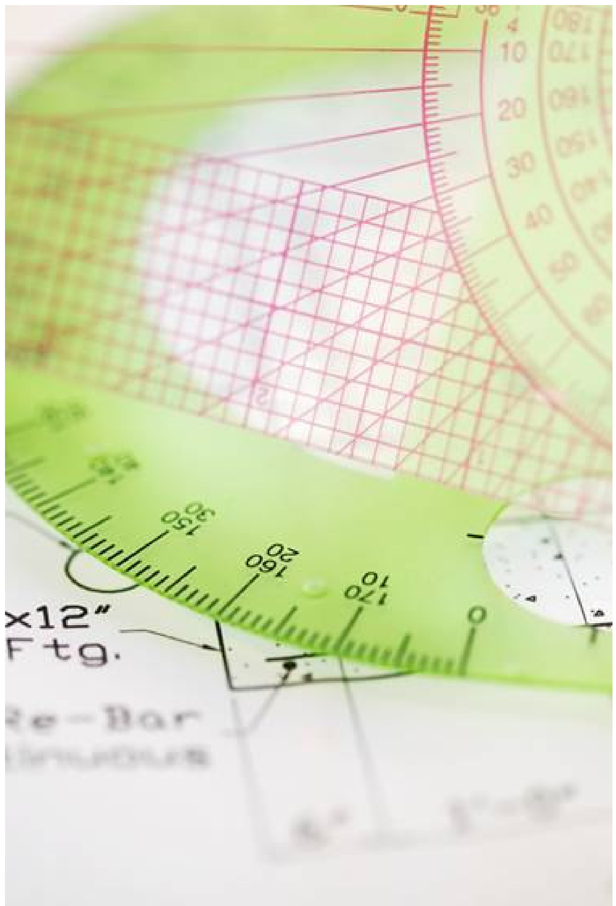
Investors' Alidade

Tactical Asset Allocation View



First Quarter 2008

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cannon asset managers

We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.

Warren Buffet

The herd instinct among forecasters makes sheep look like independent thinkers.

Edgar R. Fiedler

Executive Summary: Equities and Real Estate Remain at the Frontline, but the Outlook for Cash Improves

Asset allocation plays a critical role in investment results in that asset allocation has a significant influence on returns achieved by investment portfolios. Also, asset allocation plays a key role in determining the risk to which a portfolio is exposed. In determining optimal asset allocation, investors need to give consideration to at least two issues, namely strategic asset allocation and tactical asset allocation.

Strategic asset allocation caters for the specific requirements that an investor has of a portfolio – which can range from short-term capital protection to long-term capital growth. Thus, strategic asset allocation refers to the long-run asset allocation make-up of a portfolio. However, the long run is made up of a series of short runs, and when considered from a shorter-term stance it is evident that up-weighting or down-weighting the allocations that are made to each of the asset classes held in a portfolio can play a role in improving the risk and return features of a portfolio. Such shorter-run changes to asset allocation are referred to as changes in tactical asset allocation. In turn, tactical asset allocations are motivated by a suite of factors that include political, economic and capital market conditions.

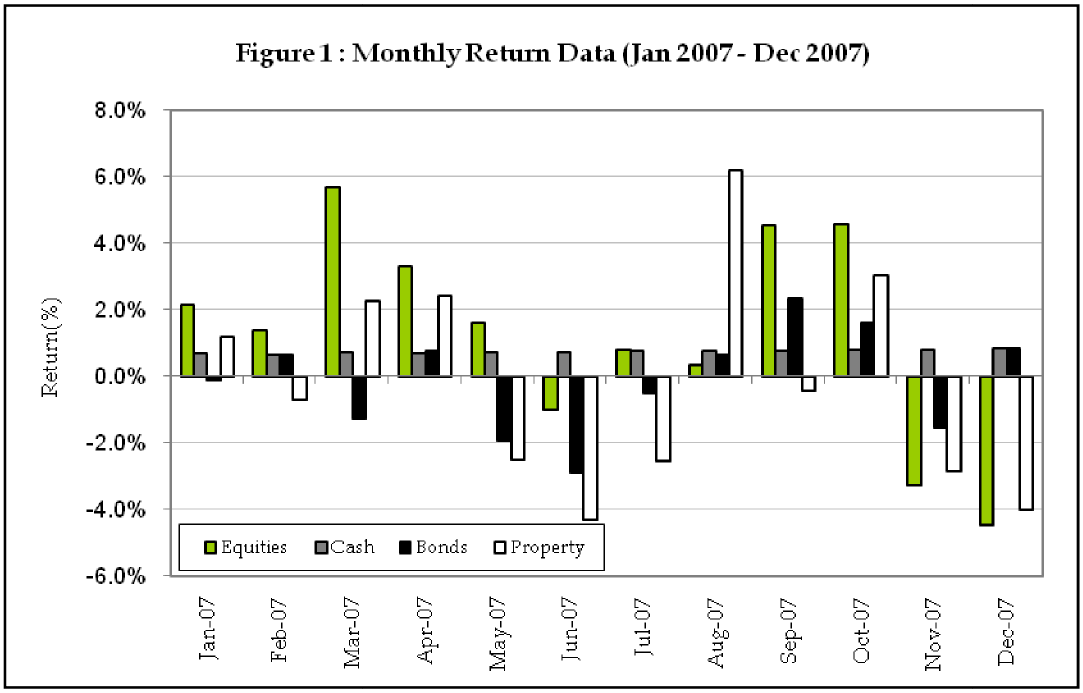
Against the above backdrop, this note reports on factors that Cannon Asset Managers' investment process identifies as influencing the nearer-term performance on the major domestic asset classes. The result offers guidance on tactical asset allocation. In this note we also provide comment on our recent tactical stance and identify reasons for suggested changes.

Adopting a one-year view, in our December 2006 note our analysis suggested that diversified asset class portfolios should be:

- over-weight equities (moderately bullish);
- on-weight real estate (neutral);
- moderately over-weight cash (moderately bullish); and
- under-weight bonds (moderately bearish).

Our call on equities and cash has enhanced our asset allocation results: the past year saw the JSE's All Share Index (ALSI) deliver a return of 16.2 percent, and cash has offered 9.4 percent. Controlling for volatility, a proxy for short-term risk, equities delivered the best risk-adjusted return of the classes, followed by cash (see Figure 1).

Our call on bonds and real estate was under-weight and on-weight, respectively. Whilst bonds produced a positive return, the result was below the return offered by cash and equities, as well as less than price inflation. Adjusting for inflation, this negative return justifies our under-weight rating on bonds for the past 12 months. By contrast, the JSE's Real Estate Index (REAL) returned -2.7 percent over the period, which was below our expectations. Property had a very up-and-down year: starting strongly in the first four months before softening slightly in the next three months as markets became flighty. Although August saw the REAL return more than six percent, by the end of the year losses in the sector had eroded all earlier gains as property prices followed the market's lead downwards (see Figure 1).

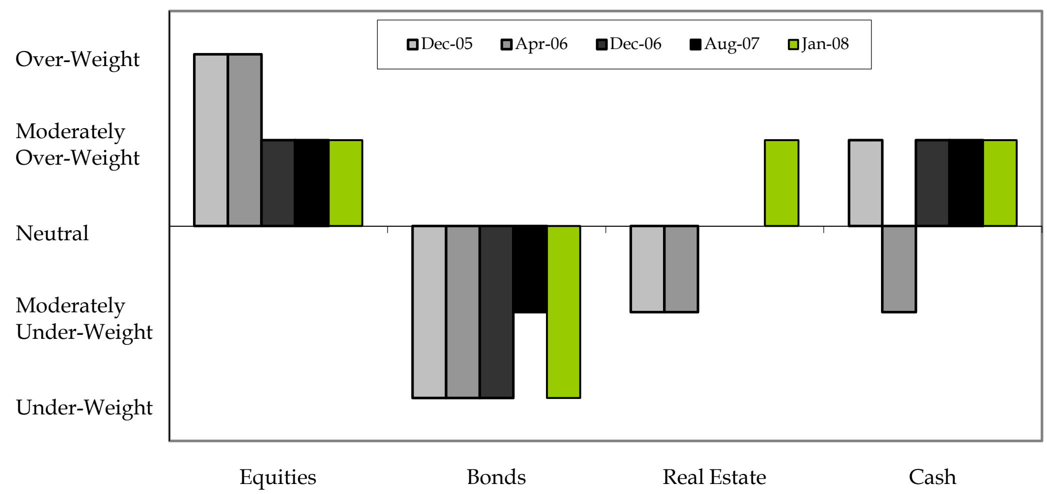


Source: Data from McGregor-BFA

Equities yielded healthy returns over the course of 2007, and although the past couple of months have seen substantial underperformance relative to the other asset classes, our analysis continues to find equities the domestic asset class of choice amongst the risky asset classes. Similarly, bonds remain the least favoured of the four domestic classes. We have a moderately over-weight rating on real estate, and we retain our cash stance, having turned moderately bullish on the asset class early in 2007.

The net results of our factor analysis are summarised below in Figure 2.

Figure 2: Asset Class Ratings (Dec 2005-Jan 2008)



Source: Cannon Asset Managers

In terms of the best to worst performing asset classes: we see equities performing the best, followed by property, then cash, and lastly bonds.

In summary, from a tactical stance, our analysis suggests that diversified asset allocation portfolios should be:

- moderately over-weight equities (moderately bullish);
- moderately over-weight real estate (moderately bullish);
- moderately over-weight cash (moderately bullish); and
- under-weight bonds (bearish).

1. The Importance of Asset Allocation

Although stock picking is widely recognised as an important skill in investment management, the emphasis that is placed on stock picking often means that the critical role that asset allocation plays in portfolio performance is overlooked.

To give traction to this point, it has been demonstrated by various researchers that asset allocation accounts for roughly nine-tenths of the variation in investment performance (Ibbotson and Kaplan, 2000). Consequently, most of the balance (but a very small part) of investment performance is accounted for by stock selection and trading activity. This is not to say that stock selection or trading are unimportant aspects of portfolio management – they are material components of the asset manager's toolkit. However, successful portfolio management begins with appropriate asset allocation.

2. The Differences between Strategic and Tactical Asset Allocation

There are two elements of successful asset allocation, namely strategic asset allocation and tactical asset allocation.

- **Strategic Asset Allocation**

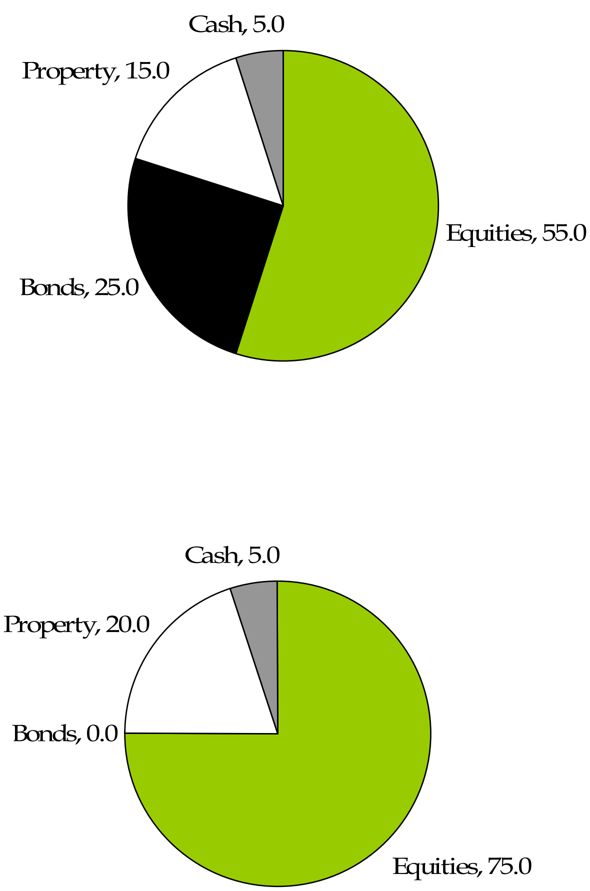
Strategic asset allocation refers to the investment management task of building portfolios so that the weights in which the different asset classes are held, cater for the characteristics of the investor. Of course the range of assets that might be incorporated in a portfolio is wide, and includes domestic and offshore equities, bonds, cash, commodity funds and hedge funds. Each asset class has specific risk and return attributes and, when assets are blended in different ways, the resulting portfolios are able to cater for a spectrum of investor characteristics. These characteristics are usually described in terms of five aspects, namely:

- the time horizon for the portfolio;
- the investor's income needs;
- purchasing-power protection needs and nominal capital protection needs;
- volatility tolerance; and
- the long-range outlooks for the asset classes.

As noted, given detailed information about the investor, the task of the investment manager becomes one of matching the asset allocation of the portfolio with the investor's characteristics. The resultant asset allocation is termed the strategic asset allocation.

For the sake of example, a domestic investment portfolio that is designed to grow capital and generate income for the investor, might anchor its asset allocation around a 55 percent weight in equities listed on the JSE Limited (JSE), 25 percent exposure to bonds that trade on the Bond Exchange of South Africa (BESA), 15 percent exposure to real estate assets, with the balance of the portfolio held in cash (see Figure 3a). By contrast, a portfolio that places more emphasis on long-term capital growth might anchor its asset allocation around higher exposures to equities and real estate (see Figure 3b). It must be emphasised though, that the illustrations below are just that – illustrations – and it remains the task of the asset manager to construct portfolios that are tailored for each set of circumstances.

Figure 3: Hypothetical Asset Allocations in the Case of (a) Retirement Portfolio and (b) Capital Growth Mandates



Source: Cannon Asset Managers

As noted, the set of circumstances that need to be catered for is wide ranging, but under each set of conditions, asset allocation plays a vital role in determining investment results.

- **Tactical Asset Allocation**

Over the long run, a suitably constructed portfolio should anchor around the asset allocations suggested by the investment mandate and the associated investor characteristics. However, the long run is made up of a series of short runs and, in the short run, it is often the case that different asset classes may offer investment opportunities – whether these opportunities provide a prospect for the asset manager to achieve better-than-average returns or to protect portfolios from above-average risk is another matter. In any event, it is here that tactical asset allocation offers the investment manager the ability to enhance returns and/or reduce risk.

Thus, tactical asset allocation refers to the investment management task of 'tilting' exposure to the different asset classes based on a suite of factors that include (but are not confined to):

- the extant economic setting and the stage of the business cycle;
- economic, investment and political risks;
- the extent to which asset markets display signs of distress, exhaustion or exuberance;
- changes in asset class quality;
- structural changes in the economy and/or capital markets; and
- the relative valuations on the different asset classes.

Against the above backdrop, Cannon Asset Managers' investment team produces the *Investors' Alidade* – an alidade is an instrument used in surveying and mapping to determine direction - to provide guidance on tactical asset allocation which is used to enhance the risk and return results we achieve for our investors through strategic allocations.

3. Using the *Investors' Alidade* to Guide Tactical Asset Allocation

The *Investors' Alidade* considers the movement and influence of factors that our research shows to be important determinants of asset class performance. Each of the major domestic asset classes is considered – namely equities, bonds, real estate and cash – with the number of factors that influence the asset classes ranging from three in the case of cash to 8 in the case of equities. In each instance our outlook is based on a one-year view to inform tactical asset allocation.

Using sophisticated regression analysis, independent models have been created for each asset class. In the case of each asset class, numerous factors were considered for inclusion in models, and then back-tested in order to determine whether the factor plays a significant role in shaping future returns. The equity and property models were back-tested to 1996, whilst the bond and cash models were back-tested to 2001. Factors that are significant in explaining returns and that make economic sense are included in the models.

The models are backward looking in the sense that they use historical macroeconomic data, as well as asset class specific data. Thus, the models are built on the premise that past data determines today's returns. Hence, all factors in the models are lagged by varying time intervals.

By way of example, we tested the year-on-year price:earnings (PE) ratio of the All Share Index against year-on-year equity (ALSI) returns. A significant relationship between equity returns and the PE ratio was found at a lag of four quarters (one year).[1] The PE ratio has a negative coefficient, which makes good economic sense: as the PE ratio increases the market becomes more expensive, thereby adversely affecting future equity returns.

Simultaneously running all four asset class models, we are able to determine the expected relative return of each asset class, and thus form bullish or bearish opinions on the relevant asset class. Whilst the models "look" one year ahead, they do not forecast returns, but rather compare expected relative performances across the domestic asset classes. In turn, identifying asset classes that offer superior or inferior relative returns paves the way for successful tactical asset allocation.

[1] The models are run on a quarterly basis; therefore, a lag of one period is equal to one quarter.

4. *Investors' Alidade* Asset Allocation Recommendations

Against the above backdrop, we summarise the results generated by Cannon Asset Managers' Asset Allocation Models for each of the main domestic asset classes in Table 1, along with a brief comment on the asset class rating and the recommendation on relative weighting.

Table 1: Tactical Stance on Domestic Asset Classes

Asset Class	Alidade Rating (Previous Rating)	Tactical Call	Cannon Asset Managers' Comment
Equities	Moderately Over-weight (Over-weight)	+	Due to the ongoing credit mess, markets across the board have been through a torrid time. January represents the worst start to the year for the JSE since records began, yet we remain confident that equities will again be the top performing asset class over the next 12 months. Since reaching levels of well over 30,000 points in October, the All Share Index has shed close to 20%, and given the decent earnings growth outlook over the next 12 months, we believe the market is awash with attractive value opportunities.
Bonds	Under-weight (Under-weight)	–	On the back of rising inflation and interest rates over the course of 2007, bonds performed poorly as was expected. Our outlook for bonds remains unchanged. In the high-but-stable current interest rate environment bonds will continue to struggle, and with no interest rate reprieve expected in the immediate future, we anticipate bonds will struggle in 2008.
Real Estate	Moderately Over-weight (On-weight)	+	Real estate was the worst performing asset class over 2007, returning negative returns. The steep increase in interest rates, especially in the second half of 2007, worked against the class. The recent selloff in listed property, however, has created value within the asset class. Coupling current valuations with sound growth prospects and a stable interest rate setting, we upgrade our weighting to moderately over-weight.
Cash	Moderately Over-weight (Moderately Over-weight)	+	With inflation having remained above its target range of 3%-6% since April 2007, interest rates have been on the rise. Due to the high oil and food prices, the outlook for inflation remains gloomy. Therefore, we can expect interest rates to remain firm in the immediate future. When this view is coupled with the current market volatility, we continue to adopt a moderately-bullish view on cash.

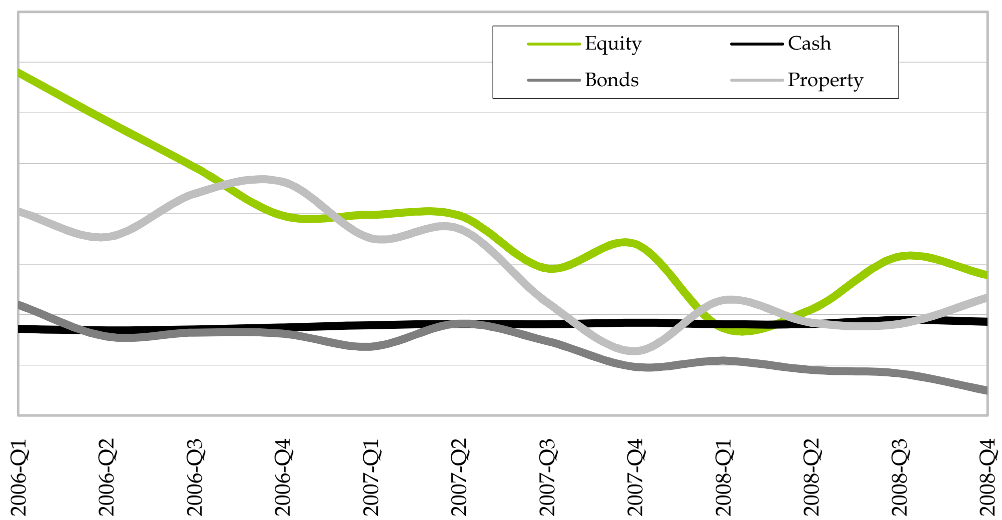
Source: Cannon Asset Managers

Based on the above, it is our expectation that equities will constitute the top performing asset class over the next 12 months. This view is consistent with our position over the past 12 months.

Real estate enjoys an upgrade from neutral to moderately bullish. Real estate is thus preferred to cash, which was not the case in our previous Alidade (August 2007). We maintain our moderately bullish position on cash, whilst remaining moderately bearish on bonds.

Figure 4 summarises our views on relative expected rates of return for each of the major domestic asset classes on a 12-month horizon.

Figure 4: Expected Relative Asset Class Performance



Source: Cannon Asset Managers

The graph depicts the relative 12 month performance of each asset class. It can be seen that equities' 12-month performance to the end of Quarter 4, 2008 is expected to be greater than cash, bonds and real estate.

Finer detail on the factors that influence our outlook for each asset class is provided in Tables 2-5.

5. Detailed Analysis of the *Investors' Alidade* Asset Class Components

Tables 2-5 provide a detailed breakdown of the component scores for each of the asset classes.

Table 2: Investors' Alidade Equity Class Components

Equity Factors	Lag	Coefficient	Effect	Movement
CPIX (Change YoY)	-1	-	-	Inflation has moved above the 3%-6% range; this is negative for equities.
ZAR/USD Exchange Rate	-3	-	?	Over the course of the year the exchange rate remained relatively stable, despite periods of Dollar weakness.
GDP Growth (YoY)	-3	+	+	GDP growth remains around the 5% level, but is anticipated to slow in 2008.
Dow Jones	-5	+	+	Despite recent volatility, the Dow Jones produced positive returns in 2007.
Commodity Prices	-6	+	+	Commodity prices continued to rise over the course of 2007. Prices should hold into 2008.
Sovereign Spread	-6	-	-	The sovereign spread has begun to increase; the impact on equities is negative.
Cash:Equity Ratio in Unit Trusts	-5	+	-	Cash, as a percentage of holdings, has been decreasing.
Market PE Ratio	-4	-	+	The market PE ratio is in decline; the lower rating makes a stronger case for equities.

Table 3: Investors' Alidade Bond Class Components

Bond Factors	Lag	Coefficient	Effect	Movement
Inflation Differential Between South Africa and the US	-3	-	-	The inflation differential continues to widen.
ZAR/USD Exchange Rate	-5	-	?	Over the course of the year the exchange rate remained relatively stable, despite periods of Dollar weakness.
Sovereign Spread	-6	-	+	The sovereign spread has begun to increase; reversal of this effect will aid bonds.
Relative Valuation Between Bonds and Equities	-3	-	-	Bond yields are increasing relative to equity yields.
Yield Curve	-8	+	-	The yield curve is currently inverted; this is negative for (long-dated) bonds.

Table 4: Investors' Alidade Property Class Components

Property Factors	Lag	Coefficient	Effect	Movement
GDP Growth	-2	+	+	GDP growth remains around the 5% level, but is anticipated to slow in 2008.
Interest Rates	-1	-	-	Interest rates remain high on the back of inflation breaching its target range.
Number of Buildings Completed	-5	+	+	The number of buildings completed remains on the rise; this has traditionally been positively correlated with property sector returns.
Relative Valuation Between Bonds and Property	-1	+	+	Property valuations are improving relative to bond yields.
CPIX (Change YoY)	-6	-	-	Inflation has moved above the 3%-6% range; this is negative for property stocks.

Table 5: Investors' Alidade Cash Class Components

Cash Factors	Lag	Coefficient	Effect	Movement
Yield Curve	-10	+	_	The yield curve is currently inverted.
CPIX (Change YoY)	-2	+	+	Inflation has moved above the 3%-6% range; this is positive for cash returns.
ZAR/USD Exchange Rate	-5	+	?	Over the course of the year the exchange rate remained relatively stable, despite periods of Dollar weakness.

References and Bibliography

Ibbotson, R.G. and Kaplan, P.D. (2000) Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance, *Financial Analysts Journal*, January/February, pp26-33.

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