

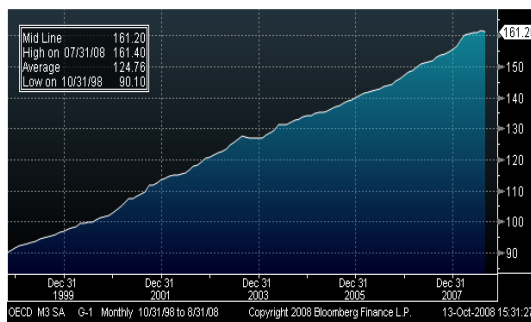
**“Everyone has a plan till they get hit.” (Mike Tyson 1990)**

The resumption of the global equity bear market and the continued falls in commodities & ZAR resulted in our return to profitability in September while most funds struggled domestically & globally. This appears to be early validation of the bounce-back analysis on this fund that was included with last month’s report.

If we are following the Japan 1990 road-map then South Africa, having given up 45% of its’ 5 year bull market gains, is technically well placed for a substantial bounce. As the fund, true to its’ trend following mandate, is still short of the SA equity market (albeit in reduced size) we have purchased portfolio insurance via OTM calls. We remain short of ZAR & SA long bonds.

**The Global Margin Call**

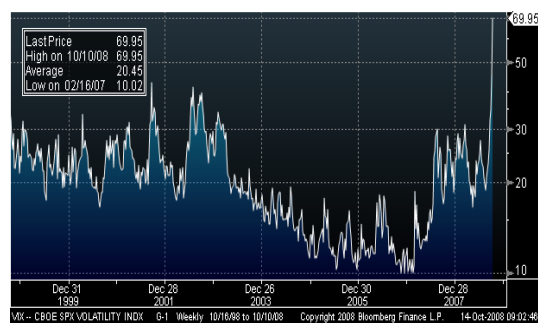
Now that the financial markets are in the throes of their global margin call there is apparently anomalous price behaviour. Risk (leverage) is being taken off the table. In spite of huge liquidity injections, asset price inflation is reversing & remaining liquidity is returning to USA. The carry trade is unwinding & the US \$ is strengthening.



What is apparent is that the recent bull markets in property, commodities & equities was not the result of an economic miracle, but rather the rotation of hot portfolio flows around the globe. For 10 years the global volume of money has increased (US M3 above left), and its’ price has fallen (US 10 yr bond rate above right). The asset markets are now showing every sign of returning to where they came from in 2003 (below: Platinum left & JSE Top40 right).



What is clear is that decades-old rules & relationships are changing fast, and prices have not yet reached their new equilibrium levels. We find the VIX (right) fascinating in this regard. Many mean-reversion, overbought/oversold strategies & discretionary traders would have sold volatility near the previous peaks of 43%. These would now be substantially out of the money. Behavioural finance states that prices overshoot; trend following capitalises on that bias.



**“Do you want Beta or BMT?” (Trendline 2008) (Big Match Temperament)**

In 2008 the South African bond, commodity, currency & equity markets functioned normally throughout the global rout – as they did in the Emerging Market Crisis in 1998 when they were used as a proxy for hedging exposure in other emerging markets which had been closed. In addition no restrictions have ever been introduced on short selling.

Our investment process adjusts dynamically to the new environment, enabling us to continue business uninterrupted by the crisis of the day – moves that result in the closure of other markets are often just another trading day in SA.

The above factors, together with its' high beta nature, make this an attractive environment for a diversified systematic trend following strategy, which capitalises on the extended price trends such as those which have prevailed this year. Trend following has the additional benefits of having greater trading liquidity than investor liquidity (reducing investor claustrophobia), and minimising counterparty risk by restricting exposure to margined exchange-traded instruments.

We believe that appropriate portfolio construction, risk budgeting and position management routines are more important in the South African environment than the highly sophisticated, high speed algorithmic trade identification & implementation prevalent in developed markets. The local South African conditions require a high degree of clear thought & robustness rather than intricacy – few parts of this market are accessible via automated algorithms. Execution expertise is an important qualitative element that is often overlooked by investors' quantitative filters.

**Andy Pfaff and Renault Kay**

September 2008