



Investment Report Year End 2011

Last year proved to be one of the worst years in the stock market in living memory, ranking with 2008 for sustained price volatility and share price declines. During the year shares in many world asset markets fell sharply in value, as the Eurozone crisis worsened and growth prospects for the world economy deteriorated.

After a short period of calm at the beginning of the year, few markets escaped a general sell-off. Fairly quickly, European markets declined by -35%, India by -35%, China by -35%, and the UK by -20%. Against this backdrop the Kudu fund delivered a return over the year of -7.7%, a return which ranked the fund above 99% of Emerging Market funds and 98% of European funds.

There are two reasons why the fund ranked in the top handful of a thousand or more global funds investing in emerging markets. The first, is that we correctly predicted that the Eurozone would worsen, because Europe's leaders lacked the will and agreement to enact a solution; the second reason, is that individual shares held by the fund - amongst them, Woolworths, Mr Price, and Exxaro in South Africa - delivered strong returns during 2011.

The first few weeks of 2012 have shown how quickly sentiment can change in the stock market. Confidence has jumped in many markets, with yields on Spanish and Italian bonds falling sharply and bank stocks rising in value.

This move is a reminder of how important a factor confidence is in the behaviour of markets. During 2011 markets suffered from a chronic and self-reinforcing decline in confidence. However, when confidence is restored - even for a few weeks, a downward spiral can be reversed, first in financial markets and then in the wider economy.

It is too early to say whether this revival in confidence will be sustained, but there are four positive factors which offer support for financial asset prices in 2012 - even as the Eurozone's problems continue to act as a damaging drag on market sentiment and stock prices.

- 1) The resilience of the US economy
- 2) Credit provision by the European Central Bank
- 3) Growth in emerging markets

US Growth

The first support for asset markets comes from the US - still the dominant world economy. During 2011 the American economy proved stronger than many observers expected - and in recent months economic data and sales figures have consistently exceeded expectations. Most notably, unemployment figures are beginning to improve. The latest numbers were the best for three years.

Since unemployment data typically lags wider economic recovery from recessions, this evidence is particularly noteworthy, since it suggests that the economic cycle which began with contraction in 2008, may finally be drawing to a close.

The strength of the US economy has provided the backdrop for a steady push higher in US share prices - with markets reacting positively to good news and falling to fall on the release of further negative news from Europe.

The stock market has received vocal support from Warren Buffett, the legendary US investor - who has repeatedly highlighted the value offered by many stocks at current prices. For a man with a large share portfolio this view may not appear that unusual - except for the fact that in his sixty year lifetime of stock market investment, making himself for a while the richest man in America, Warren Buffett has very seldom expressed such a decisive view on market valuations.

The European Central Bank

The second support for asset markets is the provision of credit by the European Central Bank. Trapped between Germany and the rest of Europe, the ECB spent an uncomfortable 2011, trying to prevent a market collapse but not risk a German veto. Behind the controversy, the ECB has been pivotal in supporting European markets in recent months.

The latest release of balance sheet figures from the ECB show how the bank has proved to be a vital lender of last resort for Europe's banks - supplying close to 1.5 Trillion Euros of liquidity in recent months. This lending is in effect a form of quantitative easing. Rather than buying secondary assets outright as in the US and UK models of QE, the ECB lends credit to European banks, who buy assets themselves. In widening the range of collateral accepted, the ECB model has some advantages over the Fed approach.

This easing has reduced the pressure on stressed European banks - in particular in Italy and France - and offered a vote of confidence in Unicredit's Italian bell-weather rights issue.

Emerging Market Growth

The third factor supporting asset markets is the resilience of growth in emerging markets. In 2011 emerging market shares suffered the worst declines in global markets, in spite of the fact that growth in earnings and wider regional economies was robust. A decline in valuations rather than a decline in earnings. Company earnings in fact grew during the year - leading to a marked fall in share valuations.

Data from Indonesia, Brazil, India, Russia, and China, has proved better than expected, with growth driven by an apparently sustainable range of supporting local factors. This strong performance in emerging markets provided an important source of profit increases for most multinational Blue Chip companies - and compensates for at least a part of the damage expected from flat or declining demand in Europe.

Low Equity Valuations

During 2011 many traditional stock market investors lost interest in holding long-term share investments and chose to sell their portfolios - no matter how attractive their valuations appeared. Retail American investors sold over \$200 Billion from Equity mutual funds. These sales played a large part in the stock market falls in most world markets.

The continuing selling of shares as an asset class, has left many stocks trading at valuation levels which would have been considered outstandingly cheap at any time in the last twenty five years.

In Europe Blue Chip shares trade on just 10 times earnings with dividend yields of 4%. In the US similar stocks trade on 13 times earnings; in Emerging Markets leading companies can be bought on 5-8 times earnings.

There are highly visible reasons why shares are trading so cheaply. Europe faces an economic crisis which appears to defy immediate resolution - and the outlook for global growth is uncertain. However, in my view, much of this pessimism is already reflected in share valuations. As recent market moves in the United States have shown, even a small improvement in investor sentiment - when the consensus has shifted against owning shares - can cause share prices to rally sharply.

For investors like Warren Buffett - who at the age of 86 has experienced a number of market cycles - these valuations offer a moment of historic opportunity, particularly since the actions of central banks around the world all but ensure that any investment in Bonds will be eroded by inflation - as banks try to encourage economic recovery.

Buffett has always argued that shares in strong companies hold a fundamental value - which is separate from the temporary price shown on the stock market trading screen. In his opinion this is never more true than at the present, when valuations for the strongest companies in the world are little more than ten times their annual earnings.

Kudu fund outlook

The fund portfolio continues to invest with considerable caution - holding a widely diversified range of shares in only the strongest Blue Chip companies, operating in industries with favourable growth conditions and rising demand. At present we continue to hedge a proportion of these investments with short positions in other assets.

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