value on their ability to operate as successful going concerns, despite their long histories of doing so.

The result was that Allan Gray did not own the shares that appeared to be rising in value, and did own the shares that appeared to be dropping in value. In overall performance terms, this is a double blow over the short term. This created a period of sharp relative short-term underperformance. In fact it was one of the worst quarters in Allan Gray's history in terms of relative performance!

But, in sticking to the philosophy in spite of this short-term underperformance, the eventual convergence of share price and business value resulted in significant outperformance in 2002. Anglo American's share price only achieved a similar level four years later whilst many of the industrial shares rose to multiples of their lows.

# Your investment decisions

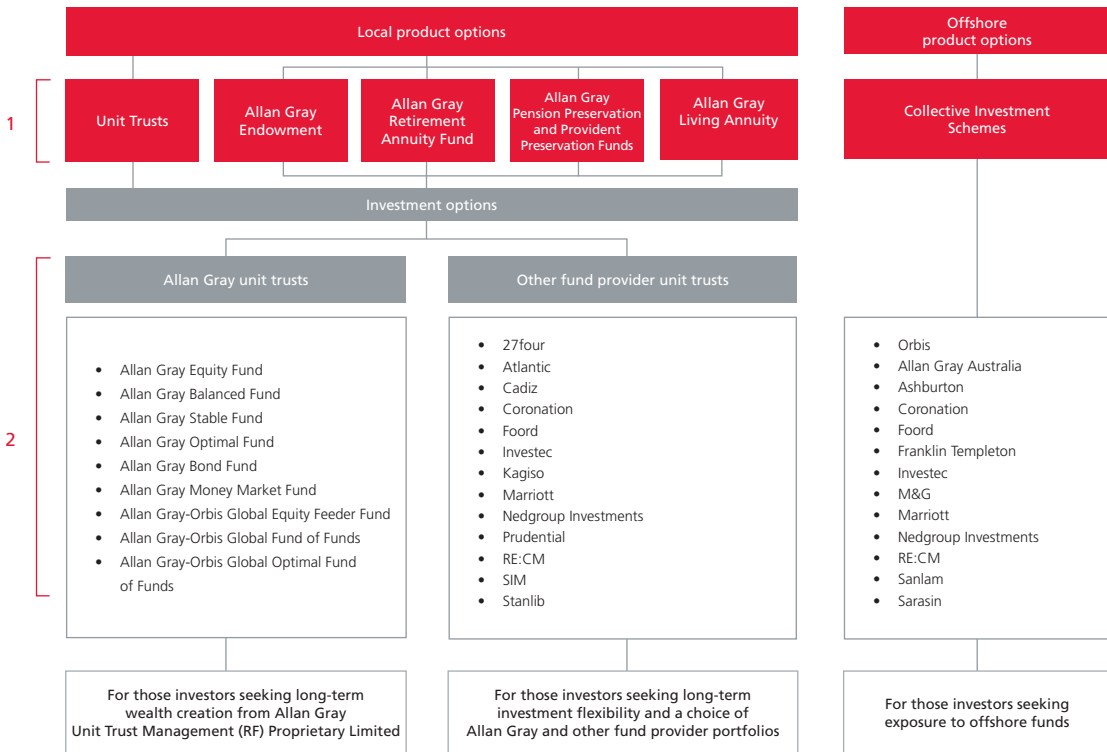
When you invest with Allan Gray, there are two decisions to make:

## 1. Deciding on which product may be appropriate to your circumstances

In line with our business principles and philosophy, the Allan Gray Investor Services product range has been designed to offer practical and uncomplicated investment solutions that are transparent and flexible.

## 2. Selecting the underlying fund/s into which you wish your money to be invested

Investors may choose to invest in a range of Allan Gray unit trusts and unit trusts from other fund providers available on the Allan Gray investment platform, or a range of offshore funds.



## Making investment decisions can be a complicated task

If you are not comfortable making your own investment decisions, or do not have the time, engage the services of an independent financial adviser. Using a financial adviser is an effective way to overcome a lack of investment knowledge, or to recognise that you may not have enough time to be a diligent investor whilst managing all the other pressures of life.

The best advisers are independent and will help you take a holistic approach to your investment by considering your other sources of income, your other investments and your specific investment needs. They will provide a combination of investment advice, retirement planning, estate planning and tax advice. Like fund managers, financial advisers should be chosen carefully and word-of-mouth recommendations generally work best.

# The benefits of investing with Allan Gray

## Excellent investment track record

Since its establishment in 1974, Allan Gray has consistently achieved superior returns at lower-than-average risk of loss. Our performance track record has been achieved by consistently applying a simple, clearly defined investment philosophy based on sound business principles. We pride ourselves on the quality of our in-house fundamental research, which is acknowledged to be the most rigorous in the industry.

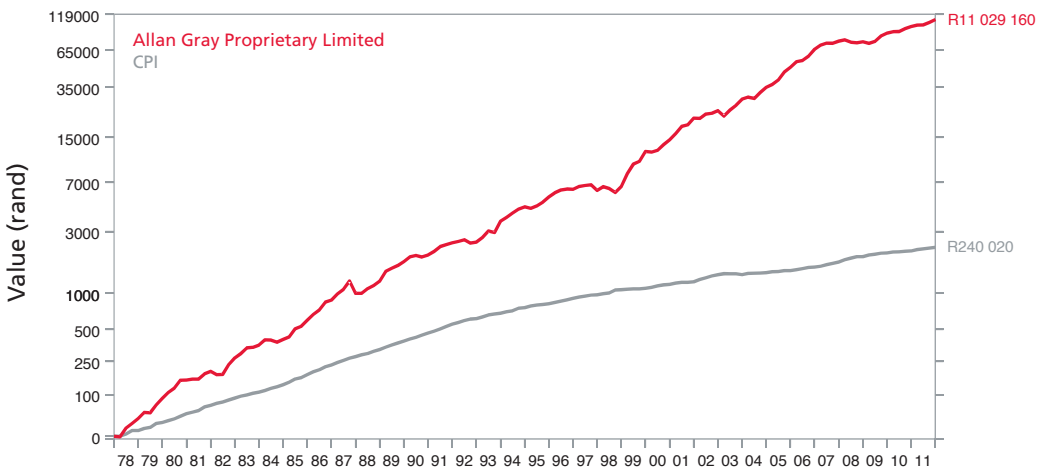
## Value for money

Our core source of income is a performance-related investment management fee charged on assets under management. We aim to provide our investors with superior performance after deducting our investment management fee.

## Simplicity of choice

We provide access to an uncomplicated range of unit trusts designed to enable you to easily select an underlying fund to suit your risk profile.

Allan Gray Proprietary Limited equity returns relative to the Consumer Price Index (CPI)  
1 January 1978 – 31 December 2011



Present value of R10 000 invested on 01/01/1978

**R11 029 160**

R240 020

Annualised performance from 01/01/1978 to 31/12/2011

**22.9 %**

9.8%

Source: I-Net Bridge, as calculated by Allan Gray Proprietary Limited as at 31 December 2011

# | What you can expect from Allan Gray

## Transparency

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All fees are fully disclosed and we will keep you regularly informed on all aspects of your investment.

## Flexibility

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You may switch between the unit trusts at any time at no cost.

## Trust

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Your trust in us is paramount. We aim to earn and retain your trust through unquestionable business ethics and honest communication.

## Freedom

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You may transfer your investment to any other approved product, at no cost or penalty subject to prevailing legislation.

## Prompt service

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We take great pride in providing an efficient, personalised service, which we continually strive to improve.

# | Contact details

Please contact your independent financial adviser if you have any questions. Alternatively, our contact details are below.

Allan Gray Client Service Centre:

Tel: 0860 000 654 or 021 415 2301

Fax: 0860 000 655 or 021 415 2492

Email: [info@allangray.co.za](mailto:info@allangray.co.za)

Website: [www.allangray.co.za](http://www.allangray.co.za)

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The Allan Gray Retirement Annuity Fund, the Allan Gray Pension Preservation Fund and the Allan Gray Provident Preservation Fund are all administered by Allan Gray Investment Services Proprietary Limited, an authorised administrative financial services provider. The Allan Gray Living Annuity and Allan Gray Endowment Policy are both underwritten by Allan Gray Life Limited, an authorised financial services provider.

The underlying investment options of the Allan Gray individual life and retirement products are unit trusts.

Collective Investment Schemes (unit trusts) are generally medium- to long- term investments. The value of participatory interest (units) may go down as well as up. Past performance is not necessarily a guide to the future. Unit trust prices are calculated on a net asset value basis, which, for money market funds, is the total book value of all assets in the portfolio divided by the number of units in issue. The Allan Gray Money Market Fund aims to maintain a constant price of 100 cents per unit. The total return to the investor is primarily made up of interest received but may also include any gain or loss made on any particular instrument held. In most cases this will have the effect of increasing or decreasing the daily yield, but in some cases, for example in the event of a default on the part of an issuer of any instrument held by the fund, it can have the effect of a capital loss. Such losses will be borne by the Allan Gray Money Market Fund and its investors and in order to maintain a constant price of 100 cents per unit, investors' unit holdings will be reduced to the extent of such losses. Fluctuations or movements in exchange rates may also be the cause of the value of underlying international investments going up or down. Unit trusts are traded at ruling prices. Commissions and incentives may be paid and if so, would be included in the overall costs. Different classes of units apply to the Allan Gray Equity, Balanced, Stable and Optimal Funds only and are subject to different fees and charges. A detailed schedule of fees and charges and maximum commissions is available on request from the company. Forward pricing is used. A fund of funds unit trust may only invest in other unit trusts, which levy their own charges, that could result in a higher fee structure for these portfolios. A feeder fund is a unit trust fund that, apart from assets in liquid form, consists solely of units in a single portfolio of a collective investment scheme. All of the unit trusts except the Allan Gray Money Market Fund may be capped at any time in order for them to be managed in accordance with their mandates. Allan Gray Unit Trust Management (RF) Proprietary Limited is a member of the Association for Savings & Investment SA (ASISA). Allan Gray Proprietary Limited, an authorised financial services provider, is the appointed investment manager of Allan Gray Unit Trust Management (RF) Proprietary Limited.