



Merry Christmas

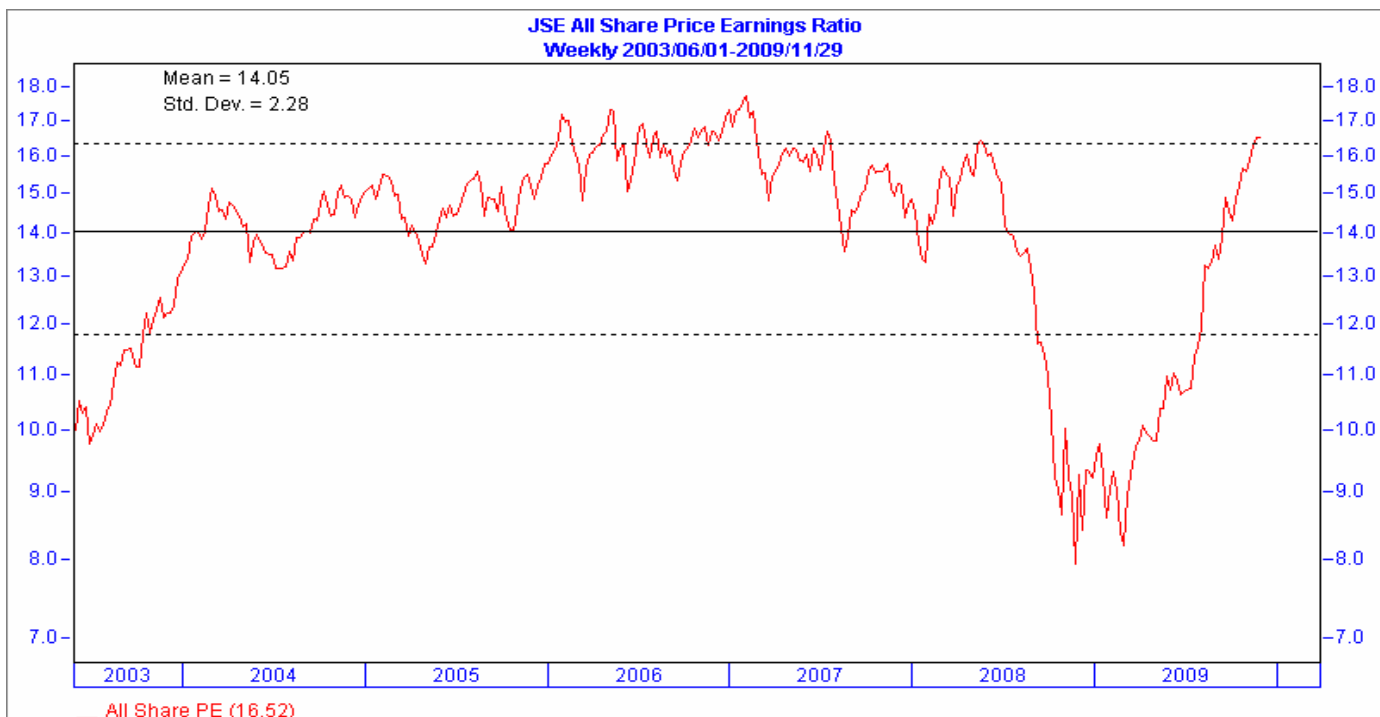
The end of 2009 is now upon us and what a fascinating year it has been! The year started with a brief respite rally but that faded very quickly, taking the All Share in March back to the (low) levels seen in November 2008. But just when fear was at its peak and investor capitulation readily apparent, the market began a reasonably steady climb to its current levels. To put some numbers to this story: The All Share declined 46% peak to trough but has subsequently risen 51% from the low. Now that may sound like we have got all our losses back but unfortunately maths doesn't work this way – we are in fact still some 19% off the previous high.

Ok, so much for the history lesson about highs and lows but what does the future hold? Bring out the crystal ball! When we think about the level of the market, and whether it is expensive, cheap or fair, we pay much attention to future earnings/cash flows. Ultimately it is these factors that drive the market in the medium to longer term – obviously in the short term there are a range of other variables to consider but for our style of investing these are largely irrelevant.

Off the high historical earnings base level of a year ago, when the market collapsed, the price:earnings (PE) multiple fell too, halving to a cheap 8x. Of course at that rating level, the market was pricing in a decline in earnings (of some magnitude), which did indeed unfold. Earnings are now down 30% from peak levels a year ago. But, from March this year the market is up 51% notwithstanding sharply declining earnings and as a consequence the market PE is back to 16.5x historical

Leading Indicators:

	1mth % ch	3mths % ch	12 mths % ch
JSE	+1.77	+6.88	+28
S&P	+2.1	+4.58	+21.4
Nik- kei	+19.1	-4.8	+1.3
Oil	-3.38	+6.65	+75.6
Gold	+3.6	+14.7	+49
R:\$	-1.6	-6.4	+26
R:£	+1	+1	+18

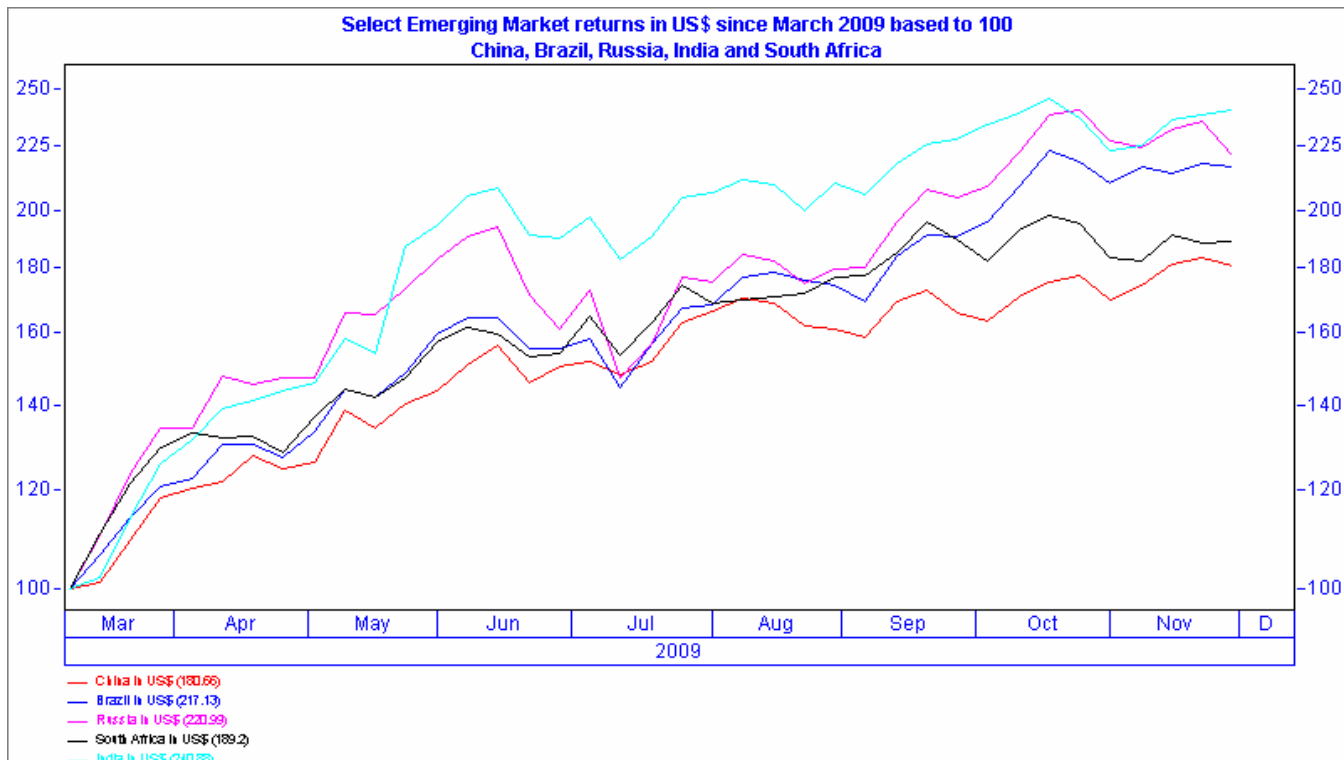


The question to ask is why has the market run so hard? In our view there are two key reasons:

1. Excess liquidity in the system post global bailouts.
2. Significantly elevated earnings expectations.

Money which was pumped into the system post the banking crisis has found a home – initially low risk destinations such as money market funds attracted vast inflows. But as sentiment shifted (in part driven by the near zero returns offered in the money market) flows headed toward more risky asset classes, notably equities and more specifically emerging markets.

In the chart below we show the spectacular recovery seen in the BRIC countries (Brazil, Russia, India and China) and South Africa since March 2009. The chart is dollar based.



We think the authorities in most Western World countries are extremely unlikely to raise interest rates before they are absolutely certain the crisis is over and the consumer can handle more expensive debt. It is no surprise to see central bankers and economists drawing parallels with the Great Depression but more importantly highlighting the need to keep rates low for longer, something that did not happen back then, resulting in a prolonged and deep recession. As a result the positive momentum could still be with us for some time but we would caution against buying for this reason only. As quick as this money flows into emerging markets it can exit as well. "Dubai World" type announcements do no good for perceptually riskier asset classes!

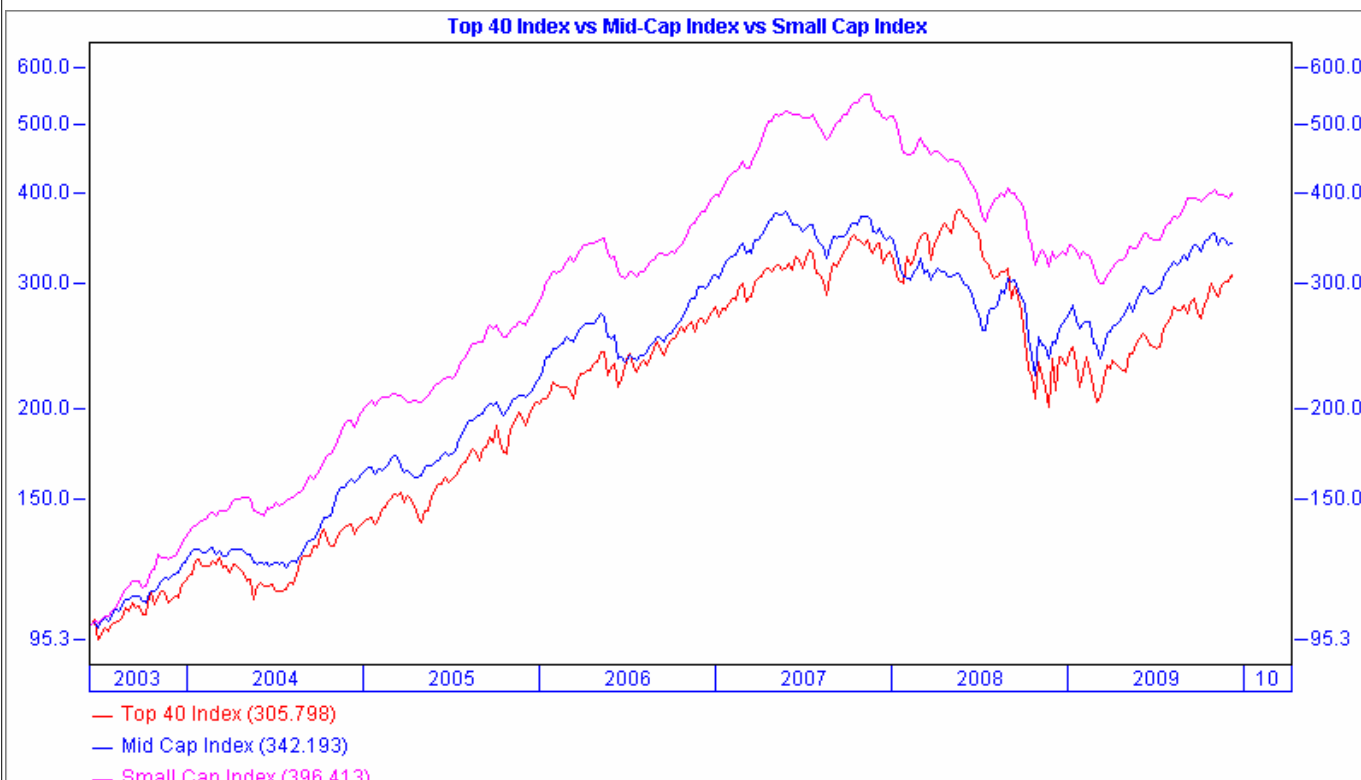
As to earnings expectations: Post the significant decline in earnings over the past year it is perhaps not too surprising that future earnings are expected to rise materially off this low(ish) base. If we use Nedbank Securities' quant's team consensus forecasts, we have noted a material upward shift in numbers. Year 1 forward earnings growth forecasts have moved from +10% to +21% to +27% over the past 6, 3 and 1 months. While for year 2 the forecasts have moved from -3% to +10% to +24% over the same period – quite a turnaround in such a short period!

Sure commodity prices have rebounded somewhat but this is mostly offset by a much stronger rand. Also consumer spending remains under significant pressure and if GDP forecasts over the next two years are to be believed then implied in the earnings forecasts is material margin enhancement. We just cannot get our minds around this as virtually every management team we speak to can't stress enough how difficult things are out there right now and warn of margin erosion in the wake of excess capacity. We consider the risks to consensus earnings forecasts to be on the downside and hence are not actively buying the market from a fundamental standpoint.

As a result we maintain or view that clients should be nibbling away at blue chip counters that are defensive, have strong balance sheets, a global client base, trade at reasonable valuations and offer a high probability of maintaining or growing dividends over the next two years.

Future Titans Fund

You would have heard us talk about our new unit trust (Future Titans) which was launched officially in September 2009. This is a flexible fund mandated to invest in non-top40 shares. Our key reasons for starting the fund are: Firstly, we aim to generate superior returns and two; by wrapping the portfolio in a unit trust structure we avoid any complications around tax on trading i.e. only capital gains is applicable. Insofar as expected returns go, the chart below shows the performance of the top40 shares against the mid and small cap shares. Generally, albeit with increased volatility, the small and mid cap shares tend to outperform the big companies which is something which investors simply cannot ignore. We think it makes tremendous sense to put 5-10% of your portfolio into a fund of this sort. The fund is up 7% since launch.



Christmas Stocking

As is tradition, the team at ClucasGray presents its Christmas stocking at this time. However, it would not be fair to present this year's stocking without having a peak at how we performed last year.

Family Member	Company Name	Current Price	26-Nov-08	% performance
Ratty Mother-In-law	BRITISH AM TOBACCO	23593	26000	-9.3
Dad	SAB	22327	14800	50.9
Beloved Wife	MASSMART	8343	8000	4.3
Married Daughter	ASTRAL	10385	8000	29.8
Loyal Housekeeper	CASHBUILD	7500	5000	50.0
Responsible son	METROFILE	130	80	62.5
Wild boy	METMAR	375	380	-1.3
Youngest Daughter	ADVTECH	500	330	51.5
Myself	MTN GROUP	11739	10100	16.2
Average Performance				28.3
All Share		27144	21209	28.0

Christmas Stocking continues...

So seven of our nine stocks ended in the green and overall we performed in line with the market despite having virtually zero commodity exposure. Interestingly, our worst performer was British American Tobacco which has been severely hit by the strength of the rand. At current levels we continue to strongly believe in this counter and as such it is once again featured in our 2010 list. Enjoy the read.

For my ratty mother-in-law: British American Tobacco (BTI)

Fortunately my dear old mother-in-law took advantage of the strong Rand and went for an extended vacation in Asia with her bridge friends. She has come back more grumpy than ever! She moans incessantly about our smoking laws being too strict particularly after coming back from a smoking friendly region like Thailand and Bali. British American Tobacco has good exposure to this part of the world and with a strong balance sheet, excellent cash flow, steady growth prospects and a dividend yield of around 5.5% we are happy to keep this one for the old lady.

For my dad: Sasol (SOL)

Around the kitchen table and a few glasses of good red later, my dad began philosophising about the state of affairs. And not for the first time our conversation migrated to the high cost of living – notably travel. I decided then and there that I would Christmas wrap a parcel of Sasol shares to hedge the cost of his weekly trips to Howick. Sasol has been through a torrid time in the past year what with fast falling key profit drivers and costly global slaps on the wrist for anti-competitive behaviour. Based on an improved outlook (yes the rand will need to weaken a bit), strong balance sheet, wonderful cash generation and continued pipeline of growth opportunities, I think dad may just be able to afford a trip further afield.

For my beloved wife: Astral (ARL)

Astral stays in the stocking notwithstanding a nice 30% capital gain over the past year plus 6% in dividend. My wife has always been a fan of the lowly rated chicken but value for money it still comfortably trumps all other protein sources. However, a chicken in turkey disguise may not be met with much enthusiasm from dad on Christmas Eve! Current excess supply and the strong rand is hampering price initiatives in the short term but cost containment and help from cheaper feed prices should assist the margin into next year.

For my recently married daughter: Altech (ALT)

With last year's investment in Astral having returned 30% my eldest daughter has not written me off completely. As newly weds she consistently complains about how expensive it is to run her own house – this doesn't stop her running up huge cell phone bills though! Altech now has 81% of revenue that can be deemed as annuity based and they have put this money to good use investing in strong growth assets in East Africa. After its recent run we may have to be patient on this one, but we do really like this company for the longer term.

For our loyal housekeeper: African Bank (ABL)

Having just attended the African Bank (Abil) annual results presentation I once again went away feeling very comfortable about the company and more importantly the strength of the management team. These guys understand the risk/reward relationship better than most. Sure the timing of the Ellerines purchase was poor and costly on short term earnings but the rationale and fit remains promising. Ellerines is turning the corner and while I loathe Gracie buying anything on credit, Abil's combined offering is certainly more cost effective than most. And of course Abil will pay a very handsome dividend compared to the market – just the ticket for our dear Grace.

For my responsible son: Bidvest (BVT)

My football crazy eldest son has been looking to invest in a company that will benefit from the World Cup 2010. Bidvest, being a diversified services group, has done a lot of work internally to position itself for a recovery in economic growth both here and offshore. There is no doubt the company will benefit from the windfall of the World Cup, the motor vehicle side will show some recovery off this base and any weakness in the currency would boost the returns from their compelling offshore businesses.

For my wild boy: GoldReef Casinos (GDF)

Having dropped a few rands at the tables in his time I have finally convinced him that a guaranteed way to make money at the tables is to own the casino. Unlike this little tike I do read my SENS announcements and recently noted that Tsogo Sun is now legally permitted by the provincial gambling boards to make a bid for Goldreef Casinos – something it has been angling for for some time now. In addition I think 2010 should be a better year for the industry, driven by a slow improvement in consumer sentiment and a rampant six week period over the world cup.

For my youngest daughter: Petmin (PET)

The apple of my eye gets a junior miner in her stocking. Via its metallurgical coal operation and its quartzite business Petmin has solid predictable cash flows. In addition it has a stake in a potentially valuable iron ore project which is only scheduled to deliver earnings in 3 years time. Importantly, the current valuation of the company does not reflect any value in this iron ore project and I have high hopes that the market's perception of this asset will change over the next year.

And finally for myself: Investec Tier 1

You may laugh when I say my stock picking abilities have been severely tested over the past year given the strong upward momentum in the market but regardless I have found it difficult. Post the Armageddon in markets late last year I have been spending quite some time playing the corporate bond markets as apparent returns have been mouth watering. Recently I have bought some Investec Tier 1 preference shares, yielding 9.5% in Euros and offering 35% upside to redemption/step up. And of course for this investment and some others I wish Cosatu luck in sinking the Rand...

Don't forget:

1. Our website www.cgim.co.za. Besides accessing portfolios via this site, you can find a range of information about ClucasGray Ltd and its staff plus access all our old letters.
2. Remember Tim Fearnhead, a consultant to ClucasGray, can help you out with all needs relating to trusts, wills, retirement planning etc.