

Monthly Commentary – February 2009 (and incorporating a few days of March 2009)

Bonds

Our long held view that: domestic bond yields were too low, the yield curve was too inverted and that certain credit spreads would stabilise at high levels proved valuable to our fixed income holdings in February. As yields rose, the yield curve normalised and spreads steadied, short bonds returned +0.4% and long bonds lost 5.0%. However, we still don't see great value in long bonds. We estimate that for current yields on 10 year bonds to ultimately be vindicated, South African inflation will need to average less than 3% over the next 10 years. That strikes us as highly improbable. Even with the once-off fillip from the revised methodology for calculating CPI, the maiden CPI release under the new system was 8.1%.

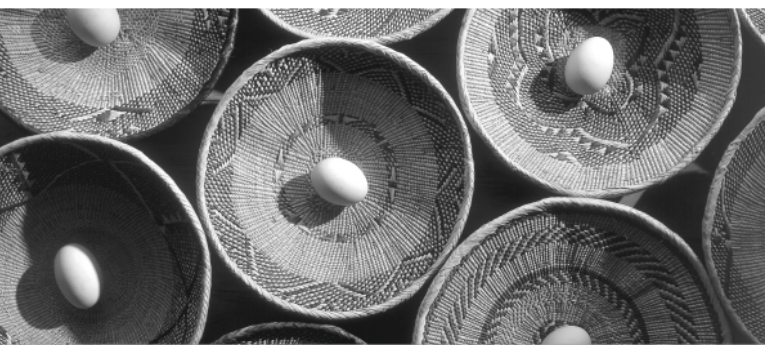
Equities

February brought us another bout of early promise - the market was up 5% at one point, before falling 14% from there to finish down nearly 10%. Using PE as a valuation metric, the All Share finished February at a new low since the creation of the "New South Africa". The PE was last this low in February 1988.

Among significant contributors to the most recent sharp falls were index heavyweights (actually, erstwhile index heavyweights) Anglo American and Old Mutual. Both recently reported financial year-end results to December 2008, and the boards of both elected to cut their dividends. In the case of the much longer-listed Anglo American, it was the first dividend cut since 1939!

The famous Modigliani-Miller theorem holds, as its most important corollary, that a firm's dividend policy does not matter. The rough idea is that a shareholder can generate a dividend income to his liking by merely making incremental sales, in the absence of capital gains tax at any rate. This discovery in modern finance helped Franco Modigliani to win the 1985 Nobel Prize. If he were still alive, we would be intrigued to hear his views on the market's reactions to Anglo American and Old Mutual's announcements: The former's share price promptly lost 16% and the latter's 13%. So much then for the "capital structure irrelevance principle".

Our belief is that Messrs Modigliani and Miller were correct in an academic sense, but may have graciously made the assumption that all listed companies were scrupulously honest (clearly untrue) and that markets did not embrace quite long-lived fashions. By the former we mean that we have long been concerned when (relatively easily manipulated) earnings growth announcements were not matched by (hard cash) dividend growth announcements. By way of example for the latter, one has only to look back nine or ten years, to a period when the markets were not only forgiving but actively supportive of no dividends in the vaunted "TMT" sector. The idea, especially popular with growth investors, was that these companies' managers had much better ideas of where to make new investments than did their shareholders. Of course, that proved a dreadful fallacy. By our calculations, the cumulative dividends paid by Dimension Data, for example, since the resumption of paying any dividends at all, in late 2006, as a percentage of the company's all time high market capitalisation, are a paltry 0.039%.



Clearly, the current fashion is to crave dividends. Yet, would this have been wise for Anglo American and Old Mutual right now? Ms Cynthia Carroll is cutting some 20,000 jobs across Anglo, is drastically cutting capital expenditure and in a refreshingly candid statement, has admitted to having no idea how much further commodities may fall. Mr Julian Roberts is obliged, under current circumstances, to maintain comfortable levels of capital, which he has assured shareholders is the case. So, how much sense would it make for these two companies to pander to transient shareholder whims, only to risk soon returning to the debt or equity markets for further capital? We think that although it is regrettable to have arrived at this juncture, both CEO's have acted prudently.

There are many ways to skin a cat, but the market's treatment of these companies' share prices has afforded a plethora of staggering valuation inferences. By ascribing only moderate valuations to certain components of their business empires, it can be shown that significant other parts are being priced at zero or below. Once this craziness passes, the upside could be tremendous.

At the time of writing, Old Mutual's market capitalisation was:
42% lower than Harmony's, half of ABSA's, 15% lower than Nedbank's (in which it owns a 53% stake), 88% lower than SAB Miller's, and about the same size as Shoprite's and Bidvest's. Are there still any proponents of the efficient market theory?

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Orthogonal Investments