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Annual letter to investors

Walter Aylett, Aylett & Co. | 14 March 2007

At Aylett & Company we are unequivocal proponents of long term investing. I've often been known to speak out against a short-term investment focus, which in my view provokes more than a general sense of malaise. Investment professionals are in a strong position to influence this focus amongst their clients and, not surprisingly, one's chosen form and frequency of communication, not discounting the content, can go a long way in keeping clients well informed and mindful of their Investment Manager's thinking. In this regard I favour an annual letter. The primary aim of this letter is to communicate to investors how their capital has been allocated and which provides them with enough information to make an assessment of that effort. A successful review, in our opinion, will therefore:

- Provide candid communication
- Equip the reader with relevant information to assess our capital allocation efforts
- Clearly indicate the risk (defined as permanent loss of capital) undertaken
- Give the reader a clear understanding of all costs incurred
- Ensure that investors are in synch and comfortable with our thinking

This letter should, therefore, not be seen as a marketing document that provides a tribute to our investment management efforts.

The particular date of our annual letter is not significant and coincides with our annual audit. As investors well know, one's start and end date can give remarkably different results by simply moving either out by a day. Our capital allocation is much longer term and the intention is for our investors to be able to judge our efforts by reading our annual reviews as time goes by. Here again, a comparison I often quote between ourselves and golfers: we both prefer being asked about our game after the full round, rather than eighteen times a game.

How we see our job at Aylett & Co.

Clients allocate their savings to us in order for us to meet some liability in the future. Preferably this time horizon is at least five years, or even better, ten. Our job is to find assets that will not only preserve your purchasing power in real terms, but that will also earn a satisfactory real return on that capital. A major element of this effort is invested in trying to understand the assets and thus avoid overpaying for them. One of the maxims we fervently believe in, is that your return is determined by the price you pay and not by the exit price.

South Africa is an open economy and we tend to be held at the mercy of the currency. Many of the future liabilities we will face will be dollar, euro or yen based. It stands to reason, therefore, that for us to meet these liabilities we have to invest, not only in assets that will grow faster than the South African inflation rate but also faster than the long term weakness of the currency. Investment opportunities in our region are currently scarce, owing to the spectacular returns seen by investors over the last four years. Ten year returns for domestic property, bonds and equities have been terrific and the only asset class, which has been poor in rand terms, has been investments made offshore. The major reason for this underperformance has been rand strength.

The Nedgroup Investments Bravata Worldwide Flexible Fund's broad foreign flexibility sets the context within which we manage the fund. On this particular mandate we consider domestic shares and their attractiveness relative to the global pot that they ultimately form a sub-set of. Against this backdrop, in trying to understand local companies, we sometimes come to appreciate that their overseas competitors are far more attractive. As the globe has gotten accessibly smaller, we are also coming across companies with interesting prospects not common to our region. This all really points to greater flexibility and, with the nature of Nedgroup Investments Bravata Worldwide Flexible Fund's mandate; management of the fund is given the scope to finding those special investment opportunities.

The nature of the fund

The fund's mandate is flexible and allows us to invest in any asset class we choose to, including foreign assets. We are governed by unit trust regulations and, as a result may not invest in hedge funds and unlisted shares. Importantly, we have the ability to invest up to about 95% of the assets offshore.

Our goal is to preserve the purchasing power of the investor. In measurable terms our aim is to beat CPIX plus 4% after costs have been added back. This objective is due to change but more on this later (see section on Costs).

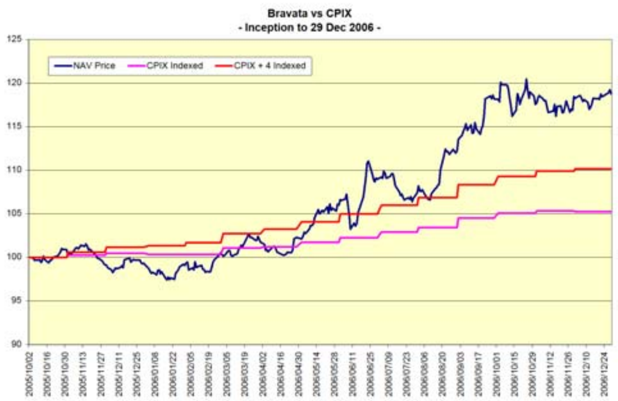
Performance of the fund

The fund was launched on 1 October 2005 and it now has R450 million assets under management. We are grateful for the trust and support shown by investors.

The first three months of the fund were characterised by significant inflows, and our inability to invest that capital in a rational fashion makes that initial period difficult to comment on. For example, a significant amount of money flowed into the fund towards the end of December, a month known to be characterised by short-term illiquidity and questionable share price appreciation for the year-end. We chose not to invest, as the terms were not favourable. Comparison has, therefore, been made to asset classes for the twelve-month period ending 31 December 2006.

Following, is a table of asset classes (returns for the year ended 31 December 2006) in which we could have invested. Only the major markets have been listed but it gives the reader a good indication of the various returns achieved. The first column shows the relevant currency return and the second column highlights the return converted to rand, being the number used to judge our efforts. (The following returns exclude dividends. Sources: Bloombergs and Aylett & Co.)

	Foreign	**Rand**
Local Markets	%	%
All Share	n/a	38
All Bond	n/a	6
Property trusts	n/a	16
Cash	n/a	8
Offshore Equity		
Global MSCI	23	35
FTSE 100	11	39
S&P 500	14	25
Hang Seng	34	47
Nikkei 225	7	17
AUS200	19	41
Dax	22	50
CAC 40	18	44
Offshore Fixed Interest		
US10 TBill	2	12
UK long	1	28
Eurobond (GermanBund proxy)	- 1	22
Aussie bond	2	21
Japanese bond	0.5	10
Aussie bond mat 10/15/07	5	25



For the calendar year 2006, the fund delivered a return of 20.5%, while our target benchmark returned 9%. Since inception, the fund has delivered 19% versus 10.2% for the target. These returns are after all costs.

On the face of it our return looks acceptable, but when one looks at the returns of the various sectors in the above table, should our return not have been higher?

One year is not a long time in the markets and we have chosen to do a few unpopular things. We have a substantial exposure to Japanese domestic assets and have investments in large US companies. We lacked exposure to commodity shares, which started their bull run in 1999, and we were reluctant to invest in emerging markets that have benefited from the Yale effect (see below). Finally, we chose to invest in sovereign debt that offered cash rates not too far from South African rates. Let us look into this in a little more detail.

At the beginning of 2006, with the rand at record levels i.e. very strong relative to global currencies, we had a chance to invest in one year Australian bonds at 5.25% versus the South African government bond at 7.5%.We chose the former. The result was that we earned 21% versus 7.5%. Our risk was lower because the Aussie bond had a higher credit rating than SA. Not a bad return for very little risk, as opposed to investing in emerging equity markets. In May 2006 our fund went up while equity markets, for a short while, gave a negative return. Returns that create a non correlated result are more our style. This is important because we have noticed that our fund does well when the markets are poor and enjoys less of the upside when markets are bullish. In a world where markets around the globe seem to have become increasingly correlated, this trait, I suppose, should be welcome. Focusing on the longer term (five years or more), the graph we would envisage for the Nedgroup Investments Bravata Worldwide Flexible Fund's investment performance would indicate low long term volatility with greater downside protection, and upside capture that is steady rather than full tilt. Given the investment objective of the fund, we're comfortable with the fact that this picture may well lack spectacular spikes over the shorter term.

Mistakes made were simply not backing our views more strongly (local banks and insurance). Furthermore, our conservative stance forced us to exit too early from businesses that clearly had a tailwind. Mr. Price comes to mind. Sometimes it helps to sit on one's hands! We only had one share, Intec, where it appears we may have suffered a permanent loss of capital. While the amount lost was not significant (0.3% of the fund), we judge ourselves harshly given our definition of risk: losing money. In Intec's case, the goodwill we paid was simply too high. It was a good reminder of that definitive ingredient any investment must have, a margin of safety. Finally, a higher exposure to European currencies may have offered an additional 1 or 2%.

I am reminded here of a letter written by Howard Marks of Oaktree Capital to his clients on the topic of performance. He observed that in the late 90's a foundation was disappointed with its 15% per annum return, while similar funds achieved 20% annually. The same foundation achieved 2% in the subsequent three years when other funds were delivering negative returns. The trustees of the fund were delighted. It is funny how they felt good about earning 2% but terrible about making 15%. We feel good, not ecstatic about our 19.5%.

Let's all look like Yale

During the last decade, the foundation that managed the Yale University assets did a superb job of investing. In particular they invested a substantial amount in what today are being called "Alternative Assets" or hedge funds, private equity, commodity and emerging market funds. As the globe has experienced a sustained period of global liquidity growing faster than global Gross National Product, this effect has led to more cash chasing too few opportunities.

In the past, this money found its way to large caps and US bonds. Now this money is moving into alternative assets. Trustees of major funds, faced with more realistic returns from developed markets, have sought to make up the shortfall from anything with an exotic label. Emerging markets and commodity funds have been major beneficiaries and prices continue to be bid up. In addition, leverage is being used extensively. Risk premiums are being pushed down in this world awash with liquidity. Private equity, to my mind, is just another word for a leveraged buyout vehicle. All of this will lead assets back into dangerous bubble territory. Our choice is not to invest alongside these assets, but rather to seek high-class sovereign assets, until some clarity (or sanity) is achieved. Our style is suited to investing on our terms and at the moment these terms are not presenting themselves.

Investment strategy: large cap in the USA

During the course of 2006 we took a decision to invest in large American companies. This was at a time when these companies were being neglected for various reasons. For us in South Africa, this seemed like a wonderful once-off opportunity. Let me explain. These companies are dominant and own brands that are the market leaders. These shares seldom trade at a discount to smaller companies, whose products command much smaller market share. Finally, the cash generation of these large caps is quite phenomenal. Wal-Mart, with a market cap of about 190 billion dollars, produces 18 billion dollars a year before store expansion. Our yield is almost ten per cent before store expansion. Wal-Mart opens two stores a day and one a week in China. Now, what would happen if they stop opening stores or slowed down a bit? The cash would come back to investors.

There are two components that make up our purchase price: the level of the rand and the US dollar price of the assets. At the time the rand was at about six rand to the dollar. We are not experts at predicting currencies, but its strength felt overdone. Foreign investors could not get enough of South African assets, and commodities were bounding ahead. Seven rand seemed a more correct level. Incidentally, the rand went to almost 8 rand to the dollar in the May 2006 sell off. So, for a start, we were buying world class assets with a 17% buffer.

The second part of the equation is the price of the US assets. Coke is a share that we purchased against a background of the dollar disappearing as the world's reserve currency. Most analysts expect Coke's earnings to grow at 5-9% per annum. Boring! Its share price had gone nowhere for almost nine years. Yet its market cap had reduced from a high of $200 billion to just under $100bn, the reason partly being the buyback of its own shares by the company. The company has purchased almost 37% of the outstanding stock.

The dividend combined with the buyback amounts to over 5 billion dollars a year. Compound that amount by 9% and do the math - you get your money back in 14 years. This is versus the US long bond term of twenty years. What about the weaker dollar and its effect on a company like Coke? The company earns 80% of its revenue from outside the US and so in the long term stands to benefit from dollar weakness.

Other shares that we have purchased whose non-US revenues are growing are Berkshire Hathaway, Cisco, Dell, Wal-Mart, Tyco, Schering-Plough and Conoco Philips.

When evaluating a share, we often ask what the private market value of the company is? Private market value is the price we think owners would pay for taking the company private. It can also mean the price of similar companies that have been acquired. By applying that price multiple to the company it can give one some kind of idea of private market value. The sheer size of these companies we have invested in is, we believe, the only hindrance to these companies being taken private. To some extent this provides support to our thinking.

Investment strategy: domestic Japan

We have noticed a few things about investing in Japan. Firstly, the 15-year bear market in equities appears to have come to an end. Secondly, the world has benefited from a huge supply of liquidity in the form of borrowing in the low yielding yen and investing in global assets and yes you guessed it: all those exotic assets! The effect of this has created a weak Japanese currency. Thirdly, much of the rise from the Nikkei's low has been from Japanese exporters. Domestic stocks have not participated in this rise to the same extent. Many of these stocks trade at net asset value or just above book value. In the western markets our shares trade at multiples of book value. Naturally their growth prospects are arguably better, but in Japan these companies are not priced for any growth at all.

Investors seem to have forgotten that Japan is the world's second biggest economy. It is a core beneficiary of Asia's growth and there are many western style activities taking place that make Japan more shareholder friendly:

- Share buybacks
- Increasing dividend yields
- Collapse of the chaebols (conglomerates)

- Real estate appreciation
- Unwinding of cross holdings
- Strong cash flow leading to capital investment
- First hostile bid

So let's apply our equation. We think the Yen could appreciate by 10% and that the market could go up by 15% per annum. It is not inconceivable that we could double our investment over five years. Our dilemma is that we are not sure when this will happen, nor is the catalyst of prime concern. Experience has shown that if one invests sensibly based on facts that are right and well researched, one will ultimately be rewarded for one's patience. At the moment Mr. Market does not want to own Japan and we, and a few of our esteemed industry colleagues do.

Risk

There are large dissertations written on how to deal with risk, and yes, people get given Nobel prizes for their work. They add a few Greek letters into the definition and we have a whole industry servicing investors on risk. Being Greek, I could add a few Hellenic letters of my own, but that probably wouldn't be polite.

Our definition of risk is permanent loss of capital invested. Hence we believe that risk management should be undertaken before the investment is made. In making an investment, you are right because your reasoning is based on facts, facts that are correct and true. Rather than over diversifying, we are of the thinking that investing a significant amount of capital in the right ideas will go very far. The problem with this form of investing is that it leads to greater short-term volatility than a diversified portfolio. In the longer term, because your investment has worked out, it takes the sting out of intermediate volatility. Japan's volatility, for instance, has given us many buying opportunities, qualified importantly by facts that make us very comfortable with owning Japan.

Let me leave you with a few interesting anecdotes on risk. Howard Marks points out that very few investors complain about volatility on the upside. Jeremy Grantham quotes his favourite example of how the definition of risk, i.e. volatility or mean variance, was comprised. In 1982, the S&P had a Price Earnings (P/E) multiple of 8 and in 2000 a P/E of 35. During these two years volatility was broadly similar, yet in 1982 the market sold for half the replacement cost and in 2000 for 3 times. We all know that 1982 was a time to buy and 2000 a time to sell, yet risk was supposedly the same! Finally, to my favourite example: As I understand it, hedge funds in broad simple terms were supposed to manage the downside and volatility of one's investment. Last September Amaranth Funds took a 65% haircut on a leveraged bet on natural gas prices. To quote Tweedy Browne; "We are not aware of an index fund that crashed 65% in two weeks."

The risk we now face is career risk; holding cash uses plenty of career risk units.

Fees

The fund currently charges a fixed fee of 1.5% (excluding VAT). We are also awarded a performance fee should we achieve a return in excess of CPIX plus 4% per annum. Currently this fee is 20% of the outperformance of the target. So, in simple terms, if we were to deliver 10% in excess of the targeted return we would earn 2%. Our total fee charged to the fund would then be 3.5% plus VAT. For 2006, the performance fee earned was 1.9% (excluding VAT).

Consideration has being given to changing the fee structure to the benefit of the investor. To this end, we have agreed to cap the performance fee at 2% (excluding VAT). Furthermore, the target has been increased by 1% to CPIX plus 5%. These changes are effective from 1 January 2007.

* Above fee structures apply to A class unit holders.

Our prospects

Our style is always to look at investments as businesses that we may want to own, and we strongly favour this business approach to investing. Macro economic or top down investing does not comfortably fit into this process. If a business has good assets, is appropriately priced and is run by quality management, it can be a great investment in spite of prevailing sentiment. We also find it very difficult to talk about the future for the simple reason that one cannot predict with any degree of certainty. Seldom does one get forecasting on interest rates, foreign exchange rates and inflation truly correct. Instead, we choose to look at the fundamentals of the business and value it accordingly. This is a much easier and measurable exercise. What we do know about the future is that when prospects are overtly encouraging and markets keep on going up excessively, the risk of losing capital rises. The opposite applies when pessimism prevails and unbeatable bargains arise.

To be frank, I am not quite sure what to make of the future. It certainly feels tilted to the downside. The globe is awash with liquidity, risk premiums for investing in risky assets (emerging markets) are very low, inflation has surprised (UK) and as Fred Hickey says of the US economy; “Goldilocks has imbibed a bit too much liquidity”. Leverage deals are very popular and prices are being bid up. The old adage of money burning a hole in one’s pocket, can just as aptly apply to the markets.

Learned investors are divided about what the future holds and generally most expect an up year. Having said this, there are a few lone but strong cases being made for investor caution. In a rising interest rate environment, with factors being what they are, we tend to bide our time and take career risk. In this climate, cash tends to be our short-term choice and the Nedgroup Investments Bravata Worldwide Flexible Fund is conservatively positioned with almost 40% cash. The investments we have made are currently out of favour. Exposure to emerging markets is low. Neglected Japan, and to a lesser extent large Cap USA, is where our money is.

Finally, I need to mention a word of thanks to all our investors and their Financial Advisers for the support shown to us. The team at Aylett & Co. is working very hard at scouring the world for moneymaking ideas, and investors can take comfort that almost the entire investable wealth of the Aylett family is invested in the fund. Our fortunes are intimately tied to those of our investors. Our staff may also not invest in individual share counters and their future earnings are linked to the performance of the fund.

Should investors wish to access additional information on the Nedgroup Investments Bravata Worldwide Flexible Fund for the reported period, please visit the Nedgroup Investments website at: www.nedgroupinvestments.co.za. If that does not meet your requirements you are more than welcome to give us a call at Aylett & Co. on 021 673 1460.

Weekly Economic Monitor

Review of 26 February to 2 March 2007 and preview of 5 to 9 March 2007

Nedbank Economic Unit

Domestic market review

Comment	Index	Level at week close	Movement for the week
Equity market: The local market recovered gradually, helped by recovery in some of the global equity markets.	All Share Basic materials Industrial Financial	25 923,5 26 465,9 22 417,7 23 809,5	+1.4% +1.4% +1.4% +2.0%
Bond market: The local bond market was strong.	R194 2008 R153 2010 R157 2015	7.98% 7.63%	-0.05% -0.06%
Money market: Rates were mixed.	3-month JIBAR	9.09%	+0.01%

Domestic economy review

Comment

Both gross **reserves** and the **international liquidity** position (net reserves) rose further in February. The dollar value of gross reserves increased by $461 million to $26,343 million, while the international liquidity position improved by $457 million to $23,736 million. The value of gold reserves rose sharply on the back of a 4.4% increase in the dollar gold price, while physical gold holdings by the Reserve Bank remained almost unchanged. The rand value of gross reserves jumped to R191.2 billion in February from R187.7 billion in January due to an increase in the dollar value of reserves, while the rand was stable during the month. This level of reserves could comfortably cover about five months of merchandise imports.

Commodities market

Comment	Commodity	Level at week close	Movement for the week
Commodity markets were mixed this week.	Gold/ounce Platinum/ounce Brent crude oil/barrel	$648,9 $1 198,0 $62,3	+1.0% -0.6% +1.1%

Currency market

Comment	Currency	Level at week close	Previous week close
The **rand** recovered slightly, supported by improving emerging market sentiment and a higher gold price.	R/$ R/£ R/€	7,33 14,16 9,63	7,35 14,28 9,76

International market review

Comment	Index	Level at week close	Previous week close
International equity markets continued their downward correction early last week, as investors reduced their risk exposure on the back of an expected slowdown in global growth, before regaining some of their losses in the latter half of the week.	Dow Jones S&P 500 NASDAQ Nikkei 225 FTSE 100 German Dax French CAC	12 276,3 1 402,9 2 387,6 6 245,2 6 716,5 5 537,8 17 164,0	+1,3% +1.1% +0.8% +2.1% +1.7% +2.1% -0.3%

US unemployment rate fell to 5,5% from 5,6%. Hourly earnings rose to $17,16 in February, up from $17,10 in January and weekly hours worked was also steady at 33,7. Continued growth in service sector jobs is helping to sustain job growth, despite weakness in manufacturing and housing. This should continue to help support US consumption and the housing market. The **US trade deficit** narrowed to $59,1 billion in January from $61,5 billion in December. The deficit with China widened to $21,3 billion from $19 billion, while that with Japan narrowed to $6,5 billion from $7,5 billion. The deficit is likely to have peaked for now, with oil prices down from an all time high reached in 2006 as well as foreign economic growth remaining strong, increasing demand for US exports.

The **Bank of England (BOE)** kept interest rates unchanged at 5,25% on Thursday last week. Financial markets are factoring in an additional rate hike before June this year. **Manufacturing production** fell by 0,2% m-o-m (up 2% y-o-y) in January. **Industrial production** rose by 0,1% m-o-m (up 0,4% y-o-y) in January. Weakness in the manufacturing sector was broad based, with 10 of the 13 sectors recording declines. Chemicals and man-made fibres recorded the biggest decline, contracting by 1% m-o-m. Three interest rate increases since August and a strong pound are beginning to have an effect on the manufacturing sector.

In the **Eurozone, fourth quarter GDP** grew by 0.9% q-o-q. During 2006, GDP grew by 2.6% compared to 1,4% in 2005. Expansion in the Eurozone continues to be driven by business investment and growth in exports, which is counteracting the effect of higher interest rates on domestic consumption. **Retail sales** fell by 0,1% in January, as demand for non-food products declined. Over the year, ‘food, drinks and tobacco’ fell by 1,6%, while the non-food sector increased by 1,3% y-o-y. Germany experienced the largest decline over the month, as the increase in VAT began to take effect. The **European Central Bank (ECB)** increased rates by 0,25% to 3,75% at the end of their MPC meeting. A tightening labour market, continued growth in credit and strong economic growth have contributed to concerns that the output gap in the euro area will narrow, creating medium-term inflation risks. However, the ECB is unlikely to raise rates at their April meeting, as they wait to determine the impact of the recent rate hikes.

Japan’s diffusion index of leading economic indicators fell to 35 in January, from 37,5 in December. A reading above 50 suggests an economic expansion in the months ahead, while a reading below 50 suggests a contraction. The recent turmoil on the global stock market, due in part to fears that the US economy may slow, curbing demand worldwide, has added to concerns that the Japanese economy may follow. As a slowdown in exports, one of the key drivers of Japan's growth would make the economy vulnerable given the weakness of consumer spending.

The week ahead

Local economic releases scheduled for this week include **manufacturing production** for January.

Internationally, key economic releases due this week include **US retail sales, producer price inflation** and **consumer inflation, Eurozone industrial production** and **consumer inflation**, **UK producer inflation, trade data** and the **unemployment rate** and **Japan’s fourth quarter GDP.**