

# Expectations for 2011

## Solutions for Retirement



### Income Focused Investing

Contact us on 0800 336 555  
or visit [www.marriott.co.za](http://www.marriott.co.za)

**MARRIOTT**

A Member of the  **OLD MUTUAL** Investment Group

 A FULL MEMBER OF THE ASSOCIATION FOR SAVINGS & INVESTMENT SA

Licensed Financial Services Provider

## Introduction

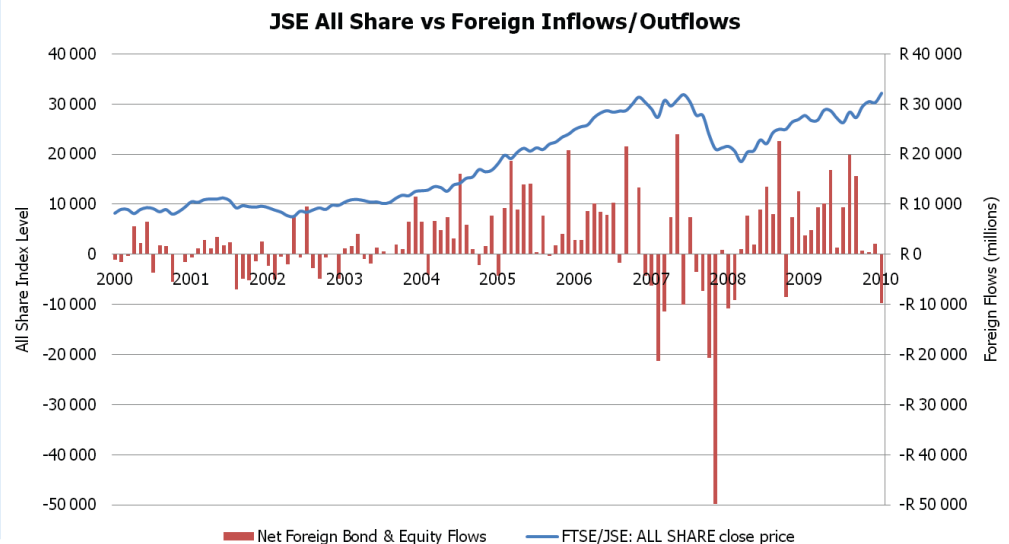
During 2010, the South African investment environment was characterised by foreign demand for bonds and equities, a strong Rand and consequent low inflation. This encouraged further interest rate cuts resulting in an economy that was good for consumers but not for exporting and mining. The extraordinary success of the Soccer World Cup elevated South Africa in the eyes of the world and left a very positive feeling in so many minds.

The year ahead may well be one of a changing investment environment, characterised by rising inflation, higher interest rates, a consumer under pressure and a downward adjustment of many asset prices.

## 2010 – A Year of Recovery and Foreign Capital Flows

Local and foreign equity returns during 2010 were good, at 16.1% and 15.1% respectively.

2010 has been a year that has erased the losses investors experienced as a result of the worldwide credit crisis and subsequent global recession. The JSE All Share index rose 16.1% during 2010. The chart reflects the impact foreign inflows have on the prices of JSE securities.



Local share and bond prices were supported by high foreign capital inflows and low inflation.

The JSE recovery and the good returns of property (+29.6%) and bonds (+15%) may be attributed to the high levels of foreign inflows, having increased demand for South African listed securities beyond local demand. A consequence of R96.6 billion of foreign inflows has been a strong currency which, in turn, resulted in lower inflation and support for all SA asset classes.

## Foreign Inflows Cause Rand Strength and Drive SA Inflation Down

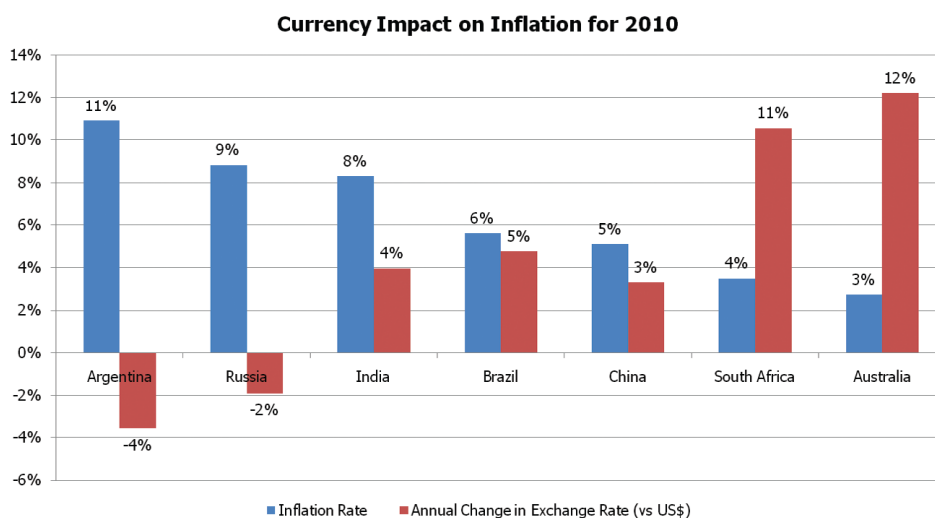
Local inflation was dampened by a strong Rand which may be attributed to foreign capital inflows.

Inflationary expectations have a profound effect on asset prices as inflation threatens the purchasing power of the income produced by those assets. Foreign inflows during 2010 have contributed to an 11% appreciation of the annual R/US\$ exchange rate helping to contain inflation at historically low levels.

The table below shows the direct relationship between foreign flows and the currency.

Year ending	Exchange Rate (R/US\$)	Annual Net foreign flows (R)
Dec 2007	6.81	+65.4bn
Dec 2008	9.53	-70.4bn
Dec 2009	7.40	+102.0bn
Dec 2010	6.62	+96.6bn

The chart below demonstrates that countries which have had currency appreciation during 2010 have experienced low inflation.



Looking ahead to 2011, higher expected interest rates in developed markets are likely to reduce the attractiveness of SA Interest rates. This should lead to a decrease in the quantum of foreign inflows into South African capital markets. Further appreciation of the Rand from current levels is therefore highly improbable and the buffer against the inflationary impact of excessive wage increases, hefty electricity tariff hikes and rapidly rising food and energy prices will be lost.

Declining foreign inflows will result in a weaker Rand and consequent higher inflation.

## 2011 – Rising Inflation and Expensive Income Streams

We consider inflation to be the most important economic variable as it influences the income yield and income growth prospects of all asset classes. In addition to this it has a profound impact on the lifestyle of income-dependent investors as well as being the benchmark for real returns.

Approximately 23% of the inflation basket is a measurement of food and fuel prices which are directly impacted by the currency. The table below demonstrates the dampening impact of the currency strength and the mounting pressure of inflation in these two commodities. We remain of the view that inflation over the next 5 years will average around 7%.

Change in 2010	Food Index	Oil Price
Increase in US\$ terms	29.0%	21.6%
Increase in Rand Terms	15.4%	8.8%

Inflation is a critical variable and we expect it to rise in 2011.

Dec 2008: Inflation 9.5%  
Dec 2009: Inflation 6.3%  
Dec 2010: Inflation 3.5%

# Where is the Value - Asset Class Expectations – 2011

## South African Market

We continue to favour inflation linked bonds over fixed interest bonds.

Property appreciated on the rising bond tide and remains expensive.

Low, and declining, interest rates have kept money market returns muted.

### SA Bonds – fixed interest to be avoided

#### Fixed Interest Bonds:

Dec 2009 yield 9.1%  
 Dec 2010 yield 8.1%  
 Average 2010 bond fund return 14.6%

#### Inflation Linked Bonds:

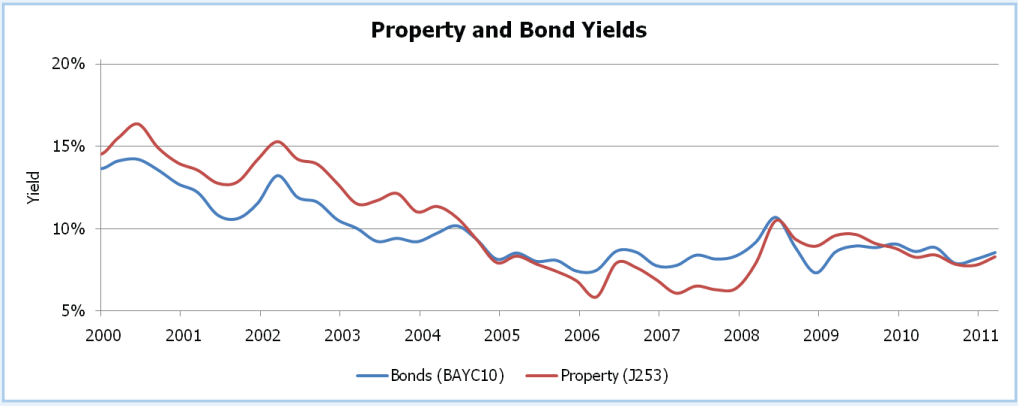
Dec 2009 yield 3.2%  
 Dec 2010 yield 2.7%  
 Average 2010 Fund Return 9.4%

The South African bond market has benefited from increased foreign demand and the impact of a strong Rand on inflation. These dynamics are unlikely to continue in 2011 due to rising inflation and an anticipated decline in foreign demand. We continue to favour inflation-linked bonds due to their attractive real yields and inflation hedged income.

### SA Listed Property – remains overpriced

Dec 2009 yield 8.1%  
 Dec 2010 yield 7.3%  
 Average 2010 property fund sector return 24.3%

With a strong positive correlation between property and bond yields, property has benefited from the re-rating of the bond market. Property fundamentals remain weak and given the longer term inflation outlook in South Africa we continue to consider property to be an expensive source of income. Property has strong bond-like characteristics, resulting in the yields of both asset classes being highly correlated as seen in the chart below.



### SA Money Market Instruments – a parking bay to preserve capital

Dec 2009 yield 7.2%  
 Dec 2010 yield 5.6%  
 Average 2010 Money Market return 6.8%

Cash rates during 2010 declined by 1.5%. Suitable alternative money market instruments (90 days) could at best enhance cash rates by 0.6%. Instruments up to a three year term improved yields by up to 2.2%. Our expectation for the year ahead is cash rates rising by approximately 1%.

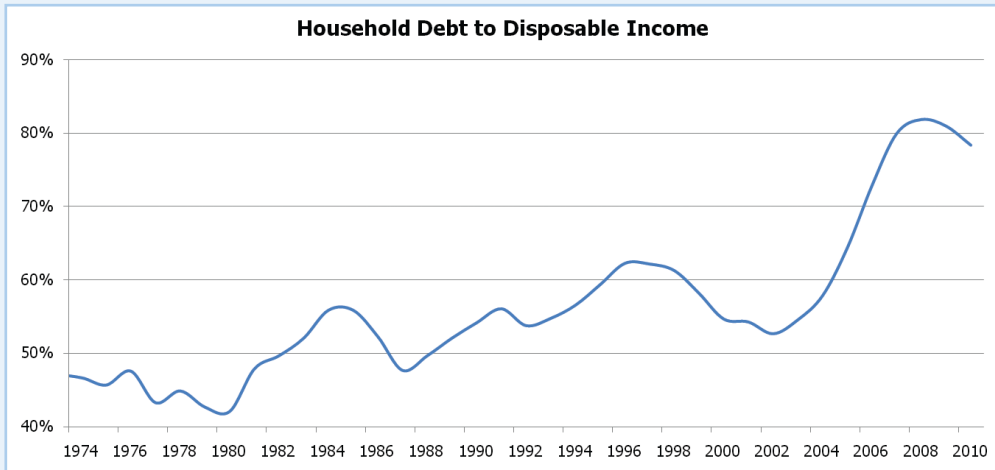
### SA Listed Equities – low dividend yields

Dec 2009 dividend yield 2.2%  
 Dec 2010 dividend yield 2.2%  
 Average 2010 Equity Fund return 18.0%      Average 2010 Industrial Fund return 26.0%  
 Average 2010 Financial Fund return 17.1%      Average 2010 Resource Fund return 12.7%

Dividends generated by South African companies increased by approximately 16% during the course of 2010. This may be attributed to the resumption of certain dividends that were waived during the financial crisis as well as a buoyant consumer who has enjoyed greater spending power on the back of lower interest rates and greater than inflation wage increases.

Household consumption reverted to pre-recession levels during 2010 on the back of historically-low interest rates. The SA consumer remains overly indebted and under-saved. Consequently, any increase in interest rates is likely to impact consumption significantly. With the likelihood of rising inflation and interest rates in the years ahead, we anticipate that the consumer will have less spending power which will ultimately retard dividend growth of many SA companies. The chart below shows the high level of consumer debt in SA.

The consumer sector was buoyant on the back of historically low interest rates.



Last year's increase in dividends, coupled with an equivalent rise in share prices, has resulted in the dividend yields of South African equities remaining unchanged at 2.2%. A combination of low dividend yields without the prospect of high dividend growth suggests poor returns from local equities.

Poor outlook for equities in 2011.

## International Markets

### International Real Estate – inflation hedged income at fair value

Dec 2009 yield 6.7%  
Dec 2010 yield 4.6%

From 2009 we promoted international real estate due to above-average dividend yields and the sustainability of those dividends. Although substantial price appreciation has reduced the attractiveness of this asset class, international real estate still offers investors an inflation-hedged income stream at fair value.

International real estate is still attractive in spite of strong price growth.

### International Fixed Interest Bonds – avoid negative real returns

Dec 2009 yield 3.8%  
Dec 2010 yield 3.3%

With rising food and energy prices and the re-emergence of inflation in a number of global markets, it would be prudent to avoid international long bonds.

International bonds are expensive and unlikely to deliver real returns.

### International First World Large Cap Equities – valuable global dividend streams

Dec 2009 yield 4.3%  
Dec 2010 yield 3.7%

Recovery in the first world economies continued throughout 2010 and the prospects for dividend growth from international equities have improved. Considering that dividend yields of first world large cap equities are well above their historic averages, these income streams continue to offer good value. It should be noted that these first world large cap equities are global companies deriving a substantial portion of their revenues from emerging markets.

The positive outlook for first world equities continues to gather momentum.

# 2011 – An Environment that Favours the Marriott Funds

Inflation and rising interest rates are the economic environment that favours the Marriott Income Focused Investment Style as it presents opportunities to buy income streams at more reasonable prices. All the Marriott funds have been positioned in accordance with the views expressed above.

## Income Funds – an improving environment

Property and long bonds have been avoided because of low yields. We will reinvest when yields are appropriate.

These include the High Income Fund, Core Income Fund, Income Fund, Property Income Fund and Property Equity Fund.

For the last three to four years, the Marriott Income Funds have been focused on long term preservation of capital and income. The ideal income-producing asset classes (property and bonds) have had to be avoided due to low yields relative to longer term inflation expectations. While these asset classes have produced good returns in the last year, the risk of substantial capital loss remains high. We are reluctant to include an expensive asset class in a portfolio as it puts investors' capital at risk.

Throughout 2010 the Marriott Income Funds (excluding property) have produced returns in line with money market returns. Investors who have drawn more income than money market rates have experienced a small decline in capital value.

Assuming rising inflation, it is anticipated that the instruments in these portfolios will produce more income and have growth in capital values. These instruments include corporate debt, structured NCDs, preference shares and inflation linked bonds. We look forward to re-investing in property and long bonds as these are the instruments that offer retired investors the most secure and reliable long term income. They will however only be included when the income streams are appropriately priced with yields reflecting higher inflation.

## Equity Funds – the value is in the First World

While a weak economic outlook continues, industries providing basic necessities are included. Banks and cyclical business are excluded.

### The Marriott Dividend Growth Fund – expensive dividend streams

The Dividend Growth Fund aims to provide Investors with an acceptable tax-free dividend yield and growing levels of dividend income. The universe of South African securities that produce reliable growing dividends is fairly limited. The banking, pharmaceutical, food, clothing and telecommunication industries are typical investments of the Dividend Growth Fund. Industries with unpredictable revenues like commodity producers and construction are therefore excluded. Over the past three years and typical of a recession, the industries providing basic necessities have prevailed. Marriott served investors well in observing the coming recession and adjusting exposures away from banks and cyclical businesses into companies offering consumer necessities or value for money.

With an expectation of rising inflation and interest rates in the years ahead, we anticipate that the consumer will struggle. As a result, the fund remains defensively positioned to ensure reliability in dividends despite a modest economic outlook. Over the last decade the Dividend Growth Fund has increased its distributions to investors by 13% per annum which has exceeded inflation by approximately 7% per annum.

## The Marriott First World Equity and International Real Estate Funds – high dividend yields

The Marriott International Funds have been positioned to take advantage of the attractive dividend yields that can be found in both first world mega-cap stocks and international real estate. With dividend yields of some of the biggest companies in the world still well above bond yields, equity valuations in these markets are presenting investors with a significant opportunity to generate inflation-beating returns over the next five years.

## Combination Funds – again the value is in the First World

These funds combine high yielding securities and equities in order to provide a reasonable yield and a reliable inflation-hedged distribution.

### Prudential Income Fund (Rand denominated) – low equity exposure – no property and fixed interest bonds

The Prudential Income Fund remains relatively under-exposed to local equities (32%) and has maximised its exposure to international equities (25%) within prudential investment guidelines. The remainder of the portfolio has a similar overall asset allocation to that of the Core and High Income Funds.

### Worldwide Fund (Rand denominated) – pure Rand hedge

The Worldwide Fund has 70% international exposure and 25% local equity exposure. The current strength of the Rand combined with value offshore makes this an attractive option.

### International Growth Fund (US\$ denominated) – absolute value

The current asset allocation of the International Growth Fund is 77% international equities, 13% international real estate and 7% inflation-linked bonds. This balanced portfolio provides investors with an attractive dividend yield in first world currencies and sound prospects for dividend growth.

Exposures to first world equities have been maximised. Fixed interest bonds have been excluded.

## In Conclusion

The year ahead is likely to be characterised by rising inflation, higher interest rates, a consumer under pressure and a downward adjustment of many asset prices.

We at Marriott are, however, confident that the environment is conducive to producing the desired outcome for retired investors.

**Marriott House**  
2 Delamore Road Hillcrest 3610  
PO Box 2099 Hillcrest 3650 South Africa  
Communication Centre 0800 336 555  
Tel +27 (0)31 765 0700 Fax +27 (0)31 765 0790  
Email [info@marriott.co.za](mailto:info@marriott.co.za) [www.marriott.co.za](http://www.marriott.co.za)

Collective Investment Schemes in Securities are medium- to long-term investments. The value of your investment may go down as well as up and past performance is not necessarily a guide to future performance. Collective Investments are traded at ruling prices and can engage in borrowing and scrip lending. Collective Investment prices are calculated on a net asset value basis. Net asset value is the net value of all assets in the portfolio, including any income accrual and less any permissible deductions from the portfolio. Where initial fees are applicable, these fees are deducted from the investment consideration and the balance invested in the units at the net asset value. A schedule of fees and charges and maximum commissions is available from Marriott. Commission and incentives may be paid from the initial fee. Forward pricing is used. Marriott Unit Trust Management Company is a member of the Old Mutual Investment Group.



A Member of the  OLD MUTUAL Investment Group

Licensed Financial Services Provider