CLUCASGRAY Investment Management

Newsletter

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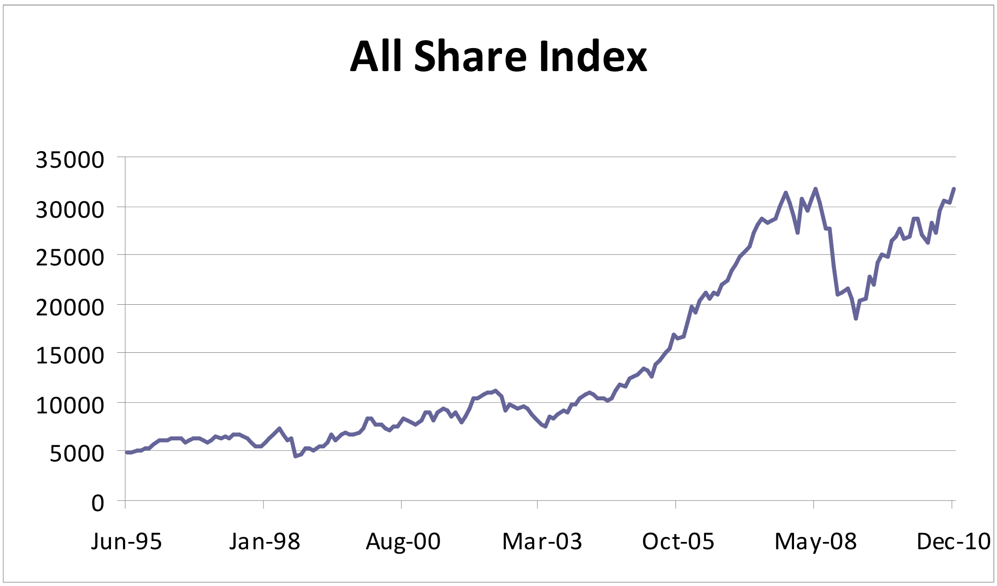
Merry Christmas

A very happy Christmas to all.

2010 has been (so far) another good year on the market. The All Share index is up 15% from the beginning of the year and a significant 70% from the lows in early 2009. We are now less than 5% away from the all-time high.



Leading Indicators:

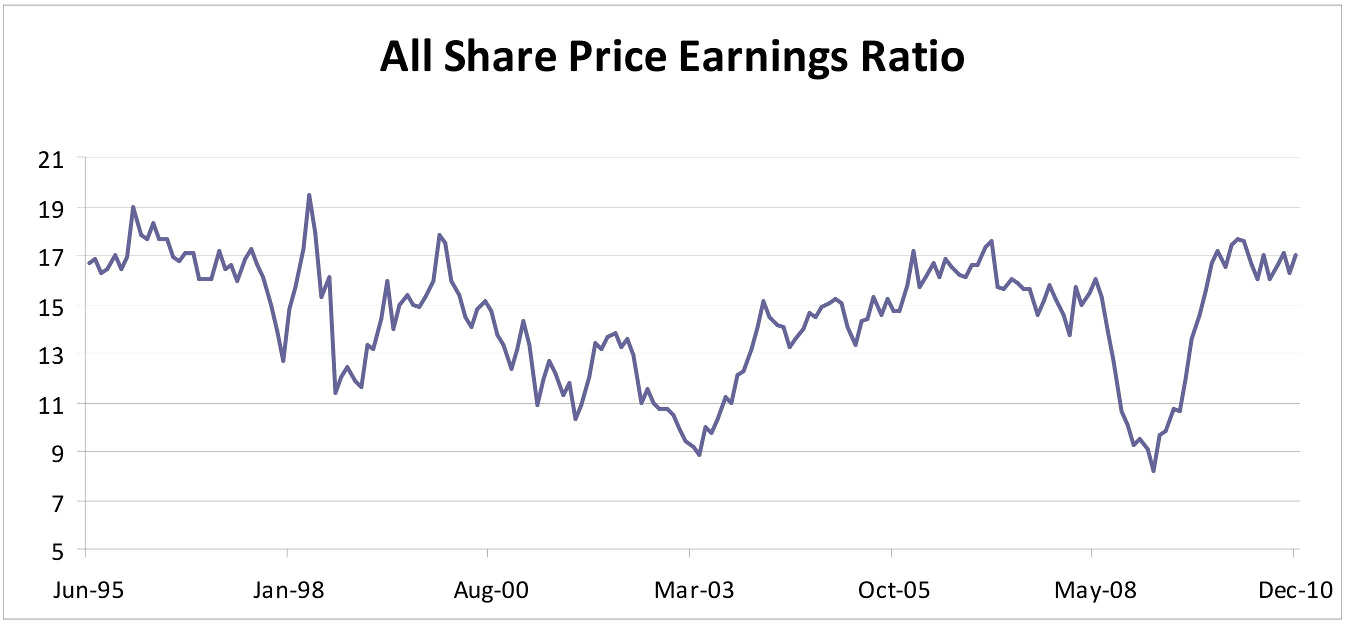
	1mth % ch	3mths % ch	12 mths % ch
JSE	0	+13	+18
S&P	+1	+11	+11
Nik-kei	+2	+13	+4
Oil	+3	+18	+22
Gold	-2	+10	+21
R:$	+1	-4	-9
R:£	-1	-2	-12

Based on the above chart, a reasonable man could assume all is well once again in both the local and global financial markets. However we know that is simply not the case. Global country debt is at unprecedented levels and state bailouts are becoming common practice. The simple reality is that trillions of dollars have been pumped into the western world's financial sector to try and keep it afloat. To date this "quantitative easing" has worked but the jury is out as to its longer term implications.

The immediate impact of this excess money in the system has been a flow of funds toward high yield equities and bonds and as a consequence emerging stock and bond markets have performed admirably and currencies have been well supported by foreign inflows.

In this environment no one really knows what tomorrow will hold let alone a year from now and for this reason we feel it is imperative to stick to the basics when it comes to investing. Fundamentals must, in our opinion, represent the cornerstone of any investment decision. In essence, regardless of the macro picture, a company is worth no more than the value of its future cash flows discounted at an appropriate rate.

At ClucasGray we constantly monitor the "attractiveness" of the market by checking where the long term price earnings (PE) ratio sits relative to history. The chart below shows this trend and it is readily apparent that we are sitting at the upper end of the trading range seen over the past 15 years. However in isolation this data point is not too relevant in that future earnings growth could result in a decline in this value to more moderate levels. In this regard we note that consensus earnings for the All Share show growth of 31% and 16% over the next two years, resulting in the 12-month forward PE declining to 11.1x – only marginally ahead of the long term average. Also, it is worth pointing out that we are currently in a structurally lower interest rate environment than in the past which too can be a justification for higher PEs.

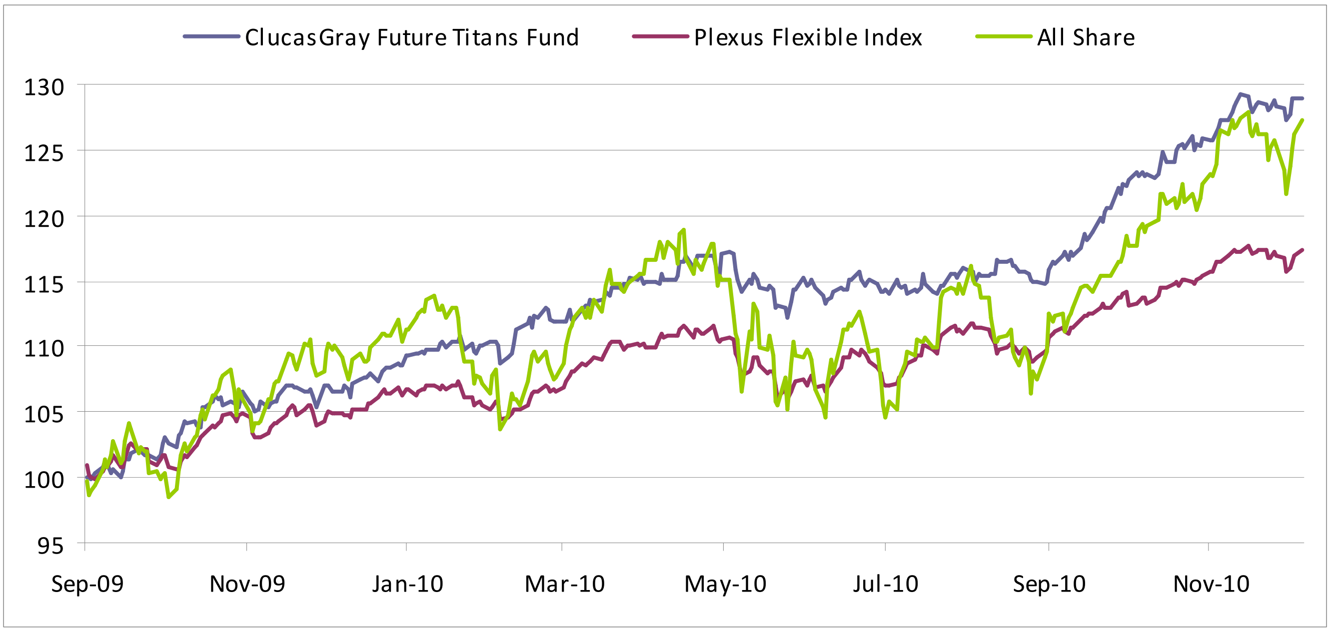


So with that in mind we have little doubt that 2011 will bring many more challenges. Rest assured though that the team of ClucasGray will work hard to maximize your profits and limit the losses. Regardless of the long term macro outlook we remain firm in our view that investing in equities is one of the best ways to ensure your money grows in real terms. We, as long term investors, do not attempt to time the entry and exit points precisely as this is a fruitless exercise.

Future Titans Fund

The ClucasGray Future Titans fund is now well into its second year of operation and is currently valued at R52m. Since 1 January 2010, the fund has delivered 21.6% growth versus the Plexus Flexible Fund index growth of 16.8%. Our philosophy in running the fund is to "kick the tyres" and stay close to management. Our investment criteria are squarely focused on cash earnings as opposed to accounting earnings. Typically, though not always, we tend to make investments in companies that are under-researched thus providing a relative opportunity versus the general market. An example of this inefficient pricing was on Brimstone shares which traded at over a 50% discount to the NAV prior to the announcement of the listing of Life Healthcare. We hold several other companies in the fund which we believe could double in the future and await the catalysts for the re-rating.

The chart below shows the progression of the future Titans Fund since launch against its peer group unit trusts (Flexible Index) and the All Share.



Christmas Stocking

Our 2010 stocking has returned 20% against an 18% return from the All Share. Two shares in particular hurt our performance – Altech and Gold Reef City. We hope to have a better relative performance this year so herewith our hamper for 2011

For my mother-in-law: Bidvest (BVT)

Last year I gave the old duck British American Tobacco and while she was happy about her dividend she was not too chuffed about the paltry growth shown in the share price. I tried to explain that the currency has gone against her but she fobbed me off with a mutter. This year I am giving her another blue chip, namely Bidvest. I recently met with management and had the opportunity to go through each division's outlook and I think things are improving for this group. Notably I get the impression that we may now not be too far away from a splitting of this big company into either two or three parts. Critically a separate foreign listing for the extensive food service offering of Bidvest could go a long way to finally attracting a decent rating for this quality leg of the company.

For my Dad: Nampak (NPK)

Nampak has been a dog for 15 years, driven into the ground by a tired and uninspiring management team. However things began to turn when the old (finally) made way for a new team headed up by Andrew Marshall, the former CEO of Oceana Fishing. Over the past eighteen months he has stopped unnecessary capital expenditure, reduced costs, exerted tighter control over working capital, and disposed of uncompetitive businesses. At the same time investments have continued in core businesses where a competitive advantage exists. In addition there seems to be a renewed vigor to take the business into other parts of Africa and capitalize on the higher economic growth evident in those regions. Nampak's cash generation is substantial and its balance sheet is strong. This company will be a good dividend payer!

For my beloved wife: Tongaat (TON)

…if she aint sweet enough, a good dose of Tongaat will certainly help. Tongaat's investment thesis is largely based on the significant hidden value lying in its existing asset base – notably it's very extensive land holdings but also it's underutilized milling capacity. I reckon that these hidden assets could be worth R150/share and that excludes its utilized milling assets, plantations and starch business. In addition Tongaat has significant scope to generate excess electricity at its sugar mills but it is waiting on a defined co-generation policy to be enacted before moving ahead. The unraveling of this value will take time but that is one thing I have a lot of with my wife.

For my married daughter: Cipla Medical Products (CMP)

She notices that her Grandparents still look pretty perky at their age - reason being those generic drugs that keep them going so well. With the advent of all those baby boomers reaching retirement and everybody living longer, she reckons the demand for drugs is going to be overwhelming. On a price earnings of just 11x for this fast growing company, I think she is onto a winning wicket.

Our loyal housekeeper: African Bank (ABL)

Grace was ecstatic about my gift of Cashbuild last year and obviously has high expectations for the year ahead. Her retirement home is taking wonderful shape and is, in no small part, due to some funding from African Bank. African Bank has had a tough time of it in the past couple of years owing almost entirely to its acquisition of Ellerines at precisely the wrong time. But that is now a thing of the past and management has spent substantial time and money fixing the problems. After attending the latest annual results presentation, I walked away thinking that this business is now on the verge of really starting to perform. The outlook for the furniture business (Ellerines) is much improved and more importantly, the bank is expected to have a bumper period over the next few years. I am looking for earnings growth of at least 20% over the next 2 year period, which should provide a solid underpin to a rising share price and growing dividend flow.

For my responsible son: Metmar (MML)

Some years ago, I gave Metmar to my wild boy and he did pretty well out of it but obviously sold too early. This year I am giving Metmar to my responsible son as I feel the maturing of this company suits his personality to a tee. The core business of Metmar is commodities trading, not necessarily a highly rated stream of earnings but valuable nevertheless given the quantum and consistency. Management is key in this sort of company and we remain extremely optimistic as to the talent, honesty and depth on display from the Metmar team. The real exciting facet to Metmar is its growing number of minority stakes in some exciting mining ventures. In this regard we would note its interests in Kalagadi Manganese, SA Metals, Pering Zinc, Zimbabwe Alloys, Kivu Resources and some chrome and coal ventures. These operations should supply significant volumes for the trading business in due course and provide a meaningful uplift to the company's net asset value.

For my wild boy: ELB Group (ELR)

I have thought long and hard on this one and it finally struck me; give him the antidote to his exotic lifestyle, the antithesis to wild, the "conserve" in conservative. ELB is a company with a long proud record of growth, providing solutions to the mining, power, port, construction and industrial sectors in the field of materials handling and appropriate process plants. ELB is well positioned to benefit from both the ongoing infrastructure spend in Southern Africa (and Australia) as well as the increase in capacities and efficiencies being implemented by the global resources and power industry sectors. ELB is relatively conservatively valued at 7.5x earnings, is cash generative and is well underpinned by a R13/share net asset value (R10/share of which is cash!).

For my youngest daughter: Eastern Platinum (EPS)

The apple of my eye once again gets a junior mining stock. Eastern Platinum is the only junior South African miner to ever make Goldman Sachs Conviction Buy list – quite possibility due to its attractive valuation, low cost position and significant volume growth expectations. Currently Eastplat's only operation is the Crocodile River Mine which producers 130k PGM oz but this is expected to double by 2014 based on expansion plans. In addition further growth opportunities exist for this company in its current undeveloped eastern limb projects of Mareesburg and Kennedy Vale. Above all it is my hope that this investment provides a solid hedge against her rising appetite for expensive jewelry.

And finally for myself: Investec (INP)

Finally I have bought Investec for myself. Since the onset of the financial crisis, the bank has done a remarkable job of strengthening its balance sheet, buttoning down the hatches and laying a solid platform for growth. Stephen Koseff and his team thrive when there are deals to be done and I have no doubt that they will be on the front foot once the environment improves. Importantly also, major impairments are now a thing of the past. We believe that this bodes well for earnings and dividend growth.

Regards
The Team at ClucasGray