Adviser Choice

Investec Cautious Managed Fund

As at 31 March 2011

Market review

Equity markets performed well during the quarter considering the negative headwinds, which in preceding years would have resulted in sharp falls in risk appetite. Developed markets (4.9%) outperformed the emerging market composite (2.1%), despite a 9% drop in Japanese equities in March and a 6% weaker close over the quarter.

Local equities mimicked global market volatility, recovering January's losses and ending the quarter marginally higher (1.1%). Resource counters performed best, with Sasol, the only oil & gas producer constituent in the index, rising 13.1%. Diversified miners closed 3.2% higher while paper stocks added 15.5% over the period. Platinum stocks lost 10.5%. Both the industrial and financial sectors underperformed the broader market, closing down 0.3% and up 0.7%, respectively. Again, there was substantial dispersion amongst the various sub-sectors, with construction (-25%), food producers (-4.3%) and pharmaceuticals (-11.5%) underperforming, while mobile telecommunication (3.9%), life insurance (6.4%) and industrial metals (14.5%) enjoyed strong returns.

Local bonds traded weaker over the quarter, with the All Bond Index losing 1.6%. The yield curve has continued to steepen, while inflation concerns both globally and at home have been more pervasive. The firm rand has offset gains in oil prices for now, while food prices, rising at producer level, have not been passed on to consumers. Listed property, highly sensitive to the bond market, also gave up some of its 2010 gains, closing 2.2% weaker. Commercial property fundamentals remain under pressure, though highly dissimilar across regions and asset type. A recovery in growth, coupled with a lagged onset of new supply, will lend support to the market over the next year. Cash, as measured by the STeFI, provided a steady 1.4% over the quarter.

Portfolio review

The portfolio had a very strong first quarter in both absolute and relative terms. Our defensive positioning enabled the portfolio to advance, while most asset classes moved sideways for the quarter.

We maintained an extremely high cash weighting as a direct consequence of the dearth of attractive investment opportunities in the domestic market. Our local equity weighting remains below average due to a significant hedge. The hedged equity position added great value as our underlying equities significantly outperformed the market. The main contributors were Sasol, Harmony, MTN, Steinhoff and SABMiller. In addition, our lack of exposure to the construction and platinum sectors added value.

Portfolio activity

Our positioning remains virtually unchanged with minimal activity over the quarter. The portfolio's cash holdings are high and we are well positioned to take advantage of future opportunities.

Portfolio positioning

The portfolio's equity weighting remains high on a gross basis, while the net domestic equity weighting is significantly below average as a result of stock market hedging. We remain defensively positioned in domestic equities. Local equities are fairly evenly split across broad sector lines and comprise a select group of stocks that we continue to believe should outperform the broader market over the medium term. In aggregate, the composition of our underlying domestic equities remains significantly different to the market index. Correlations are declining and valuations are more relevant to market participants. This bodes well for future returns. Recent trends are very encouraging for our typically contrarian and valuation-conscious approach. Our current positioning is premised on the following key views:

- We are not prepared to accept risk at this juncture. Valuations do not adequately compensate investors for their investment risk and we are intentionally maintaining the 'anti-risk' composition of the portfolio.
- The domestic equity market is overvalued and overbought, offering only speculative merit for market participants willing to embrace price momentum.
- Domestic equities have seen a synchronised upswing since the March 2009 lows, resulting in a lack of individual stocks that meet our strict criteria of absolute undervaluation.
- We are content to hold cash, despite it being universally despised. We remain confident that attractive opportunities will emerge when the current risk binge comes to an end.

We are once again at odds with the consensus opinion as reflected in recent asset price movements. Such a view suggests that embracing risk is the correct way to be positioned and that it is pointless to fight the flood of liquidity that will engulf markets in the medium term. We do not share this view, as reflected in our current portfolio positioning.

In summary, we retain a dramatically reduced exposure to risk assets and our underlying equity holdings have a quality and defensive bias. The fundamental reasons for our positioning remain intact. We would require a significant decline in risk assets or strong evidence of a sustainable earnings recovery, to change our view or the composition of the portfolio.

We anticipate increasing our bond weighting into price weakness, as higher inflation expectations and global yield pressures present a headwind in the medium term. We maintain our low (and hedged) domestic equity weighting and would only change our positioning if value returns to the market.