

THINGS ARE LOOKING UP!

In past issues of the *GrayIssue* we highlighted the significant disparities in valuations within our market, and that we believe the best value is currently in South African industrial shares. These disparities create opportunities for long-term investors like Allan Gray to position their portfolios thus providing the prospect of superior future returns. We are currently experiencing such a period.

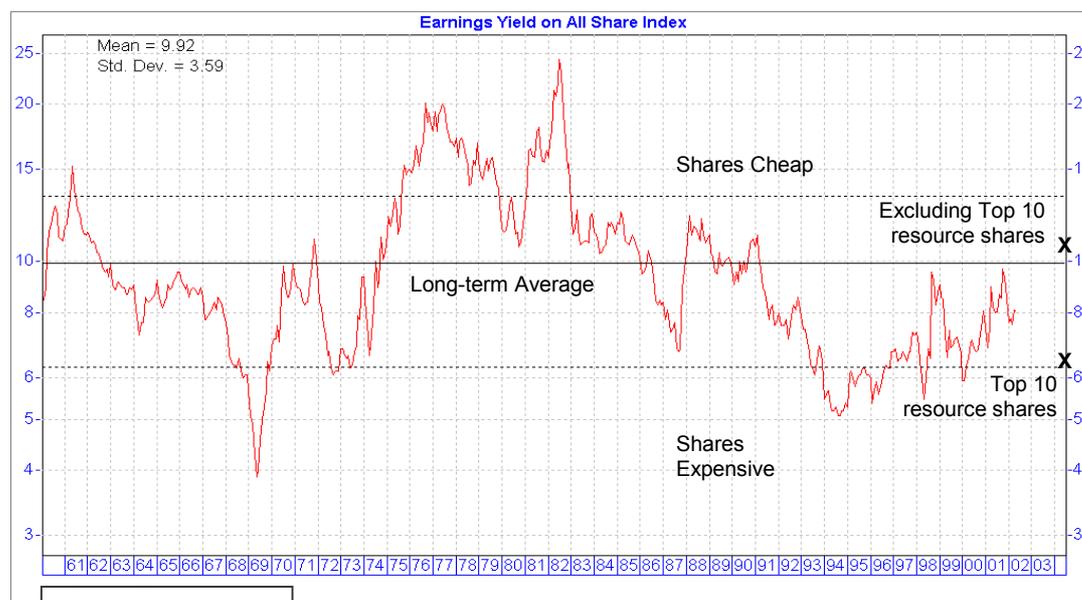
At present the overall South African stockmarket does not offer much value. The 8.0% All Share Index earnings yield is not particularly attractive in comparison to the after tax return on the South African 10-year government bond of 8.3%. Neither is it particularly attractive in relation to the historic earnings yield offered by the South African stockmarket. This may dissuade investors from making investments in South African equities. However, while the overall market as represented by the All Share Index is currently near its all time high, this masks the significant opportunities available to investors.

The table below reflects the earnings yield of the All Share Index (ALSI) and the earnings yield of the ALSI if one had to exclude the largest 10 resource shares.

All Share Index earnings yield	8.0%
Top 10 resource shares earnings yield	6.1%
All Share Index earnings yield (excluding Top 10 resource shares)	11.1%
After tax yield on South African 10-year bond (tax rate at 30%)	8.3%
Yield on South African 10-year bond	11.9%
Tax at 30% tax rate	3.6%

The largest 10 resource shares constitute 45% of the ALSI. On average, they trade at a 6.1% earnings yield (Price Earnings Ratio of 19). Excluding these shares, the rest of the market is trading on an 11.1% earnings yield (Price Earnings Ratio of 9). Clearly therefore the large resource shares appear very fully priced and the undervalued opportunities appear to be in the rest of the market.

Currently, the historic earnings of South African industrial companies are low. Not only are earnings depressed after a weak domestic economy but also the pricing power of industrial companies has been significantly enhanced by the depreciation of the Rand, which should have a material benefit to future earnings. The relatively high earnings yield and current low level of earnings, with the prospects for strong earnings growth, make South African industrial shares a very attractive investment prospect.



Therefore despite the lack of value inherent in the overall market, there remain opportunities for superior long-term returns in South African equities.