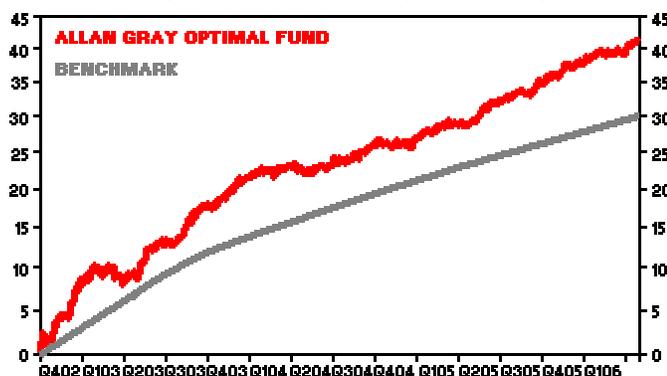


The Allan Gray Optimal Fund: For returns uncorrelated with equity markets

The Allan Gray Optimal Fund was launched on 1 September 2002, over three and a half years ago, and is targeted at investors with a long-term investment horizon who are risk-averse and seeking to minimize exposure to the inherent volatility of the stockmarket. The Optimal Fund is best described as a long-term absolute return fund or a hedged (as opposed to a 'hedge') fund. In essence, the Fund seeks to capture a portion of the returns generated by Allan Gray's stock selection without exposing investors to the level of volatility they would typically experience in a pure equity fund.

The since inception performance of the Allan Gray Optimal Fund (AGOF) as well as its benchmark is reflected in the graph to the right (1 September 2002 to 30 April 2006). AGOF delivered a 40.8% cumulative unannualised return since inception, comfortably ahead of the benchmark (FirstRand daily call rate) of 30.1%.

Cumulative performance from inception to 30 April 2006



In order to refresh investors' understanding on how they should expect the Fund to perform over long periods of time, it is worthwhile to revisit the Fund's construction and also therefore its sources of return. The Optimal Fund invests in a portfolio of shares that is specifically constructed to capture a reasonable portion of Allan Gray's equity alpha (out/underperformance) versus the average manager over a period of time. At the same time, the risk inherent in the overall stockmarket is hedged out by selling stock index futures. The overall return that the Optimal Fund delivers therefore comprises 2 components, namely:

1. The return on cash (that is implicit in the pricing of the sold futures contracts) plus or minus
2. The out/underperformance of the Fund's share portfolio versus that of the Index – the alpha.

While the return on cash is generally more certain, a key variable in the likely performance of AGOF is Allan Gray's overall ability to pick stocks that will outperform the average manager and therefore deliver positive alpha. Over very short periods of time it is impossible to gauge which way alpha will go. Particularly when asset prices are generally high and disparity within the stockmarket is generally low, the opportunity to deliver alpha in the short-term is often reduced. In the current market, we are finding that while the high overall level of asset prices means that margins of safety across investments has declined, our bottom-up fundamental research is still uncovering certain investments that we believe will outperform the stockmarket over the long-term, thereby delivering positive alpha for our clients over this time.

Despite the significant run in equity markets we have experienced since the market bottomed in April 2003, it appears that many investors' appetites for equity-only exposure remains high. As with all types of investments, it is impossible to determine when exactly the perfect time is to invest in a particular asset class or investment. The same is true for the Optimal Fund. In times of strong equity markets, the Optimal Fund, with its very low net equity exposure, will naturally produce an overall absolute return far lower than the overall stockmarket or a pure equity fund. However, when equity markets are high and therefore the possibility of negative returns from equities is also high, the Optimal Fund should continue to deliver an absolute return, thereby outperforming overall equities during such a bear market. This is essentially due to the fact that the Optimal Fund is designed to deliver a return that is *uncorrelated* to the stockmarket over long periods of time.

While the overall stockmarket (ALSI) is off its all-time high recorded in early May 2006, it is still trading at a very high absolute level, trading on a historic price earnings ratio of 16x, well above the market's long-term average of 11.5x. In this current environment of considerably increased volatility and increasing risk of capital loss from overall equity markets, we believe the Optimal Fund's potential to deliver long-term absolute returns is a particularly attractive one.

Commentary by Delphine Govender, Portfolio Manager and Director of Allan Gray Limited