Jonathan Brodie

Trevor Black

TURMOIL REIGNS IN THE MARKETS. WHAT SHOULD I DO NEXT?

EXECUTIVE SUMMARY: With the events of the recent past in mind, Jonathan Brodie and Trevor Black, from our offshore partner Orbis, deliver some insights on making investment decisions. They note that successful long-term investment performance requires a partnership: your investment manager needs to have an effective approach to enable it to outperform markets, and you and/or your advisers need to ensure that you do not react inappropriately to short-term factors. Together this partnership can build long-term value.

Much has been written about the turmoil which has engulfed world financial markets for the past 18 months. Rather than a post-mortem, or an attempt at forecasting outcomes, we thought it might be helpful to address a more focused question: given the events of the recent past, how should a long-term investor react?

By describing what we at Orbis are doing, we hope to provide some guidance on how to answer this question.

Increased exposure to technology companies

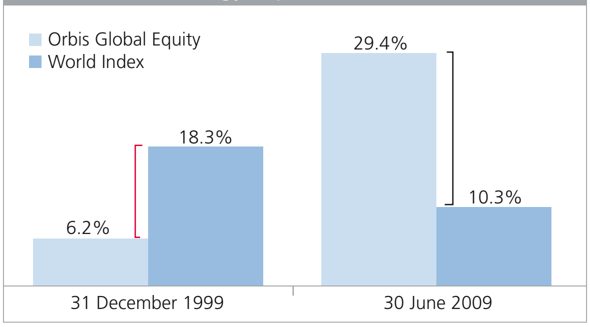
We currently have a significant exposure to technology companies. This is a marked shift from the end of 1999, the peak of the technology, media and telecommunications (TMT) bubble. At the time, we wrote in our annual report:

'Your Fund has very little invested in technology shares. This does not reflect scepticism regarding the wonderful potential of technological developments such as the internet.'

Back then we were concerned about the very high valuation and prices the market was paying for these businesses. Ten years later, we find that the information technology (IT) industry is more mature. Spending money on core IT is now central to all organisations. Company valuations are supported by real cash flows, while in the bubble they were largely speculative.

We find a number of technology companies attractive as a direct result of applying our existing philosophy to bottom-up stock picking. Each of our holdings appeals to us because of the specific business characteristics involved. The reason for the cluster in the technology area is a response – we think reasoned and consistent – to the opportunity set which the market now offers us.

GRAPH 1 Technology exposure - then and now



Source: Orbis research

In some cases, such as Microsoft and Samsung, we see solid businesses meeting our criteria for valuable franchises with attractive margins of safety. Google appeals to us as it has a strong competitive position, but the stock has been sold off indiscriminately. And then there are companies where an adverse market cycle has allowed us to buy long-term winners at a discount, particularly in the semi-conductor industry, which accounts for about 10% of our portfolio.

The point here is that while we have changed our weighting in technology stocks from what we held in 1999 in response to developments in those businesses, there has been no change in the rigour of our bottom-up analysis or in our investment philosophy. And because we have high conviction in our analysis and our philosophy, we are able to withstand short-term price movements and ultimately to behave logically at times when it has been extremely hard for global investors to do so.

This point is as relevant for investors in our funds as it is for ourselves – investors do not always stay invested for long enough to enjoy the benefits of our approach, and their investments do not always perform as well as the funds in which they have invested. This is because the returns experienced by the investor depend not only on the returns generated by the manager, but also on the time and timing of the investor's holding in the fund.

How should you respond to recent turmoil in the markets?

There are three key determinants of the returns which investors experience over time: the performance of markets, the performance of the manager, and the behaviour of the investor in timing his or her exposure to their chosen investment managers.

> "By chasing recent winners, investors make allocation decisions between funds by looking in the rear-view mirror ..."

1. Do not give up on equities

We at Orbis claim little expertise in predicting overall market returns. However, we do not agree with those who believe they should give up on the stock market entirely. It is true that the FTSE World Market Index declined over 50% from its 2007 peak to the trough earlier this year, and it is also the case that, since the inception of our funds in 1990, the Average Global Equity Fund has failed to outperform US dollar bank deposits – a fact which is particularly sobering.

Nevertheless, we are of the opinion that the long-term outlook for global equities is more attractive than bonds or cash, particularly in the face of a potential rise in inflation in coming years. If stocks offer a dividend yield of 2.5%, real long-term earnings growth is about 1% (in line with long-term normalised performance), and assuming no significant change in valuation levels (markets currently trade at about the mid-point of their long-term ranges), then stocks generally offer sound, if not remarkable, long-term value.

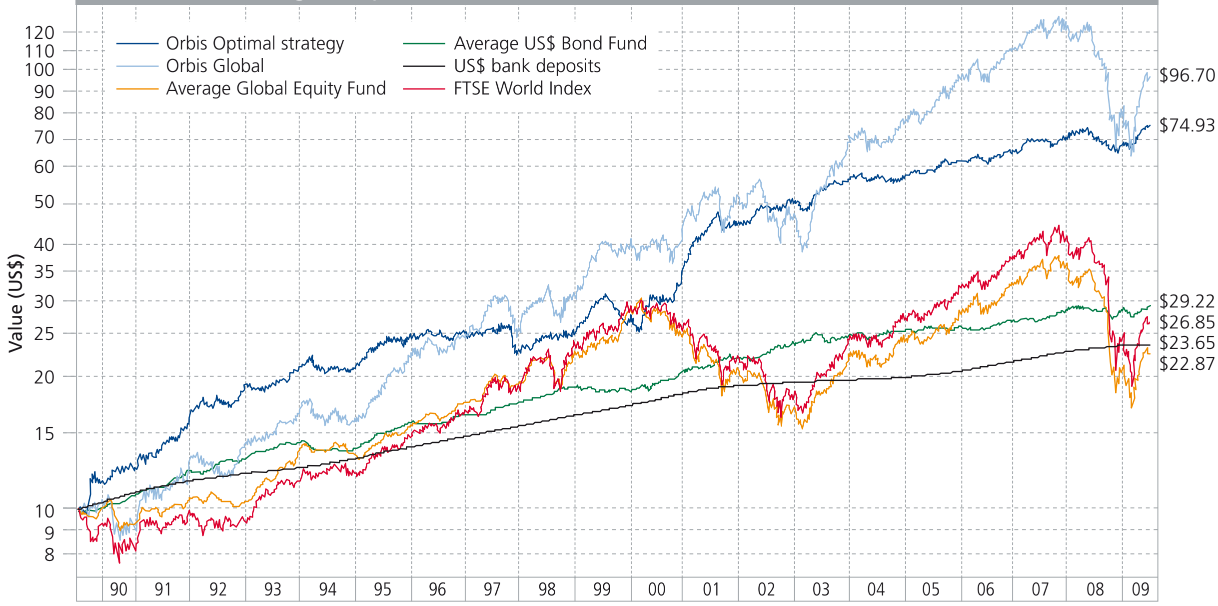
2. Choose a manager very carefully...

Turning from the market in general to managers in particular, the unfortunate reality is that over the long term, the average money manager adds little value. As indicated in **Graph 2**, the average Global Equity Fund has underperformed the market index. At Orbis, we have been fortunate to outperform over the long term – although not every year. We remind investors that outperformance does not come in a straight line.

3. ...and do not switch around

A troubling observation is that, for all long-term periods, the

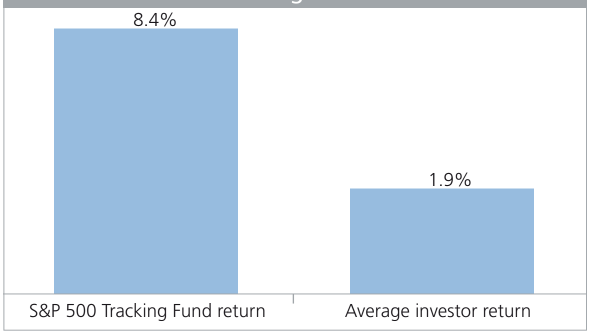
GRAPH 2 Orbis long-term performance versus the market (to 30 June 2009)



Source: FTSE World Index data source: FTSE International Limited.
Average Fund data source: ©2009 Morningstar Inc. All rights reserved.

average investor has continuously lagged the performance of the funds in which he or she was invested. By chasing recent winners, investors make allocation decisions between funds by looking in the rear-view mirror and are engaged in a systematic process of buying high and selling low. The ensuing performance gap can be wide, as shown in **Graph 3**, which highlights the impact of ill-timed shifts between funds.[1]

GRAPH 3 The cost of using the rear-view mirror



Source: Quantitative Analysis of Investor Behaviour, 2009, DALBAR Inc.

[1] Johan de Lange covered this subject is some detail in the previous issue of Quarterly Commentary in his piece 'How long is long-term? Setting reasonable goals'. (You can also read this piece on our website, www.allangray.co.za under the 'Latest news' tab.)

The investment performance partnership

One might conclude from the above discussion that we advocate not making any shifts in response to significant market changes. However, the real point is that we believe that responses to short-term price changes are generally ill-advised unless they are based on analysis and philosophy. Investors should understand the underlying philosophy and process which their managers use so that they are equipped to withstand short-term volatility and to avoid switching around inappropriately. It is this same emphasis on philosophy and process which led us to make what we believe is a sensible shift within the portfolio towards technology companies and to hold both our 1999 and current positions with conviction.

Long-term investment success requires a partnership. Investment management needs to have an effective approach to enable it to outperform markets and, critically, investors and their advisers need to ensure that they do not react inappropriately to market moves. Both the investment manager and the investor need to commit to a strategic philosophy and an established approach. Together, this partnership can build long-term value.

Richard Carter

HOW CAN YOU IMPROVE YOUR INVESTMENT RETURNS?

EXECUTIVE SUMMARY: Richard Carter highlights the gap that exists between the return you get as an investor and the actual returns generated by Allan Gray's funds. He explains the cause of this and suggests some ways to improve the returns you get out of your investment.

The difference between the returns you get from your investment and the actual fund returns

The returns of the fund are the returns generated by the portfolio managers over a period of time. The returns you actually get as an investor depend on your participation in the fund:

- How much and when you invest
- How long you remain invested
- When you disinvest

For example, if you invested R1 000 in the Allan Gray Equity Fund in the very first week that the Fund was launched (10 years ago) and kept it there, your return would be the same as the 'since inception' returns reported in our literature. If, however, you had invested R500 at the start of the Fund and a further R500 at the beginning of this year, your return would have been much less than the Fund returns over the same period.

The example below illustrates the potential difference between fund returns and investor returns:

Context

The Allan Gray Equity Fund produced a return of 35.21% for the three-year period shown in the table below:

	Fund performance
2005	50.03%
2006	43.47%
2007	14.83%
3-year return	35.21%

Scenario

Now assume that three different investors (Investor A, Investor B and Investor C) invested the same amount in total, and were invested in the Allan Gray Equity Fund over the same three years, but made their investments at different times according to the table below. The table shows that each investor's returns vary significantly both from each other and from the Fund return.

	Investor A	Investor B	Investor C
Total investment	R30 000	R30 000	R30 000
When they invest and when they take their money out	At the start of: 2005 invested R10 000 2006 invested R10 000 2007 invested R10 000	At the start of: 2005 invested R30 000	At the start of: 2005 invested R30 000 2007 withdrew R30 000
Investor return	**30.92%**	**35.21%**	**39.6%**

Investor B would have received the same return as the Fund (35.21%), having adopted a 'buy and hold' approach to his/her investment for the entire three years. Investor C could have achieved a better return than the Fund by taking his/her initial R30 000 out of the investment (excluding growth on the investment in the previous two years) at the start of 2007. This, on the face of it, looks appealing – but evidence shows that timing not only fund performance but also market performance is very difficult to do.

We measure our success by the wealth we build for our investors, not just our fund returns

Because investor returns are a function of the decisions they take as well as those our investment team take, we have only done half our job by ensuring that our funds deliver outperformance. We also need to consider the difference between fund returns and investor returns as a measure of how successful we have been at encouraging investors to remain invested for long enough to benefit from our investment approach. A fund may perform well but if it has no investors in it or if they are in the fund for too short a time to benefit from our approach, little wealth is created.

Your investing behaviour can increase or reduce the gap between your returns and fund returns

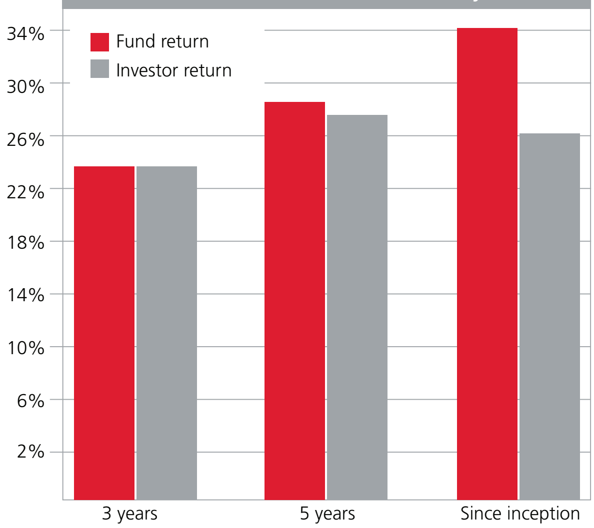
Aside from educating investors and communicating the benefits of a long-term, buy and hold approach to investing, we have little control over when investors invest or for how long they hold their investments. In fact we think that it is essential that we do not have control and that our clients have the freedom to disinvest at any time and without penalty. The degree to which your investing behaviour is aligned with our long-term philosophy will define how big or how small the gap is between the Fund's returns and your own returns.

Are we creating wealth for investors over the long term?

It is tempting for confident investors to switch between different funds in the belief that they can 'time' performance and generate better returns than staying in their current fund. While there are undoubtedly examples of this, they are few and far between and experience has shown that 'timing' fund performance is extraordinarily difficult to do, perhaps even more so than 'timing' markets – something even investment professionals find challenging.

Part of this experience is shown in **Graph 1** below, and in **Graph 2** on page 13, where you can see the Fund returns compared with the average investor returns for the Allan Gray Equity Fund and Allan Gray Balanced Fund over various time periods.

GRAPH 1 Allan Gray Equity Fund annualised returns to 31 July 2008



Source: Allan Gray research

The statistical calculation behind fund returns (time-weighted returns) and investor returns (money-weighted returns)

The difference between an investor's returns and the actual fund returns is the difference between what is referred to as 'time-weighted returns' and 'money-weighted returns'.

Fund returns (time-weighted returns)

When calculating 'time-weighted returns', the size and timing of cash flows in and out of the fund do not really matter. This calculation applies the same weighting to the returns over every period and provides the single rate of investment return which is equal to the actual fund returns over time.

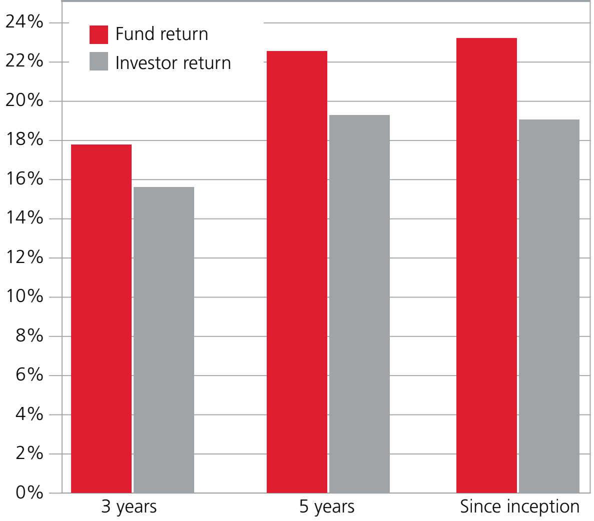
We report time-weighted returns in our documentation.

Investor returns (money-weighted returns)

'Money-weighted returns' are a much more accurate measure of actual investor returns. They take into account when the investment is made, how long that investment is held and when the returns are generated. This calculation takes the size and timing of these 'cash flows' into account.

Each investor may have a different return depending on their own pattern of investments. For the purposes of this article we are looking at the average investor returns for all investors invested in the funds.

GRAPH 2 Allan Gray Balanced Fund annualised returns to 31 July 2008



Source: Allan Gray research

It is encouraging that the average investor in the Allan Gray Equity Fund has done more or less as well as the Fund over the last five years. Indeed, in the five-year period to the end of July 2008 investors in the Allan Gray Equity Fund received 0.96% per year less than the return the Fund generated. However, the average investor in the Fund holds the Fund for only around three years, which in our view is not long enough to benefit consistently from the Fund's performance. Evidence of this is the large gap in the 'since inception' returns, showing that investors have missed out on a significant amount of performance generated by the Fund.

> "Investors … will keep the rewards of our investment approach only if they stay invested for long enough."

Over the same five-year period, investors in the Allan Gray Balanced Fund missed out on a 3.3% performance per year. This is significant and we are concerned that in spite of achieving a benchmark-beating performance, we are not creating the same level of long-term wealth for the average Balanced Fund investor. This is particularly disappointing for us when we consider that when investors choose the Allan Gray Balanced Fund, they are delegating not only the underlying share or security selection, but also the asset allocation decision (or how much is invested in equities, bonds, cash and offshore). Investors who believe in our ability to make these decisions on their behalf will keep the rewards of our investment approach only if they stay invested for long enough.

The pattern is similar for all our funds. Over most periods, investor returns have underperformed the Fund returns by a few percentage points. This may not sound like a lot but, over a five-year period, a few percentage points each year can make a significant difference.

More volatile markets increase investor fears and the price to pay for irrational switching may be high

The difference between fund returns and investor returns is likely to increase during times when the market is very high, decreasing or very volatile. These extreme conditions unsettle investors and increase the number of emotive short-term investment decisions. In the example above, the figures being used were from a bull market or period of rising returns. Whether investors would stay the course in the context of the current volatility, market extremes and anticipated 'normalisation' of market returns remains to be seen.

American mutual fund investor experience is similar to ours

We have looked at two American research studies and found that in both instances, mutual fund investor experience is similar.

1. Morningstar research shows the difference between fund returns and investor returns

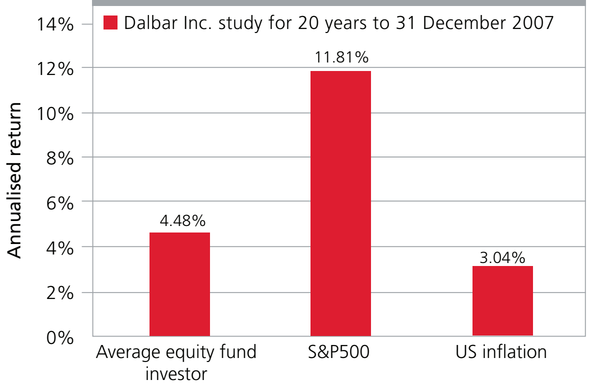
In 2006, Morningstar, a Chicago-based securities research firm, started to report mutual fund (unit trust) returns in a new way. The 'Morningstar Investor Return' gives a statistical measure of the price investors have paid for failing to be disciplined and patient by measuring the difference between fund returns and investor returns.

Morningstar research (as quoted in an article titled 'Investor return versus total return', 10 February 2006) indicates that for most mutual fund categories, fund returns and investor returns were fairly close together over the three-year and five-year periods to the end of September 2006. But the gap widened substantially over the trailing 10-year period. This may be likely because the 10-year period encompassed the late 90s bull run as well as the bear market, and both extremes tended to stimulate poor decision-making. In every diversified stock category and most sector categories, funds' 10-year investor returns lagged their total returns. The divergence was, in several cases, quite striking. For example, technology sector funds over the period on average generated total returns of 6.4% but investors lost an average of 4.2% on an annualised basis over the period. It was a similar story for growth funds which generally posted 10-year investor returns that fell far short of their total returns. The same was true for communications and health-care funds.

2. The average equity fund investor seeking to out-perform the S&P index did not achieve this goal

In a different research study by financial services research company Dalbar Inc. it was found that, on average, equity fund investors undermined their ability to create wealth through chasing past performance, switching funds and trying to time the market. As you can see in **Graph 3** below, this behaviour manifested itself in very poor returns relative to the S&P index, barely outperforming inflation.

GRAPH 3 Average equity fund investor annualised returns versus inflation



Source: Dalbar Inc.

We are committed to help you achieve the highest possible return on your investment

If you do not benefit from our long-term investment performance, we believe we will have failed in our mission to create long-term wealth for our investors. We are committed to helping our investors achieve the same performance as our funds. Below are some of the specific ways that we can do this:

1. Continue to educate and inform our investors about our approach

Our investment approach is long-term in nature. If you believe in this approach and want to benefit from it, it is important that you understand it, buy into it and remain disciplined in spite of short-term fluctuations. We will continue to emphasise the importance of taking a long-term view to investing.

2. We will not market or 'sell' funds based on short-term performance

The danger of chasing past performance is well documented. It leads to investors undermining their own investment returns through frequent switching and taking a very short-term view. Aggressive fund-specific performance advertising hypes the fear among investors of 'missing out', causes investors to switch funds more frequently and undermines the returns they get from their investment.

3. Publish an investor return for your accounts

We plan to publish your investor return per account (also known as an 'internal rate of return') on the secure area of our website. It will enable you to analyse the actual return you are getting from your investment accounts over various periods. This can be quite different from the fund return of your chosen funds, but you are able to influence this by your investment behaviour.

4. Continue to offer a simple and manageable range of funds

We realise that investing is complicated enough. We have tried to simplify this for you by maintaining a small range of funds that we aim to make as easy to understand as possible. This range includes enough choice to meet investor needs without unnecessary complexity. We will not launch funds for the sake of doing so – and therefore hope to lessen the confusion that investors may experience in the face of 'marketing hype' about new and 'better' funds.

There may be times when it is appropriate for you to disinvest or switch funds, but this depends on your personal circumstances and portfolio. Some investors are sufficiently knowledgeable, confident and disciplined to make these kind of decisions on their own. However, if you require guidance in considering your investment plan holistically, an independent adviser may be able to help you to meet your objectives and grow your wealth. They provide expertise and are able to reassure you during times of market volatility, helping you maintain the level of investment discipline you need to meet your goals.