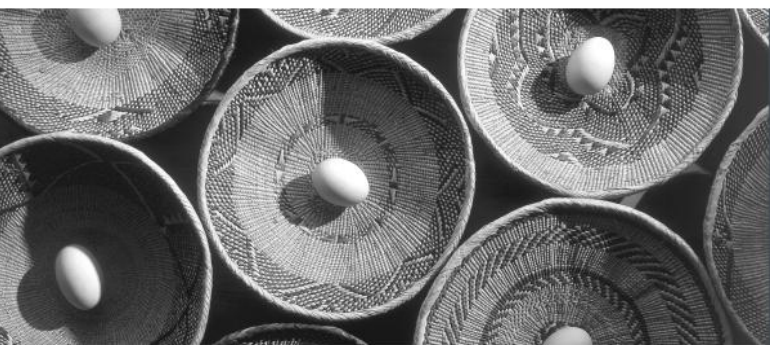


Quarterly Commentary – December 2008

The year ended with an event that also characterised how it started: an announcement of the world's biggest ever alleged fraud in the banking industry. First, an apparently rogue trader (aren't they all, when they lose money, even if they were their firm's star trader before?) at Société Générale lost EUR5bn and then Bernard Madoff hugely outdid him by making off with USD50bn in what he has admitted was a Ponzi scheme. Incidentally, Madoff now joins a list of what The New Scientist calls nominative determinism – the idea that there is a link between people's names and their occupations. Others include the urologist D. Weedon who wrote a paper on incontinence, Usain Bolt, the fastest man in history and Patty Turner, the wife of McDonald's CEO. As fervent believers in the theory of mean reversion, we were also intrigued to learn of one Richard Whitney, with whom Madoff shares some traits. Whitney was around at the time of the Great Crash in 1929. Like Madoff, he owned a stock-broking business, had once been President of an exchange (New York Stock Exchange; Madoff was once Chairman of NASDAQ) and then turned to embezzlement. Whitney ended up in jail and presumably that is where Madoff is destined.

Between 18 Jan 2008 and 19 May 2008, the All Share Index enjoyed a total return of 33%. However, from then until 20 Nov 2008, it lost a gut-wrenching 45%, so it almost seemed a relief when it ended the calendar year down (only) 23%. Measured in dollars though, it lost 45%. Perhaps we'll mention it for the last time in this report, but the popular insanity in 2006 of regarding the equity markets of Brazil, Russia, India and China (BRICs) as cheap, or worse, as appropriate diversifiers for South African investors was cruelly exposed: respectively their 2008 losses in dollars were: 55%, 74%, 65% and 51%. Developed markets also performed appallingly, but lost much less money. At -29% Japan was the winner, by losing the least, and mainly thanks to the strength of the yen. In yen, it lost 42%; worse than the loss of 39% in 1990 which was of its own making (as opposed to the credit / liquidity problems that spread from America this time around). So much then for the short-lived theory of decoupling. Actually, markets continue to couple like rabbits.

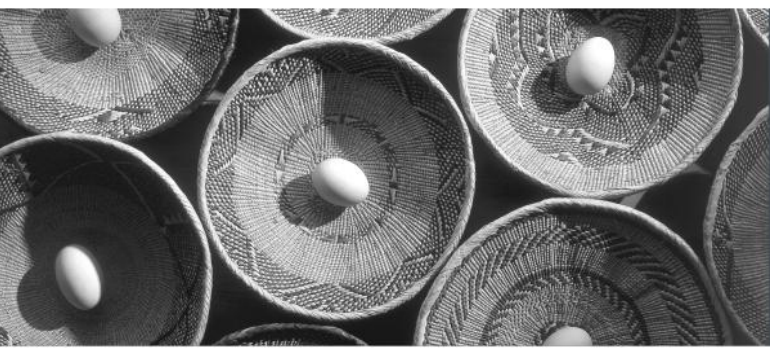
We regret that we were unable to spare our funds from this global carnage, but at least in a relative sense, since inception we have added about 3.6% over the benchmark. This effort was assisted not only by shares we held, but by shares we chose not to hold and which were material in the benchmark. Chief among the latter were two "darling" stocks, MTN and Murray and Roberts. The allure of these stocks was easy enough to understand at the beginning of the year (great stories about turnover growth, expansion outside South Africa, the 2010 World Cup and so on), but how much of this supposedly bright future was already discounted in the share prices was somewhat more difficult to ascertain. Our endeavours in this regard showed that not only did these ambitious forecasts have to come to pass, but they had to be exceeded in order for the share prices to be vindicated. Alas, the outlook actually dimmed and the share prices crashed. MTN's drawdown in 2008 was 54% and Murray and Roberts' was 63%. We recall the first time we ever saw a presentation by a listed company to the analyst community in which a laptop was used (rather than the diabolical old overhead projector slides, usually covered in fingerprints). The company was within the IT sector and was being idolised at the time. hilariously and ironically, this great IT company could not rise to the challenge of getting its own IT to work and the presentation floundered, as did the share price not long afterwards. We cannot help but mention that during the recent quiet holiday season, when markets were moribund, the entire MTN network shut down completely for almost a day. A "nothing can go wrong" prospect is always a dangerous investment.



We have commented before on the gradual resurrection of strange valuation metrics that first became popular during the TMT saga, but which were ultimately exposed for their folly. These include PEG ratios (a mathematical disaster), ARPU (Average Revenue Per User; a measure that takes no account of whether that revenue is profitable) and EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation; again conspicuously avoiding awkward losses). Murray and Roberts came to epitomise the supposedly wonderful prospects for the construction sector and once tried and tested methods of valuation could no longer support its share price, we saw the introduction of a new metric, and were struck by *déjà vu*. This time the new metric was price to order book, heroically assuming that not only were orders secure but profitable, even though both those assumptions have been sorely tested in the past. So it was with interest that we read that the Trump Towers project in Dubai, in which M&R had a 50% interest, has been suspended by its developer Nakheel.

The rot that set in as a result of sub-prime *et al* first manifested itself, understandably enough, in banks' share prices. And yet banks ended the year as one of the best sectors on the JSE, losing only 10%. Our error, in common with many value investors worldwide, was to be invested in banks too early. Still, that was better than not having a bus ticket when the bus did eventually arrive. From its nadir, the bank sector rose 35% and out-performed the overall market by 82%. Losses, rumoured losses and mark-to-market losses related to sub-prime or blamed on the evaporation of financial market liquidity surfaced earlier within the banks than within the life assurers but were actually much less injurious to banks' share prices. The beleaguered life assurance sector lost 47% in 2008. Somewhere during this temporal dislocation, (certainly not at the ideal moment) we switched our financial sector preference from the banks to the assurers, some of which are now trading at significant discounts to their break-up values, let alone their embedded values or the erstwhile, higher benchmarks – appraisal values. So management could do us a favour and abandon bothering to show up to work, and you as our investors would do rather well. More likely though, they will persist with their generally pell-mell approach to grinding themselves out of trouble, and will actually emerge again as going concerns, which would be a very good thing.

Exactly 12 months after BHP Billiton caused shareholders some consternation, the very same news unwound to our clients' funds' benefit. In November 2007, BHP Billiton announced a bid for Rio Tinto, which the board of the latter regarded as hostile and under-valued. Billiton maintained its stance that tremendous synergies were achievable, largely thanks to several contiguous properties which could be exploited much more efficiently by a merged entity. To the great credit of the Billiton board, and fortunately for its shareholders, the offer was made in scrip rather than cash, because equity markets and commodity prices subsequently plummeted. No doubt had the offer been in cash, the Rio board and more importantly Rio shareholders would have thanked their lucky stars and pocketed the cash. In the end, and in spite of the dollar value of the offer having fallen by more than 50%, the Billiton board, led by Chairman Don Argus and CEO Marius Kloppers, took a sombre view of the prevailing state of equity markets, commodity prices and probably most acutely, the gearing risk of Rio's balance sheet, and on 25th November 2008, withdrew the bid. The share price promptly appreciated by 20%, having already been up 13% the day before (on a generally good day for resource shares, rather than on another dreaded leak of sensitive information). A sad epilogue to this event is BHP's astronomic payments to investments bankers, lawyers and others, which totalled a staggering \$450m. After the passage of a decent amount of time, we would not be surprised to see a new bid for Rio from Billiton. Considering that Rio's share price fell by some 40% when the bid was withdrawn, we doubt that any new offer could be so readily rebutted by Rio's board next time. Its shareholders will surely see to that. Maybe Marius Kloppers has played an ingenious hand.



A common but somehow tenacious weakness that afflicts most value managers is buying (and selling) too early. The happy news is that the philosophy still works, in spite of this flaw. Imperial fell spectacularly from grace (it was once the favourite share among the growth investing community) and was beset by a number of problems, not least the ill-health and then untimely death of its inspirational founder. As often happens in these “hero to zero” cases, the price fell far below a level commensurate with its corporate problems. This eventually (much too late for our liking!) became widely apparent, and between early June and year-end, it outperformed the overall market by 78%. The story of Bidvest is fairly similar, as is that of Telkom relative to MTN.

Rowan Williams-Short

CIO

Orthogonal Investments