



Monthly Commentary – March 2010

“Thus, although black swans on a daily basis are not all that rare, black swans on an annual basis have never occurred”.

Harry M. Markowitz, 2009.

Equities returned nearly 8% in March and miserable memories of 2008 are receding rapidly as the market is nearly back at its all time high. Sadly, and in accordance with historical norms, all too many investors hit the panic button near the low levels and moved out of equity markets into low yielding money and bond markets, thereby locking in losses and foregoing the 74% appreciation in equities since the low point on 20th November 2008. Harry Markowitz’s wisdom is not widely heeded.

SARB Governor Gill Marcus surprised the market by cutting the repo rate to 6.50%, its lowest level since 1981, thus tacitly confirming a market suspicion that the Bank has softened its rigid policy of purely targeting inflation, since there was scant justification to cut interest rates on that measure alone. Perhaps the strength of the rand, employment figures, GDP concerns and other issues now also weigh on the MPC. At least the inflation targeting regime was not abandoned, as the effects of such a rash decision would have raised questions regarding the MPC’s credibility.

Our favourite take on the interest rate cut was that 27 of the 28 economists polled got it wrong.

The equity market correctly appreciated Ms Marcus’s modest gift. In our humble and frequently fallible view, the bond market misread the implications, as it also strengthened on the news. Presumably conventional thinking was that with a drop at the short end of the yield curve, there was scope for a drop all along the curve (opportunity cost theory). We think that a softer monetary policy implies, *ceteris paribus*, higher future inflation, which should be countered by higher long bond yields. Other big news in March was the proposed merger between Momentum and Metropolitan. Some details follow, but meanwhile, three quick observations:

1. When the founders of Orthogonal Investments see promised “synergy” or “cost reduction” or “rationalisation” benefits *actually* accruing to a financial services merger, we undertake to collectively eat our hats. These banal words are seemingly indoctrinated into investment bankers and other advisers, with little concern for reality. Think back for instance to the mega-merger of four banks that created ABSA. There were supposed to be terrific cost savings through headcount reductions, lower advertising expenses, IT savings and so on. Instead there were massive cost overruns in trying to get different computer systems to cooperate, huge new branding expenses and not least, almost insurmountable cultural differences.
2. The press releases enthused abundantly about the likely benefits to both sets of shareholders. Conspicuous by its absence was any mention of possible benefits to customers!
3. On your behalf, we have a holding in RMB Holdings, which controls Momentum through FirstRand. We think we and you will in due course be pleased to have had that management team on our side. There are some circumspective suspicions that this transaction is a first step towards an eventual exit by the founding members of the original RMB. If this transpires, we think you will be rewarded by holding the very same class of shares as those inspirational founders. At worst, they will exit at fair value; more likely, they will unlock further value. A lesson we have learnt over 20 years is to hold the same class of shares as the founders wherever possible, because holders of more liquid classes of shares with a greater market capitalisation but subordinate voting rights tend to come second in corporate activity.



Our ability to take exposure through less liquid holding companies (Pikwik and RMBH for Pick'nPay and FirstRand respectively are current examples) is one benefit of being a boutique.

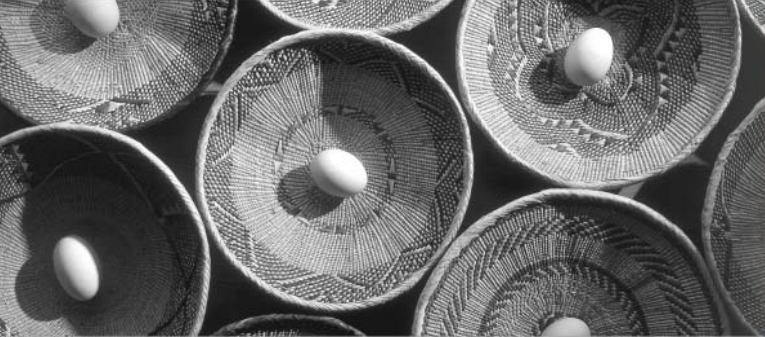
Some company news during March:

Old Mutual (held) reported final results to December 2009. There were a number of encouraging items in the results: healthy embedded value growth of 45% to 171 pence per share, the unrealised losses in the US bond portfolio, a major cause for concern over the past 18 months, reduced from -\$1.6bn at the half year (June '09) to -\$0.5bn at the end of December and Old Mutual resumed dividend payments, albeit at a very conservative level of 1.5 pps. (which was below market consensus). Old Mutual also clearly stated their strategy which will be focused on rationalisation of the group. They have indicated that they are exploring the possibility of disposing of the US life business as well as the likelihood of a partial IPO of US Asset Management. Some of the proceeds of the sale have been earmarked for reducing their debt burden. It was gratifying to see the South African businesses and management once again being centre stage.

Sanlam (not held) also reported final results to December 2009. There was evidence of a strong recovery in 2H09 with good new business profits. There was a positive net inflow into the Life business, for the first time since listing. The EB business performed better than expected, with margins increasing significantly. The EB business contributed R65m to the group new business profit of R607m. Sanlam is now trading at its embedded value (versus a long term average Price to EV of -13.5%) making it the most expensive listed insurer.

March was a busy month in terms of M&A activity in the financial sector: **FirstRand (FSR) (Held through RMH) and Metropolitan (MET) (not held)** announced the creation of a new insurance giant. The proposed transaction will be initiated by FirstRand selling Momentum to Metropolitan in exchange for a new issue of Metropolitan shares. The transaction has been priced based on the respective embedded values of Momentum and Metropolitan, though we would argue that Momentum should be rated somewhat higher than Metropolitan, given their relative long-run RoEVs. However, this should unlock value for MET shareholders as MET has traded at a substantial discount to EV for most of its recent history. FSR will unbundle its entire shareholding in the resulting shared entity (MergeCO) resulting in FSR shareholders owning about 60% of the entity and MET shareholders 40%. RMH, being a 30% shareholder of FSR, will thus own about 18% of MergeCo. RMH has indicated that it may increase that shareholding to around 25%. There is also a possibility that it will then split their current business into two: a banking focussed listing holding its holding in FSR and a listed insurance business holding its interests in MergeCo, Discovery and Outsurance.

Investec Plc (Held) announced its intention to buy the shares in Rensburg Sheppards Plc that it does not already own. Investec's current shareholding is 47%. The acquisition makes sense from a strategic point of view as it increases Investec's distribution in the UK market and further enhances the private client offering. However, the price tag was a bit rich. The offer price was at 19x 2009 earnings and 3.3% of funds under management. Also of concern is the fact that Investec will be issuing 38m new shares (5.5% of existing INP shares in issue) despite sitting on a lot of cash. However, this is understandable as Investec is still adopting a cautious view with respect to its capital position.



BHP Billiton (held) succeeded in moving the majority of its Asian iron ore customers away from annual price contracts to “shorter term landed price equivalent” prices (i.e. closer to spot prices) thus ending a 40 year old tradition in the iron ore market; one which had its origin in the Japanese market. This has long been an ambition of CEO Marius Kloppers.

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