The Atlantic Log

The Atlantic Asset Management Quarterly Newsletter

Q3 2010 **Volume 2**

Welcome to our second quarterly newsletter called the Atlantic Log. This newsletter is aimed at providing our investors and independent financial advisors with an update on our business as well as our thoughts on topical issues for the industry. In addition, we will provide the reader with a summary of our main investment views as well as other thought leadership articles which we believe will be interesting and relevant.

2010 has proven to be yet another good year for fixed income investors. While South African interest rates have continued to fall over the year we have been able to provide money market-beating returns by investing in a range of carefully selected fixed income instruments. Bonds too have been a source of return as yields have fallen over the year in sympathy with the prospects of a deflationary environment. Given the debt dynamics in the developed world we believe that interest rates will remain lower for longer as the world attempts to pay down the debt it accumulated through the 'Goldilocks Era'. This is not good news for income investors, hence we caution them to adjust their return expectations accordingly.

The investment environment in 2011 will bring much of the same as what we saw this year, hence we believe that within an investment framework of low interest rates and low bond yields we can expect another year of low income returns for investors. This makes capital preservation paramount with income returns being provided within a well considered risk framework. We expect to see equity markets continue on their volatile path, but what should continue to favour SA asset prices is foreign capital inflows looking for higher yields in the bond market, commodity market strength and a relatively strong rand. We therefore expect to see fixed income assets doing well as the world's central bankers try to engineer a recovery by keeping the patient pumped with stimulus.

Atlantic
ASSET MANAGEMENT

Industry Matters

by Murray Anderson

"The first requisite of success is the ability to apply your physical and mental energies to one problem without growing weary." **- Thomas Edison**

I came across this quote and thought it very apt for Atlantic Asset Management since we are a specialist fixed income asset manager and focus specifically in building a business within the context of one asset class. More importantly though this quote offers guidance to anybody that wants to make a success of their life and or business. I have read many books claiming to have the secret source for success and the common wisdom that keeps coming up is **focus, hard work and self belief**.

I believe it is these attributes that will ultimately assist us to achieve our goal of being the best independent fixed income asset manager in South Africa.

So, as we look forward to a break over the December holidays we reflect on the year and take stock of the things that have kept us busy and the milestones we achieved:

- **Atlantic Enhanced Income Fund – Three Year Track Record**

I am very pleased to inform you that our Atlantic Enhanced Income Fund reached the three-year mark in November. We launched the fund on 1 November 2007. This is a very important milestone for us since a three-year track record is often required before certain clients will even consider a manager for selection. More importantly for us it provides a reasonable framework over which we can demonstrate to clients how we have managed assets over this period with specific reference to our investment philosophy and style.

- **Atlantic Point Hedge Fund - Turns One**

Our fixed income hedge fund also achieved the honour of posting its first full year of performance in September. We managed to deliver performance in excess of the benchmark and with lower than average gearing.

- **Conflict of Interest Kicks In**

The new COI legislation came into effect in October. This far-reaching legislation has resulted in the industry spending a considerable amount of time debating and pondering its effects. We believe it will assist in stamping out the 'perverse incentives' that occur from time to time in the broader savings industry, but we don't believe it will have too much of a detrimental impact on our market. We feel strongly that we still have to spend time engaging with clients but have chosen to rather do this through value-add sessions such as our Fixed Income Workshops that we recently held around the country. These sessions will enable us to market our capabilities as well as provide the audience with deeper insight into the asset class in which we manage.

- **ASISA Stats**

The ASISA stats were published at the end of September, again indicating how clients have favoured the Fixed Income Variable Specialist category as a safer haven over equities. The category netted R2.37 bn inflow for the quarter. Fortunately as a fixed income manager we have benefited from this trend and due to our investment views we don't foresee this shift reversing in the near future.

I would like to thank all our supporters for their continued and valued support. We believe our partnership with you is very important and we welcome every opportunity in engaging with you, even if it is in a small way, since our business is really built on good relationships which are open and honest. As we grow our footprint in the South African investment market, this is something we want to continue to offer.

We wish you and your families a blessed and relaxing holiday season and look forward to see you early in the New Year.

OUR FUNDS AT A GLANCE

Atlantic Enhanced Income Fund:

The nature of the Fund mandate enables the manager to allocate assets in the Fund according to Atlantic's **interest rate cycle views**. The flexibility of the mandate therefore means Atlantic can react timeously to the changes in market conditions.

Atlantic Real Income Fund Fund:

The Atlantic Real Income Fund is an ideal Fund for income investors who require inflation protection and a real return over time.

Atlantic Cash Plus Fund:

The Atlantic Cash Plus Fund is an ideal Fund for investors who want the safe haven of a money-market-like portfolio, but need to generate a slightly higher return over the longer-term.

***MURRAY ANDERSON** is a founder and director of Atlantic and is the Managing Director of the business. His key areas of responsibility are the day-to-day management and strategy of the firm as well as business development and distribution. Murray's role is key in ensuring Atlantic achieves its short and long-term strategic goals.*

Homo Economicus: a species under threat

by Albert Botha

***ALBERT BOTHA** is Atlantic's Fixed Income Analyst and his area of responsibility include fixed income research, quantitative analysis and portfolio management. Albert is responsible for managing the company's money market mandates.*

Human rationality and the nobility of reason have been with us since man first started grappling with the world around himself. The steady progression of our understanding took us from primates to a space-faring species; from taking shelter from lightning, to checking our e-mail on our iPhones, in silent disdain of almighty Zeus.

Man as a rational animal is also the basis of our socio-economic theories. Man as a rational actor for his own interests is how we view politics, economics and investments – or maybe the verb should be "viewed"? Increasingly, the rationality of humanity has come into question. Bertrand Russell, the famous English philosopher, mathematician and social critic said it best:"*It has been said that man is a rational animal. All my life I have been searching for evidence which could support this.*"

As good an explanation as any for Homo Economicus can be found at Investopedia: "The basis for the majority of economic models is the assumption that all human beings are rational and will always attempt to maximize their utility - whether it be from monetary or non-monetary gains".

There are however two distinct problems using this as a basis for forecasting. The first is the predictably irrational psychological element of human emotion. The second issue is the *range* of human emotions, which apart from reason, distinguishes us from other animals. And while we often feel that decisions should be made rationally, it is inordinately difficult to achieve this. As a species we are at our best – and at our worst - when powerful emotions drive our decisions.

In the recent and ongoing financial crises, as in previous ones, we once again saw how irrational people can be. Professional investors threw all caution to the wind and rode the bull market, defying increasing signs and warnings of impending disaster. Of course once the bulls started to stampede for the exit, very few could get off in time.

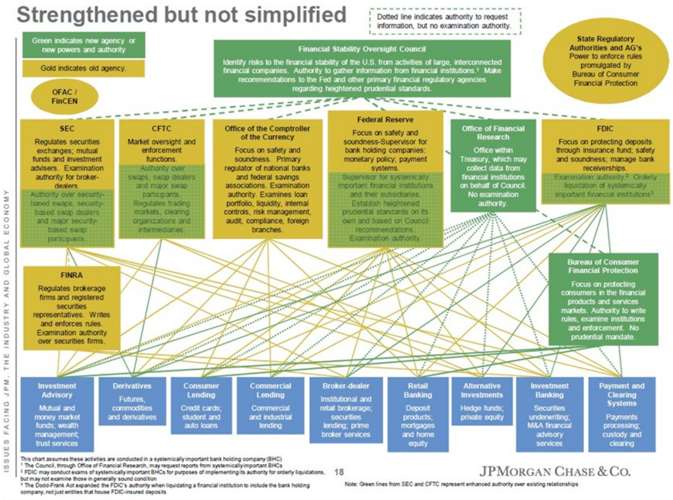
The above chart should be required reading in every school curriculum. It is a typical representation of the emotional states investors go through.

As is often the case though, investors typically enter the market at the excitement or thrill stage - often buoyed by overconfidence from recent successes. People tend to subscribe success to personal actions or skill rather than random occurrences, forgetting that "*a rising tide lifts all boats*". The problem is that markets can and do fall as well. Whatever the cause, investors take the plunge on through the emotional states from euphoria to capitulation - the perpetual cycle in the creation and destruction of wealth.

Recently, a new field emerged, studying the predisposition of humans to non-rational actions – behavioural economics. It uses a new set of tools to examine the causes of our departure from the rational actor model. It attempts to explain our tendency to use heuristics and to help us realise our susceptibility to it.

In what has become a cliché, admitting you have a problem is half the battle won – and it is a problem that almost everyone has. We saw it in playing out on the world stage, with politicians, regulators, CEOs, professional investors and Joe Public all having major roles. And yet emotional decisions are only half of the problem.

The other side of the coin is strangely not lack of reason, but insufficient reason. The world in general and the financial markets in particular have become incredibly complex. To illustrate this, below is a chart of the regulatory environment in the USA. Apart from the complex interaction between the various regulatory agencies, government, institutions and individuals, you have the global economy in turmoil due to competing economic interests, economists advising and implementing novel solutions to previously unimagined problems and Nobel Prize winners in physics trying to outdo Fields Medal recipients writing high frequency trading algorithms.



In this complex cauldron of competing issues it becomes very difficult to keep juggling all the balls – especially when someone comes along and unexpectedly greases all the balls!

Professional investors at times struggle to cope with this complexity. They sometimes make mistakes because they let their emotions dictate their actions – holding on a little too long due to greed, or not taking advantage of an opportunity due to fear. It is the inherent inability to process all of the available deluge of continuous real-time information into something meaningful that causes such mistakes.

And yet, they are only one of the actors in this ongoing saga: You have consumers that spend too much, save too little and buy houses they cannot afford. You have regulators that are too distant from the industry to properly oversee it, or they are more interested in securing and enhancing their own power base. And you have politicians that are more concerned with being re-elected rather than make the hard choices - pandering to the lowest common denominator.

This is a complex world we live in and a little more rationality along with the acceptance of our own irrationality will do wonders to improve our decisions. It is also important to recognise that, just like most of us aren't doctors and cannot do surgery simply because we may often watch ER; there are people who are trained to help with analysing financial problems - whether that is insurance or investing. Thus while we may well be predictably irrational, it does not help to ignore the fact that we are not always irrational, and professional investors are able to make decisions which are entirely acceptable to the man in the street who would not know where to start.

The Role of Government

by Arno Lawrenz

The South African Government has now released its plans, both medium and long term, for the country, as formulated in the "New Growth Path" and the MTBPS. While financial markets hoped and simultaneously feared what the release of the Medium Term Budget Policy Statement might hold in the form of subtle or not so subtle policy shifts, we are left with the feeling that not much has changed. Certainly, a lot of the substance and objectives of the new plans that were laid bare is ground that has been covered before – there is RDP, GEAR, and AsgiSA as predecessors.

Finance Minister Pravin Gordhan's response to this criticism is that we cannot change the past but that we should give the new plans our best shot. With job creation at a massive scale as a prime objective, perhaps we should take a step back in examining where Government policy is hoping to take us and examine where we are, and what we purport to change.

It would firstly need to be said that while the lofty ambitions we hold through the objectives of the MTBPS are an unequivocal necessity, we should not forget that many of the issues that need to be addressed are the outcomes that can be directly linked to past policy choices. In this we speak not only of the apartheid legacy, but also, sadly, of our post-1994 democratic national government's choices. One needs only look at the state of the Education system as a prime example. Mass unemployment, being identified as the chief issue of the new plans, is a direct result of an education policy that has failed dismally to deliver. With so much at stake, the policy choices of the late 1990's and early 2000's leave one aghast at their cruel condemnation of another entire generation of school-leavers to a lifetime of menial jobs at best.

There has been very little acknowledgement of the role that past policy choices play in the perpetuation of so many of our social ills. We need not go further into this, but there are numerous other examples to choose from – the health system and provision of housing amongst others.
Nic Borain, an independent political analyst, in a recent analysis, writes of a great disconnect between the elected leaders and the electorate as such :

"I believe there is something intrinsically harmful to ourselves and our society in the way we elevate our politicians. I recommend taking every opportunity to deflate the individuals, prick the bubble that we have surrounded them with."

What he inherently questions in this line of thinking is whether our elected leaders truly are capable of performing the miracles that the electorate expects when casting their votes. So when ministers Patel and Gordhan come up with a plan that promises to deliver South Africa from the many social ills, we should, as much as it is our leaning to pat them on the back for a job well done, gravely question whether they are truly capable of delivering. In the investment arena fund managers and analysts are not rewarded for their performance objectives, but certainly it is on their actual performance that they are rewarded. It is on the facts, rather than the theory, or the objectives. Should we judge politicians on a different basis?

Recently Mosibudi Mangena – a former Minister of Science and Technology *nogal*, (and elected politician of course) wrote of the Zimbabwean problem. No, not of the problem that the failure of the purported political power-sharing agreement there brings, but rather of the problem that the literally millions of Zimbabwean refugees represent to our country. As he writes :

"…what we are seeing on a daily basis is human misery on a massive scale and the governments of Zimbabwe and South Africa should squirm with shame for creating a situation that is not only cruel, but also tragic."

This a result, as he terms it, of South Africa's "foolish benevolence." Is it wilful ignorance? Is it because of the great divide that exists between the ordinary people and the policymakers that Borain so eloquently writes of?

__ARNO LAWRENZ__ is a founder and director of Atlantic and is the Chief Investment Officer. Arno is responsible for the investment management team and is integral in the portfolio management process and assumes the responsibility of setting the investment policy at Atlantic.

Why do we seem to be saddled with so many seemingly intractable social ills and yet have the brutal irony of being a country with 4 Nobel Peace Prize winners? When Pravin Gordhan refers to the private sector and elevates this sector to national importance, and talks of how we cannot achieve our goals without having a new social compact, then it is perhaps because he has brought a refreshing honesty to the business of government. And importantly, to the government of business. It is an honesty that is prepared to admit that without a healthy private sector this country is doomed. It is also an honesty that requires us to conduct a brutal examination of self in a meditation on our identity, our loyalties and a recognition that we have to break the hold that the past seems to have over us.

Mark Gevisser, an award-winning South African journalist asked the question recently "What makes us South African?" His question intersects the personal and the political in that he refers to that often-quoted Gini-coefficient - that in the end, we are one of the most unequal societies on earth. That brutal truth, and yes, it is brutal, cannot coincide comfortably with the concept of a Rainbow Nation.

We cannot have the shamefulness of a Zimbabwean "problem", and we cannot have the shamelessness of a Great Disconnect. It is these truths and realities that require us to hear minister Gordhan's call to lay down the arms of the past and pick up the ploughshares of the future. We cannot afford the luxury of a considered neutrality whilst around us society is awash with civil strife, class and ethnic prejudice and a wilful ignorance of our shared and common future.

So in a sense what is really required is a new growth path and plan – not for our economic policy but more importantly for our minds and consciences - a social compact that requires us to forego some of our dearest held positions in the interest not of our futures, but of that of our children and our grandchildren.

On the road to oblivion

by Erik Nel

Every journey starts with a first step…

But in a world John Mauldin calls 'The Muddle Through Economy' and Mohammed El-Erian 'The New Normal', do we even know where this journey is leading us? The impressive economic recovery experienced since March 2009 appears to be running into headwinds as authorities slowly start to remove the punchbowl.

As we map what was and what will likely be, Donald Rumsfeld's 'Known knowns' resonates well with us. There are just so many potential 'unknown unknowns', while the 'known unknowns' already scare us! What is clear at this stage is that the fiscal pain required to address economic imbalances stand the risk of perpetuating certain potential negative feedback loops.

The US housing market against a slipping demographic background is a key example in this regard.

Thus, the specific (with some poetic license) reference to the Chris Rea classic as our title (and some references could easily be drawn to the SA situation) indicates that some soul-searching will be required to steady the global economic ship:

'Well I'm standing by the river, but the water doesn't flow. It boils with every poison you can think of. And I'm underneath the streetlights, but the light of joy I know, scared beyond belief way down in the shadows. And the perverted fear of violence chokes a smile on every face, and common sense is ringing out the bell. This ain't no technological breakdown, oh no, this is the road to Hell.

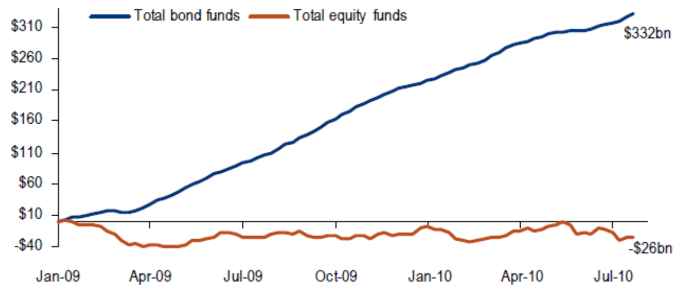
And all the roads jam up with credit, and there's nothing you can do. It's all just bits of paper flying away from you. Look out world, take a good look, what comes down here you must learn this lesson fast, and learn it well. This ain't no upwardly mobile freeway, oh no, this is the road to Hell.'

Chris Rea – The Road to Hell (1989)

Balancing act

In a recent Investment Outlook, Pimco's Bill Gross wrote about doo-doo (yes, that type of doo-doo), the reference drawn between the global economy, deteriorating demographics and, well, doo-doo, was spot on.

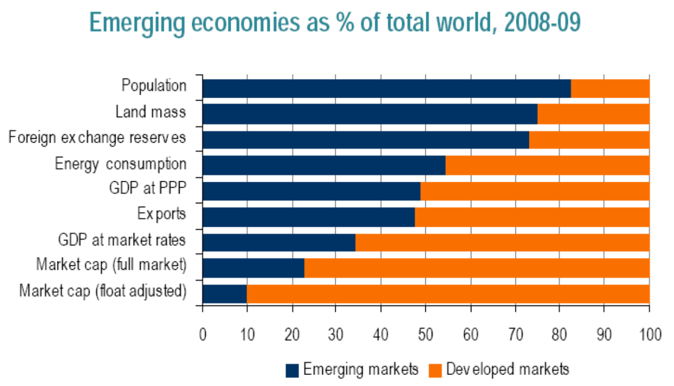
Figure 1: Government debt replacing canned beans and bottled water!



Source: Lipper FMI

At Atlantic we have been at pains to point out the shift in global power that for most part is a story of ever-growing imbalances between developed and developing markets. It is the investment implications of this shift that is more important - a theme we covered in depth in our previous Quarterly: [Deleveraging - A tale of two halves, or merely an Indian Summer?].

Figure 2: EM will no longer be ignored



Source: Bank of America Merrill Lynch

Ashmore Group's Jerome Booth – an EM pioneer – in a recent *Institutional Investor* article argued that even at 10% being allocated to EM assets, investors showed their ignorance by still being '*comfortable with 90% in the crash zone*'. He goes on to argue that '*Investors should have a 50% exposure, which equals the emerging markets' share of global economic output based on purchasing-power parity.*' Adding '*That's if they're neutral, not bullish!*'

While this stance may be slightly aggressive to some, investors with a combined $3.3 trillion worth of assets (split roughly equally between Pimco, JP Morgan Asset Management and Goldman Sachs Asset Management) argue further in the same article that asset allocation to emerging markets should be increased dramatically. JP Morgan AM is calling for at least 20%, while Pimco's Ramin Toloui shows his vote of confidence in EM local debt when saying he expects equities to underperform in coming years and that in this context, a broad split of 50-50 between EM equities and EM fixed income in a dedicated EM portfolio is more appropriately balanced.

Inflows into EM assets are clocking records almost on a weekly basis - JP Morgan reported flows into emerging-market bond funds surpassing $40bn year-to-date at the end of July. So it is little wonder that in a world where the road to oblivion seems paved for many developed markets that lived well beyond their means there is a large-scale shift to developing markets.

Disturbing signs

With the downward trend in both growth and inflation seeming firmly entrenched, weak labour and housing markets imply not only further hardship for Americans, but also an ever bigger risk of deflation as the trends in core inflation and even inflation expectations continue to slip.
Worryingly, one of the bigger bears on the Fed's FOMC, James Bullard from the St. Louis Fed, has now joined the chorus that includes award-winning Goldman Sachs economist, Jan Hatzius, arguing for policymakers to react with further (or rather renewed) policy easing, most likely in the form of further quantitative easing by buying US Treasuries (authored prior to QE2 announcement).

Notwithstanding arguments that further stimulus will only add to the burden of long-term costs to the economy, and may even create asset bubbles, inaction may have unintended consequences if inflation expectations continue to dwindle.

Evidence from a speech made by Fed Governor Ben Bernanke in 2002 confirms that it is unlikely that under his stewardship the Fed will allow deflation, and eventually a potential depression, to set in. We can therefore expect the kitchen sink and even the plumbing to come our way if that is indeed the price they feel we need to pay.

With US benchmark bond yields still hovering at 3%, Hatzius suggests it is difficult to argue that the US government has reached the limits of its debt capacity, when federal interest payments stand at less than 2% of GDP.
However, in what Ben Bernanke has termed an 'unusually uncertain' economic environment, it is disturbing to see the economy still not finding traction after all the policy action.

Make no mistake, if you don't pay the Piper, he will come calling eventually...

It's been proven that credit crises are invariably deflationary (a scramble for risk-free assets raises their value relative to goods and services). Thus, eager demand for a huge supply in government obligations in the early years of a recovery could easily mask inflationary pressures. Final demand also lacks markedly, which further explains the ineffectiveness of the multiplier effect – the impotence of velocity of money in the current context a case in point.

What history has also taught us, however, is that stimulus packages are highly inflationary in the end and that fiscal deficit-spending is almost always followed by higher taxation.

A classic comment by Puru Saxena on this subject:
'*In order to fund the increase in spending, occasionally governments raise the tax level but more often than not, they levy the most insidious form of taxation – inflation. Regardless of the consensus view, it is clear that under the guise of stimulus, policymakers are in fact confiscating private-sector wealth and steering the global economic ship towards Inflationville.*'

Looking at Figure 3, it is clear that the debt overhang in most developed nations will see an acceleration in monetary inflation in future years.

Figure 3: (Lack of) Dollar purchasing power since 1913

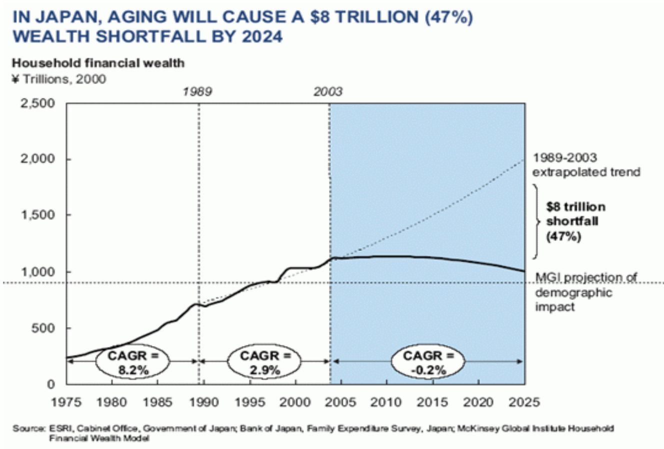
Source: Bureau of Labour Statistics

It appears we are faced with a scenario where short-term forces are markedly different from the eventual 'end-game', while the differentiation process (developing vs. developed) is also picking up pace.

Unfortunately, many emerging markets are not used to the amount of capital inflows coming their way, and some have already started implementing barriers to stem the tide. Only time will tell whether this move will prevent asset price inflation from setting in.

Demographics - only a negative for some

Figure 4: Unfortunately a developed market theme, and not the exception



At Atlantic we spend a lot of time deliberating the long-term impact the aging of Western populations will have on the global economy, as well as the shift from export-driven growth to internal-demand growth witnessed in developing Asia (and that will hopefully develop here in Africa too).

The shortfall in savings in an environment where real-return expectations have been cut back dramatically in the 'New Normal' explains in large part the phenomenon witnessed in Figure 1, but, worryingly, does not address the ever-growing divide between required returns versus expected returns.

A negative change in demographics is one of the bigger problems facing the global economic system on a longer-term basis. Some frightening statistics recently revealed that the number of dependents relative to the active working force in places such as Japan, the US and large parts of Western Europe exceed 1.5 to 1.

One does not require a Masters in Economics to appreciate that this almost irreversible (or at least for multiple generations) trend is going to put a massive strain on the fiscus of the respective countries, most likely at the cost of tax-payers.

Even China is approaching the peak of its demographic sweetspot, but in general, emerging economies are much better off, with ever-growing numbers of citizens joining the workforce and in doing so climbing the wealth ladder. This should put an almost permanent floor under meat prices and some other highly sought-after consumer goods.

Bringing it home

Clearly the preceding argument potentially holds much potential for a country such as South Africa. With expected global population growth of 40% over the next 40 years, demand for resources from South Africa, and Africa in general, could and should continue unabated.

It is perhaps often under-appreciated that when it comes to steady, reliable access to the 'stuff' the world needs to grow, the fast-growing nations including China and India aren't necessarily spoilt for choice. South Africa therefore has an unbelievable opportunity to set in motion a gateway into Africa and its vast natural resources.

It is perhaps this potential that foreign investors are now recognising, resulting in a second wave of large-scale inflows into Africa this decade (seen by some as the true final frontier market).
South Africa has been no exception with total foreign portfolio inflows of R75bn year-to-date (at time of writing), the bulk of which has been focused on the local bond market.

However, South Africa remains a country at a major crossroad, being at risk of slipping from the bottom of the Premier League, as Clem Sunter recently argued. This view was supported by Goldman Sachs's Jim O' Neill at a recent presentation when he said that Nigeria, with a population of 160 million, had a much bigger chance than South Africa of joining his infamous group of BRIC nations.

For all its potential South Africa remains a nation that suffers from unfulfilled promises. Bottlenecks, lack of service delivery, unskilled labour and illiteracy are only some of the pressing matters. On top of this, crumbling infrastructure (water, sewage, electricity, transport) could potentially continue to hold back a country that continues to show massive potential.

While we are in agreement that the current large capital inflows into South Africa are likely to be a bit more sticky than they were in the past, this is primarily because of a global shift rather than an SA-specific issue. We should also appreciate that our dependence on this funding may grow significantly in time to come as we move ever closer to having a structural deficit problem, rather than a cyclical one.

It would appear that South Africa, despite its vast potential, has some way to go to avoid the doomed road to oblivion.
It seems that Gill Marcus does indeed share similar views..

"SA has all the ingredients to be a successful country. We just need to put them in the right order and mix our mixture properly."

But the task so often seems to be beyond us. SA is forever talking about devising a new growth path but the lack of policy cohesion among the economic ministries makes it a nightmare to craft. As a result, SA is forever mixing but never producing the cake.

"I think we can do it but we need to rebuild trust and confidence in each other and ourselves ... and deal with the issues that are wrong," she says. "I've got enough on my plate — that's somebody else's baby."
Gill Marcus, SARB Governor

__ERIK NEL__ is Atlantic's Fixed Income Strategist. Erik's research spans both local and international fixed income markets and is integral in the management of the company's long only assets. In conjunction to his role as a strategist Erik has the responsibility of managing Atlantic's fixed income hedge fund, the Atlantic Point Hedge Fund.

by Erik Nel