Fundamental Index investing proves its value to investors

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October marked the third anniversary of the launch of the FTSE/JSE RAFI® 40 Index (Research Affiliates Fundamental Index) in South Africa, during which time it has outperformed 75% of all domestic general equity funds – proving that it can be a common-sense option for investors looking for equity exposure.

A fund we manage that tracks this index, the Old Mutual RAFI® 40 Tracker Fund, is currently ranked 11th out of 71 general equity funds for the three years to 31 October 2010, providing a cumulative total return of 11.72% compared to the 2.7% total return from the average domestic general equity fund over the same period.

At the same time, on an annualised basis, it has returned 3.77% per year for the three years to 31 October 2010, versus 0.76% per year for the average general equity fund, during a period that encompassed the global financial crisis.

These are significantly higher returns for investors than those of the average general equity fund, in both bull and bear market conditions. This highlights the wisdom behind the fundamental methodology used, which invested in undervalued companies during the market crash of 2009 and resulted in superior returns during the recovery. The lower fees of our index tracking fund, which are typically half those of conventional unit trusts, have also added to the outperformance.

RAFI® companies representative of the SA economy

The RAFI® 40 Index is based on the fundamental indexation concept that relies on four fundamental company measures – cash flow, book equity value, total sales and gross dividends – instead of market capitalisation, to determine company weightings in the index. The methodology involves taking an average of each of these financial measures over a five-year period, with of book value being as at review date. The best performing companies are picked to create a portfolio of 40 shares that is largely representative of the South African economy. The strategy is biased towards value investing, because it recognises strong company performance regardless of that company's share price. By contrast, market-cap indices have a tendency to overweight stocks that are overvalued and underweight stocks that are undervalued.

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One of the obvious advantages of the RAFI® 40 Index is that it avoids market sentiment by not using share price as a basis for calculating the index. Share prices can – and do – get caught up in sentiment and ignore fundamentals at times, adding to volatility. In fact, investor sentiment is increasingly driving financial market behaviour – we have seen this earlier in the year, with investors developing a herd mentality into defensive stocks like retailers. One of the reasons the Old Mutual RAFI® 40 Tracker Fund has outperformed is because the methodology avoids this behaviour.

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Fundamental Index investing proves its value to investors (continued)

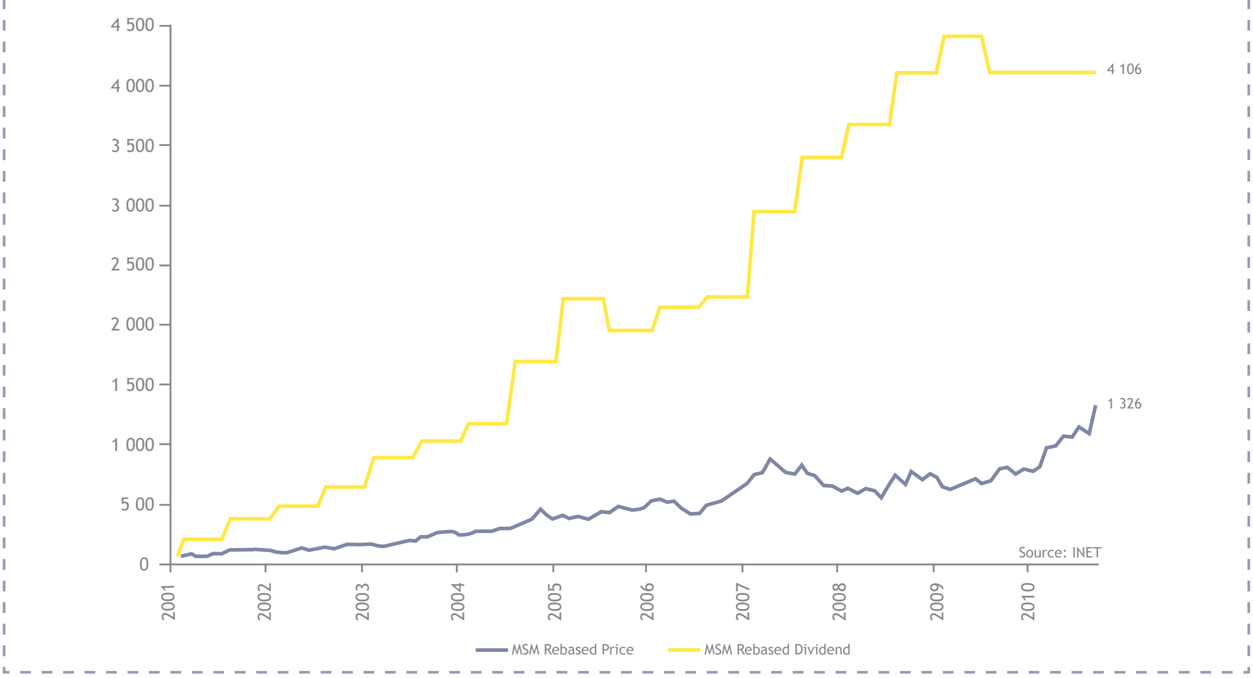
The table lists some of the positions held by the Old Mutual RAFI® 40 Tracker Fund that have contributed to its top-quartile performance over the past three years.

Stock	FTSE/JSE RAFI® 40		FTSE/JSE All Share Index		Peer Group Mean*	
	Weight	Rank	Weight	Rank	Weight	Rank
BHP Billiton	9.92%	1	12.24%	1	4.48%	4
Anglo American	9.65%	2	9.27%	2	3.64%	6
Old Mutual	6.96%	3	2.14%	12	2.29%	12
Sasol	6.07%	4	4.86%	5	8.20%	1
SABMiller	5.94%	5	6.82%	3	3.49%	7
Standard Bank	5.89%	6	4.28%	7	5.45%	2
MTN Group	4.93%	7	5.68%	4	5.16%	3
Bidvest	2.21%	13	1.26%	18	2.56%	9
Massmart	1.31%	25	0.72%	29	0.29	69
AngloGold Ashanti	1.26%	27	2.85%	9	2.03%	13
Shoprite	1.21%	28	1.31%	16	0.15%	84

Sources: FTSE/JSE and Riscura

*Holdings are derived from the Riscura Large Manager Watch Survey and are used to represent active managers.

MASSMART
PRICE VERSUS DIVIDEND GROWTH



Bidvest - overweight vs the average manager

Since 2002, the growth in Bidvest's dividend has outstripped that of its share price. As a result, the fund has had an overweight position in Bidvest relative to the average manager. In 2008 there was a sharp drop in its dividend payment as a result of the financial crisis, but as the fundamental methodology uses the five-year average dividend levels, it ignored this drop and remained invested in the share. This made the fund perfectly positioned to capture Bidvest's exceptional share price gains of 77% since early 2009.

Massmart – overweight vs the average manager

Although the share prices of many retail stocks have become overvalued in recent months due largely to foreign investor enthusiasm, the fund has been overweight Massmart over the three-year period versus the average general equity fund manager, due largely to the high rate of growth of its dividends outstripping share price growth. RAFI® recognised the attractiveness of the company's expanding economic footprint by looking at real-world measures like sales and dividends, rather than abstract accounting ratios, with the fund's overweight position yielding positive benefits for investors in the wake of the Walmart bid.

MTN - underweight vs the average manager

The fund has been, and remains, underweight in MTN — a classic growth company — because its share price has been factoring in as-yet-unrealised growth in its fundamentals. The fundamental methodology generally invests less in a company whose valuation (or price) has run ahead of its economic footprint, following more of a value approach to investing. Investing in growth stocks can be more risky, as that future growth is never guaranteed. The fund's underweight position in MTN helped to limit the impact of MTN's less impressive growth in share price performance since the financial crisis recovery in early 2009.

AngloGold Ashanti - underweight vs the average manager

The fund is currently underweight in AngloGold Ashanti versus the average general equity fund manager, as dictated by the four measures of the company's long-term economic footprint. This shows the defensive nature of the RAFI® methodology as it avoids trying to time the highly volatile short-term moves in the company's share price. This is one stock foreign investors have piled into this year, in search of higher returns in line with the "emerging markets" growth story, but fundamental measures are pointing to it being overvalued.