HOW DO WE CREATE WEALTH IN THE CURRENT CYCLE?

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RETURNS ARE TEMPORARY FROM HERE

How do we create wealth from this point forward in the current cycle? Before answering this question that faces all clients today, it's important to understand the current market conditions.

We believe this is best explained by the testimony of Adolph Miller, former Federal Reserve member, before the US senate in 1931. He was testifying about the Fed's 1927 interest rate cuts and acceleration of open market purchases, which fuelled the speculation and low quality credit expansion that culminated in the 1929 stock market peak and then collapse.

"It was the greatest and boldest operation ever undertaken by the Federal Reserve System, and, in my judgment, **resulted in one of the most costly errors** committed by it or any banking system in the last 75 years. ... **Business could not use and was not asking for increased money at that time."**

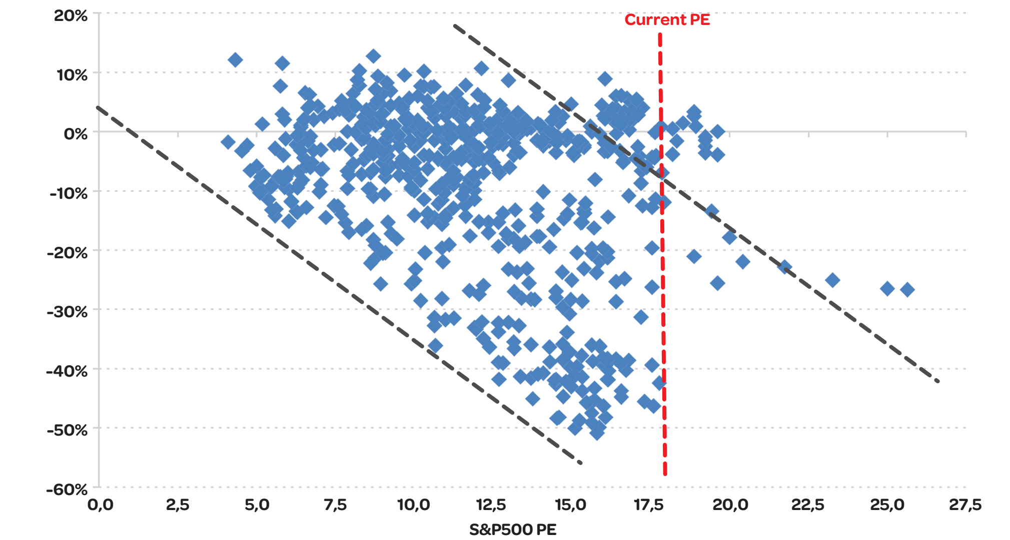
In simple terms, Miller was saying if consumers or business are not demanding money yet central banks flood them with excessive money, this leads to a misallocation of capital. Both investors and businesses allocate their wealth to any asset giving them a better return than zero. This misallocation results in excessive risk taking and the creation of asset price bubbles.

All too often investment discussions move away from the simple principal at the heart of a good investment decision: how do you create real wealth for your clients over a cycle? A client's age or when they need their wealth is only relevant to the degree of excessive risk one is prepared to take to generate that real wealth. Whether a client is 20 or 82 the simple goal is real wealth creation.

ARE WE IN A BUBBLE...?

Setting aside the technical debates about what defines an asset bubble, we look at the risk of a loss of wealth for clients over the next part of the cycle. We don't attempt to forecast the market; we simply look at what the risks are to clients' wealth if they are invested in the current set of market conditions. Historically, we have seen that deep losses of clients' wealth occur when the market is expensive, as illustrated in the graph below. It shows that investing in the market at the current valuation level historically has resulted in a loss of more than half of the clients' wealth within the next three years. So, for example, you can see that at single digit price: earnings ratios (PEs) the biggest loss a client suffered historically was less than 20%, while investing in the market at PEs above 15, losses historically have reached above 50%.

S&P500 PE VS. DEEPEST SUBSEQUENT 3-YEAR LOSS

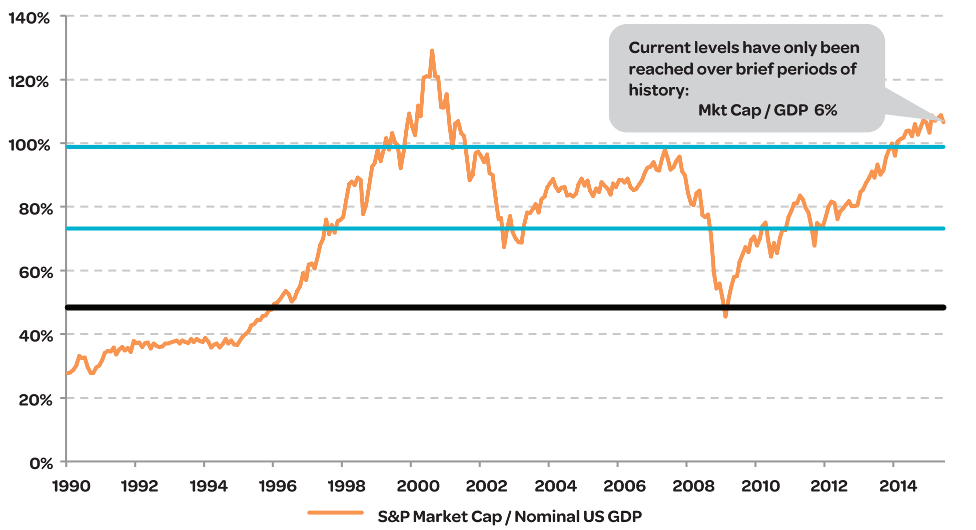


Focused Investing
STANLIB

To be absolutely clear regarding our view, **we believe this is an equity bubble and a highly advanced one.** The equity market is above the 1972, 1987 and 2007 market levels and has only been higher in the final periods leading up to the 2000 Tech Bubble. This can be measured on a variety of metrics, each with their pros and cons. The normalised PE (Shiller PE), Tobin's Q or simply an old Warren Buffet favourite of market capitalisation over GDP, all say the same thing: we have only been at these levels less than 10% of the time (as seen in the graph below).

In addition to buying the market on extremely elevated levels, an investor today would be buying an extremely over-valued market on peak margins too – an extremely toxic mix when thinking about real wealth creation for clients. We prefer to invest based on sound principles that align to our clients' real wealth creation as opposed to hope. Returns from here are, in our opinion, temporary.

MARKET CAPITALISATION OVER GDP



CURRENT PSYCHOLOGY OF THE MARKET

A zero interest rate policy drives strong emotional behaviour. Investors are willing to take risk, no matter how extreme, in order to avoid the discomfort of holding cash. This normal emotional behaviour has historically resulted in poor investment decisions and makes it difficult to generate real wealth for clients over the second part of the cycle.

We are constantly engaging with investors who are trying to justify the market levels based on the fact markets have been higher before and that low interest rates justify higher valuation levels. All that low rates do is bring forward the returns that you would experience over the cycle. Low rates do not mean perpetual higher returns, they mean we have already experienced them as they have been brought forward and from here we can expect, at best, lower returns for the next part of the cycle. The current valuations assume interest rates would be very low for at least a decade.

Low rates in practice mean excessive risk taking and a misallocation of capital. This is evident in the number of margin accounts in China and the US markets today and the excessive issuance of high yield debt by corporate America.

In our view equity market returns from here on are temporary in nature. Based on current market conditions we have no evidence on which to accept market risk at this point and therefore will not take market risk.

IT'S NOT JUST EQUITIES; YOU HAVE TO THINK ABOUT BONDS AS WELL

We are of the view that more than ever before investors need to be aware of the level of all asset classes at this point in the cycle. One of the benefits of investing into a multi-asset portfolio is that when one asset class, equity in this case, suffers a loss an alternative asset class, for example bonds, provides protection to your overall investment. This is one of the benefits of asset class diversification.

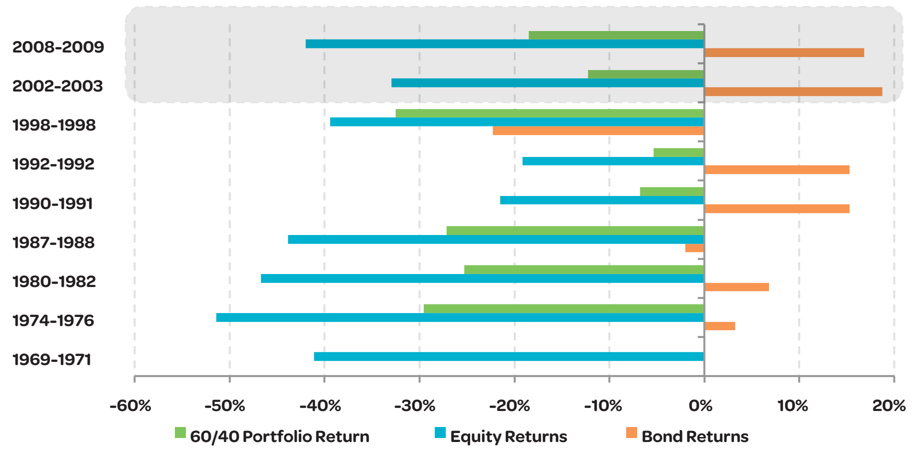
As with all asset classes the starting valuation is important. This is evident in the graph on the next page, which shows a theoretical 60/40 (equities/bonds) balanced portfolio would have protected clients' wealth in 2008 when the equity market declined 42%.

At the time bonds protected clients' wealth by delivering a 17% return for investors over the same time period. Bonds thereby mitigated clients' loss of wealth by more than half of what it could have been. Interestingly this was even more evident in the 2002/3 market correction.

However, to generate the capital returns in bonds evident in the previous cycles, two important components are necessary: the starting yield needs to be high and inflation needs to be high. This means that by the end of the cycle inflation and yields have declined, generating large capital returns for bond holders. These ingredients are not in place at the moment as both starting yields and inflation are low.

We think it is even more important, given the high equity market levels and the limited impact of the bond protection, to reduce our equity allocation to protect capital for our clients based on experiences of previous cycles.

SA MARKET

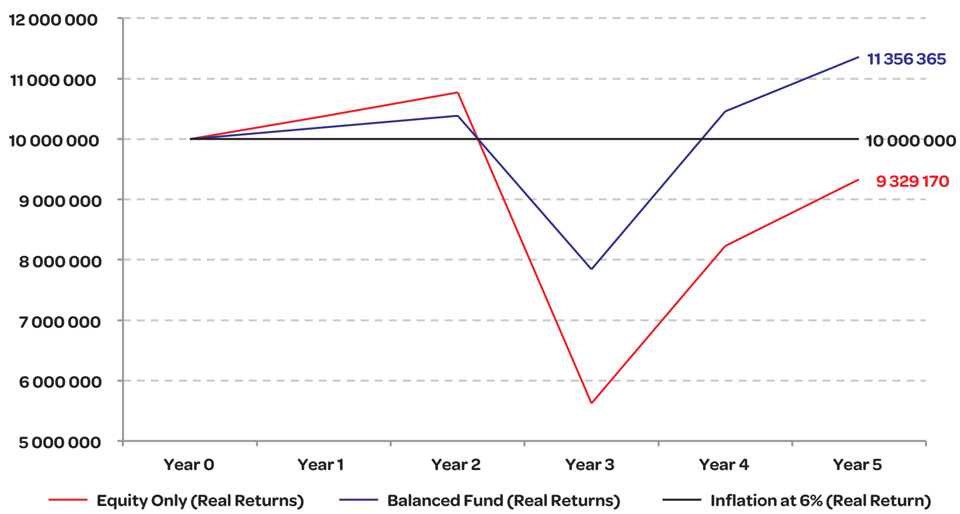


The way we think about clients' real wealth creation can be illustrated by a simple example as indicated below. If a client invested R10 million today in an equity fund (red line) and the market gave returns of 10% per annum for the next 2 years and then suffered a drawdown in year 3, even with the traditional strong rebound in the market post the correction, the client would be worse off over the full 5 year period.

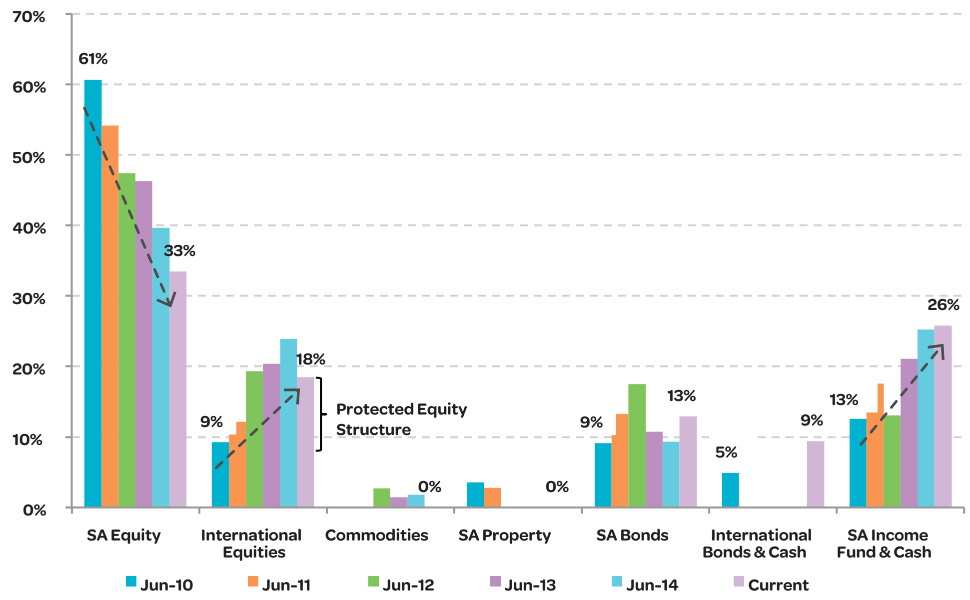
This simplistically illustrates our view that to generate real wealth over the next leg of the cycle, clients' require asset allocation positions that protect their wealth during a drawdown.

It is not important if clients do not participate in the full equity returns, as returns are temporary from here until a correction takes place. In the event that you believe that our view is wrong, we would put forward that returns from here are asymmetrical in nature, with limited upside and significant risk of a material loss of clients' wealth.

GENERATING REAL WEALTH OVER CLIENTS CYCLES



RISK PROFILE OF OUR BALANCED FUNDS



WHY STANLIB?

We have lowered the risk profile of our Balanced Funds by reducing our equity exposure in favour of high yielding income earning products, effectively moving down the risk curve on an absolute and relative basis.

When we look back at history we don't expect clients will regret the path we have chosen by the time we complete the cycle. There are enough managers willing to provide you with market risk from here – we are not one of them. We are positioned to create long-term wealth for our clients – not to try to squeeze out the next bit of marginal returns to move up a ranking table. STANLIB balanced funds are positioned differently to peers and our focus remains on doing what is right for our clients.

STANLIB BALANCED FUNDS ARE POSITIONED DIFFERENTLY TO PEERS AND OUR FOCUS REMAINS ON DOING WHAT IS RIGHT FOR OUR CLIENTS.