

# The Weekly Focus

A market and economic update

16 August 2010



# Contents

Newsflash .....	3
Market Comment .....	3
Looking Ahead .....	4
Snippets of Info .....	5
Economic Update .....	7
South Africa .....	8
United States.....	8
Globally .....	9
Weekly Market Analysis.....	11
Rates .....	12
Standard Bank Money Market Fund .....	12
STANLIB Cash Plus Fund .....	12
STANLIB Dividend Income Fund .....	12
Glossary of terminology .....	14

# Newsflash

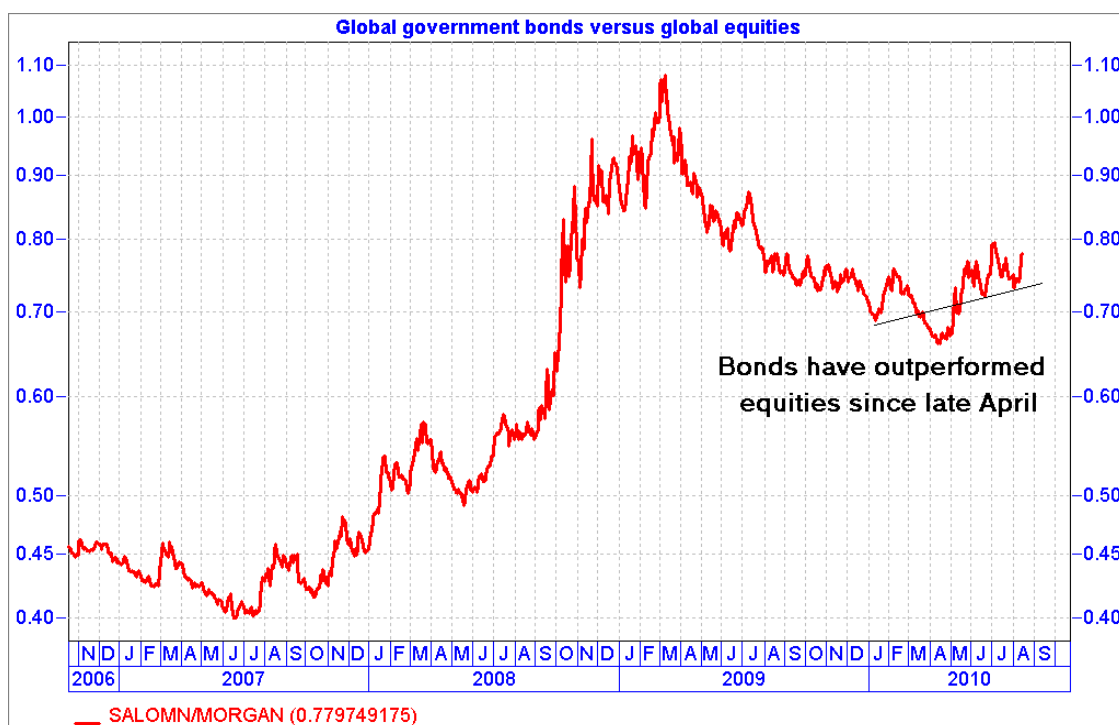
The current weakness in offshore stock markets is being regarded as a buying opportunity

## Market Comment

- Unsurprisingly, markets have been weak lately after a very strong July. With northern hemisphere investors mostly on holiday, volumes are way down (25% below average on Friday on the JSE).
- The JSE All Share Index gave up 2.7% last week and the rand weakened a tad against a stronger dollar. The MSCI World Index lost 4.2% last week (in dollars), but remains 6.7% higher than the recent low in early July.
- Weaker growth in the US is to some extent being countered by much better growth in Germany and bond yields continue to fall, reflecting fears of weaker growth and of deflation and also US government buying of bonds (pushing bond prices up, bond yields down).
- Ironically, despite Germany's strongest quarterly growth in 20 years, their ten year government bond yield has plummeted from 2.8% last month to 2.4%, the lowest in modern history. The US government ten year yield, which was over 3% in July, is now 2.7%, seemingly heading back towards the 2% level reached during early 2009.
- The positive of these lower yields is that they lead to even lower US mortgage bond yields, with the average 30 year fixed mortgage bond now at 4.4%, meaning that homes become even more affordable. The US property market is currently very weak, so this is necessary. Also lower government bond yields imply generally that the cost of money is lower, including the cost of discounting future earnings back to the present. A lower discount rate (typically the ten year government bond rate) leads to a higher present value number for earnings.
- Lower and lower government bond (and other bond) yields offshore makes our government bond yields of 8%-plus look very attractive in a world starved of yield, which means more and more funds coming in to SA in search of 'juicy' yields. Foreign investors have now invested R58bn to-date in 2010 in our bonds, which of course keeps our rand stronger for longer; and it has pushed our bond yields down (bond prices up), despite heavy government issuance. The SA government 15 year bond (R186) was yielding 9% just six weeks ago, whereas today it is yielding around 8.2%, the lowest since early 2009. As a result, bond fund unit trusts are showing 12 month returns of around 15%, which is very good for a lower risk investment. That does not, of course, mean that these high returns will continue for the next twelve months. STANLIB is forecasting 6-8% for SA bonds.

## Looking Ahead

- Whilst acknowledging the more elevated risks inherent in the world economy at this somewhat “cloudier” time (making it harder to forecast the future), STANLIB remains positive on offshore markets (overweight relative to other asset classes) and neutral on local equities, relative to other local asset classes. Offshore earnings growth and valuations look more attractive, which is not surprising after 12 years of flat markets there.
- Despite recent negative press and TV reports on the US, Japan and China, we continue to expect that a modest economic recovery and low inflation should support risk assets during the next six to twelve months. Rising earnings (which have also been better than expected in Europe), reasonable valuations and low interest rates should support equities and listed property.
- So we regard the current weakness in stock markets as a buying opportunity, especially offshore markets, including emerging markets; BUT there is no question that the risks have risen over the past few months because of the softer economic numbers and the housing slump in the US. Forecasting risks are higher because of lower visibility. It is a testing time for the bulls, while the bears may feel that victory is just within their grasp, as bonds outperform equities.
- See the chart below of global government bonds (Salomon Bros Index) versus global equities (MSCI World Index), showing bonds outperforming equities since late April, with no change as yet in sight. This is a concern for the bulls, no question. The graph shows clearly how bonds outperformed equities strongly from late 2007 until early March 2009 and again lately.

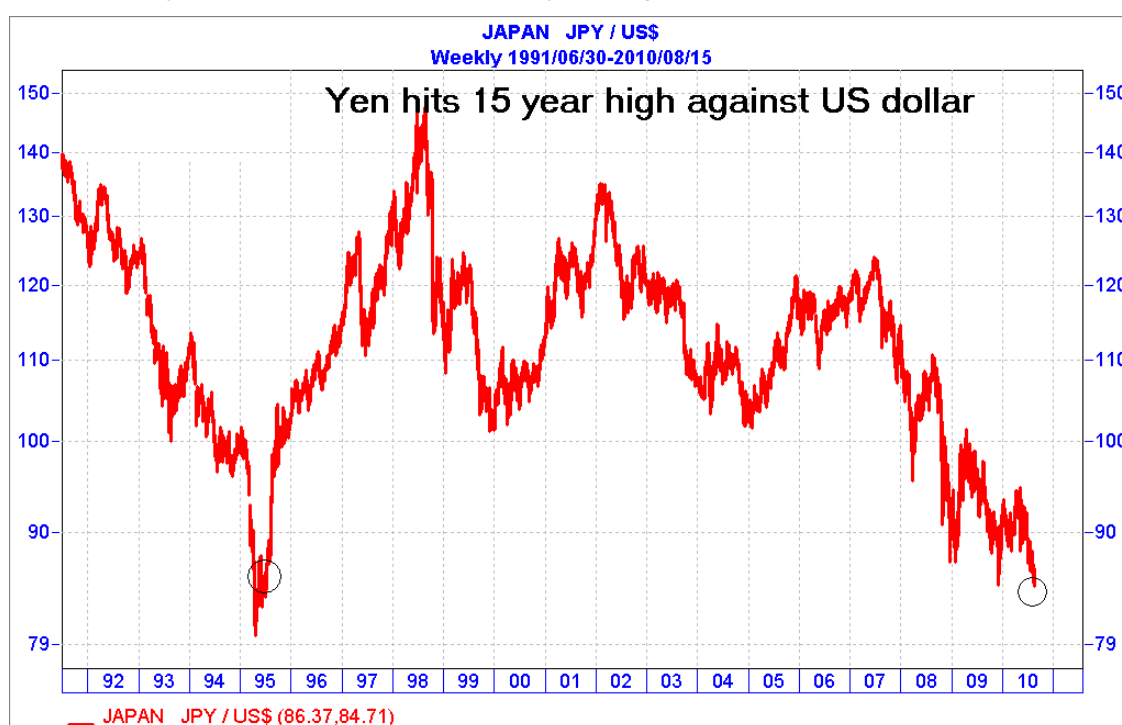


Source: I-Net Bridge

- Other nagging issues for equities are fears that the Chinese economy may be headed for a hard landing. BCA Research's view is that this is unlikely, citing strong growth in consumer spending (up 17% year-on-year) and a likelihood that the Chinese authorities will ease their recent tightening policies sooner rather than later. Recent stock market strength in China has held too, confirming these views for now.

## Snippets of Info

- The Japanese yen today hit a 15 year high against the dollar, even though the dollar has lately strengthened against most other currencies (from 1.32 to 1.28 against the euro). See chart below. The yen is at 85.6 to the dollar today, having hit 150 to the dollar in 1998.



Source: I-Net Bridge

- This ultra strong yen is likely to put pressure on Japanese corporate profits and further heighten deflation concerns. However, UBS says it's not all bad because about 50% of Japan's exports are to China and south-east Asia and are invoiced in yen. The Japanese stock market has been underperforming global markets though, plus its economy is now smaller than the Chinese economy, i.e. is now the world's 3<sup>rd</sup> biggest. BCA recommends staying underweight Japanese equities while its currency is so strong.
- Traditionally known as a big exporter, Germany's IMPORTS rose strongly in June as its economy gained 2.2% quarter-on-quarter, the highest in 20 years.
- Two thirds of European companies have so far beaten analyst earnings forecasts.

- Bank of America/Merrill Lynch analysts, says the FT, say that total US corporate earnings will surpass 2007's high of \$743bn this year AND US non-financial companies had \$1,800bn in cash and other liquid assets on their balance sheets at end March, equivalent to 7% of all corporate assets, the highest percentage in half a century.
- The optimists see this as a sign that a wave of corporate spending, including on takeovers, is about to be unleashed, as well as an increase in capital spending and eventually an increase in hiring.
- The pessimists say companies are hoarding cash because they're afraid of the future.
- BUT...share buybacks are starting again and so are dividend increases, which has historically been a good sign for equities.

**Paul Hansen**

**(Director: Group Advisory Services - Investments)**

# Economic Update

Locally, SA manufacturing rose more than expected in June, despite the 'disruptions' caused by the world cup. Manufacturing activity held-up well in the first half of 2010, but is expected to soften somewhat in the second half of the year. The outcome for June has been encouraging, but also surprising considering the recent softening in the Kagiso PMI index to below 50 and a general concern that the World Cup would be very disruptive for industry. On the whole, industry appears to have managed the world cup 'disruption' fairly well.

In the US, the Fed kept rates unchanged at 0.25%, as expected, but indicated they will use the proceeds from maturing mortgage-backed securities to purchase US government bonds. The exceptionally low Federal Fund Target rate is expected to be maintained "for an extended period". The emphasis of the latest FOMC statement suggests that the Fed has become far more concerned about the pace of the economic recovery. This seems a valid concern given the latest economic data. Unfortunately, there is not much more the Fed can do to support the recovery. A key concern now is what happens to the pace of the recovery when the "Bush tax breaks" expire at the end of the year.

US headline retail sales improved in July, but the improvement was a little less than market expectation; and if vehicle and gasoline sales are excluded, retail sales actually declined. US retail sales are still, effectively, struggling to gain any meaningful traction; but not necessarily slipping back into recession.

In the Euro area, interestingly, Germany grew faster than China in Q2 2010. This was totally not expected, given current global economic conditions. Overall, the latest GDP growth estimates for Europe imply that the Euro-area, and German GDP growth estimates in particular for 2010, are likely to be revised higher over the coming few weeks. Despite the likely upward revisions, we still expect a softer second half of the year in Europe relative to the first half.

Globally, the international 3-month wheat futures price is up 48% since the end of June 2010, mainly because of the destruction of wheat crops in Russia. Russia is currently the third largest producer of wheat in the world, but due to a severe drought, heat wave and severe fires, a third of the wheat crop has been destroyed. However, given the low base for food inflation, the current wheat price shock, coupled with other potential food price disruptions related to volatile weather conditions, could pose some general upside risk to global and local food inflation over the next 12 months.

## South Africa

### SA Retail Sales

- In June 2010, SA manufacturing production rose by an impressive 0.7% m/m (seasonally adjusted), compared with a revised increase of 0.5% m/m in May.
- On an annual basis, production is up a very healthy 8.8% y/y, which is above the previous peak annual growth rate of 8.6% y/y in April
- Although manufacturing activity is out of recession, the stability/improvement remains a little fragile. This fragility is due to the ending of key infrastructure projects, the relative strength of the Rand (which makes manufactured imports far more price competitive), and ongoing economic difficulties in the Euro-area (which makes it more difficult to grow manufactured exports).
- During the three month period from April 2010 to June 2010, manufacturing activity rose by 0.8% q/q (seasonally adjusted, but not annualised). This will tend to boost the Q2 2010 estimate of GDP. The latest production data (together with the recent concerns about the wheat price) will also tend to dampen expectations of an interest rate cut in September 2010.
- Capacity utilisation rose to a more encouraging 80.4% in Q2 2010, from 78.5% in Q1 2010. This is the highest level of capacity utilisation since the final quarter of 2008; but it is not yet at a level that would typically result in increased investment spending.

## United States

### US Interest Rates

- The US Federal Open Market Committee decided to keep the federal funds rate unchanged at 0.25%. In addition, the Fed indicated that “to help support the economic recovery” they will keep the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities.
- In making the decision the FOMC made the following key comments about the outlook for growth and inflation:
  - The pace of recovery in output and employment has slowed in recent months.
  - Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
  - Business spending on equipment and software is rising; however, investment in non-residential structures continues to be weak and employers remain reluctant to add to payrolls.
  - Housing starts remain at a depressed level.

- Measures of underlying inflation have trended lower in recent quarters and, with substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.

### US Retail Sales

- In July 2010, US headline retail sales rose by a slightly more encouraging 0.4%*m/m*, after two months of decline. This was, however, slightly below market expectations for a rise of 0.5%*m/m*, and compares with a revised decline of 0.3%*m/m* in June.
- If motor sales are excluded, retail sales rose by a more modest 0.2%*m/m* in July 2010, slightly below expectations for +0.3%*m/m*. If vehicle sales and petrol sales are excluded (which is appropriate since sales are reported in nominal terms) retail sales were actually down by 0.1%*m/m*. This was below expectations for a rise of 0.1%*m/m*. Given the above data, it is fair to conclude that the main reason for the better headline retail sales data in July was a 2.3%*m/m* rise in gasoline sales and a 1.6%*m/m* increase in motor vehicle sales.
- On an annual basis, US retail sales are up 5.5%*y/y* (in nominal terms), which is still relatively healthy, but well below the peak of 8.7%*y/y* in April 2010. Importantly,
- After improving noticeably from February 2010 to April 2010, consumer activity slowed appreciably in the months from May to July.

## Globally

### Euro Area

- In Q2 2010, German GDP grew by an amazing 2.2%*q/q* (non-annualised) or by a massive 9.0%*q/q*, annualised. The market was expecting growth of 1.3%*q/q* (+5.5%*q/q*, annualised). This is the fastest pace of the growth the country has experienced in at least two decades (certainly since reunification in 1991), and actually outpaced growth in China during Q2 2010, which was a very acceptable 7.2%*q/q*, annualised.
- There are no specific components yet available on the (demand) sources of this growth, although the clear suggestion is that net trade (exports), inventories and (to a lesser extent) capital expenditure played key roles in boosting performance.
- Strong German GDP growth was the backbone of a solid Euro Area GDP reading in Q2 2010. Euro-area GDP grew by 1.0%*q/q* (non-annualised) in Q2 2010, which was ahead of market expectations for growth of 0.7%*q/q*. Germany comprises around 25% of the Euro-area, but contributed around 65% of the growth in the region during Q2 2010.
- The rapid growth in Germany highlighted the growth differential across the Euro-area, with Greece still in a severe recession at -1.5%*q/q* and Spain barely growing at 0.2%*q/q*. Among other Euro Area countries, growth was good in Austria and the Netherlands, solid in France, and anaemic in Italy and Portugal. This growth differential is likely to raise concerns about on-going intra-regional tensions.

- Another important issue is how sustainable the German Q2 2010 boom will be, and whether it can provide a lift to the rest of the region. Clearly, part of the strong Q2 growth relates to German exports and the hence the benefit of a weaker Euro. From that perspective, the Euro currency has since strengthened relative to the Dollar, diluting this advantage. Additionally, German domestic activity is under some pressure due to the austerity measures, although the recent performance of employment and even consumption has been quite encouraging.

#### Wheat Price

- The 3-month wheat futures price on the Chicago Board of Trade (CBOT) is currently at \$7.50/bushel, which is up 48% since the end of June 2010. Scarily, a week ago the price was up at \$8.18/bushel (61.5% higher than the end of June 2010).
- This surge in the international price of wheat has been mostly due to Russia's decision to ban wheat (and other grain, mainly barley and rye) exports. The Russian crop could be as low as 60 million tons this year, and Russia needs around 79 million tons for domestic consumption.
- The type of wheat Russia produces is best suited to making unleavened bread, so much of its wheat is exported to the Middle East. Egypt is its largest market, followed by Turkey, Syria, Iran and Libya.
- International food prices have been extremely well behaved over the past year, and as a consequence food inflation is extremely low on a global scale. In South Africa, consumer food inflation was measured at 0.0%/y/y in June 2010 with overall consumer inflation at a mere 4.2%/y/y. South Africa is a net wheat importer, with domestic prices always tracking import parity prices. Fortunately, wheat prices have only a moderate weight (through bread with a weight of 1.56%) in the SA consumer price index. Using some rough estimates and industry pricing information, the current surge in the wheat price could add around 0.15 to 0.30 percentage points to CPI (depending on the pricing behaviour of Tiger Brands).

**Kevin Lings and Laura Jones**  
(STANLIB Economics)

# Weekly Market Analysis

Currencies/ indices/ commodities	Friday's Close 13/08/10	Weekly Move (%)	YTD (%)
<b>Indices</b>			
*MSCI World - US Dollar	1103.56	-4.23	-5.55
*MSCI World - Rand	8084.69	-3.03	-6.66
*MSCI Emerging Market - US Dollar	980.48	-3.01	-0.91
*MSCI Emerging Market - Rand	7182.97	-1.81	-2.07
All Share Index - US Dollar	3771.23	-3.78	0.86
All Share Index - Rand	27526.23	-2.67	-0.51
All Bond Index	332.67	1.28	11.23
Listed Property J253	795.47	-0.18	18.54
<b>Currencies</b>			
US Dollar/Rand	7.30	1.15	-0.56
Euro/Rand	9.31	-2.82	-11.35
Sterling/Rand	11.37	-1.06	-4.30
Euro/US Dollar	1.28	-3.99	-11.38
<b>Commodities</b>			
Oil Brent Crude Spot Price (\$/bl)	74.92	-7.28	-2.95
Gold Price \$/oz	1215.50	0.85	10.82
Platinum Price S/oz	1522.50	-3.27	3.61

Source: I-Net Bridge

\* MSCI - Morgan Stanley Capital International

# Rates

These rates are expressed in nominal and effective terms and should be used for indication purposes ONLY.

## Standard Bank Money Market Fund

Nominal: 6.64% per annum

Effective: 6.85% per annum

STANLIB is required to quote an effective rate which is based upon a seven-day rolling average yield for Money Market Portfolios. The above quoted yield is calculated using an annualised seven-day rolling average as at 13 August 2010. This seven-day rolling average yield may marginally differ from the actual daily distribution and should not be used for interest calculation purposes. We however, are most happy to supply you with the daily distribution rate on request, one day in arrears. The price of each participatory interest (unit) is aimed at a constant value. The total return to the investor is primarily made up of interest received but, may also include any gain or loss made on any particular instrument. In most cases this will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of reducing the capital value of the portfolio.

## STANLIB Cash Plus Fund

Effective Yield: 7.25%

## STANLIB Dividend Income Fund

Effective Yield: 4.75%

STANLIB is required to quote a current yield for Income Portfolios. This is an effective yield. The above quoted yield will vary from day to day and is a current yield as at 13 August 2010. The net (after fees) yield on the portfolio will be published daily in the major newspapers together with the "all-in" NAV price (includes the accrual for dividends and interest). This yield is a snapshot yield that reflects the weighted average running yield of all the underlying holdings of the portfolio. Monthly distributions will consist of dividends (currently tax exempt) and taxable interest. Interest will also be exempt from tax to the extent that investor's are able to make use of the applicable interest exemption as currently allowed by the Income Tax Act. The portfolio's underlying investments will determine the split between dividends and interest.

## Liberty Investments' Life Annuities

### Current Rates for 16<sup>th</sup> August - 20<sup>th</sup> August 2010

Payments are assumed to be paid monthly in advance with no guarantee period or annual escalation in income. Ages indicated assume client is the exact age shown. No tax has been deducted.							
Gender		Male			Female		
Age last birthday		55	60	65	55	60	65
Contribution	R 100,000	R 745	R 809	R 890	R 674	R 719	R 781
	R 250,000	R 1,884	R 2,045	R 2,250	R 1,706	R 1,818	R 1,974
	R 500,000	R 3,783	R 4,105	R 4,515	R 3,426	R 3,650	R 3,963
	R 1,000,000	R 7,580	R 8,225	R 9,045	R 6,865	R 7,315	R 7,940

The table above shows the monthly annuity that an annuitant will receive for life in return for the single premium in the left hand column. Note that the annuity depends on the annuitant's exact age and gender.

The rates above were calculated assuming maximum commission and will be enhanced if a commission discount is selected.

# Glossary of terminology

<b>Bonds</b>	A bond is an interest-bearing debt instrument, traditionally issued by governments as part of their budget funding sources, and now also issued by local authorities (municipalities), parastatals (Eskom) and companies. Bonds issued by the central government are often called "gilts". Bond issuers pay interest (called the "coupon") to the bondholder every 6 months. The price/value of a bond has an inverse relationship to the prevailing interest rate, so if the interest rate goes up, the value goes down, and vice versa. Bonds/gilts generally have a lower risk than shares because the holder of a gilt has the security of knowing that the gilt will be repaid in full by government or semi-government authorities at a specific time in the future. An investment in this type of asset should be viewed with a 3 to 6 year horizon.
<b>Cash</b>	An investment in cash usually refers to a savings or fixed-deposit account with a bank, or to a money market investment. Cash is generally regarded as the safest investment. Whilst it is theoretically possible to make a capital loss investing in cash, it is highly unlikely. An investment in this type of asset should be viewed with a 1 to 3 year horizon.
<b>Collective Investments</b>	Collective investments are investments in which investors' funds are pooled and managed by professional managers. Investing in shares has traditionally yielded unrivalled returns, offering investors the opportunity to build real wealth. Yet, the large amounts of money required to purchase these shares is often out of reach of smaller investors. The pooling of investors' funds makes collective investments the ideal option, providing cost effective access to the world's stock markets. This is why investing in collective investments has become so popular the world over and is considered a sound financial move by most investors.
<b>Compound Interest</b>	Compound interest refers to the interest earned on interest that was earned earlier and credited to the capital amount. For example, if you deposit R1 000 in a bank account at 10% and interest is calculated annually, your balance will be R1 100 at the end of the first year and R1 210 at the end of the second year. That extra R10, which was earned on the interest from the first year, is the result of compound interest ("interest on interest"). Interest can also be compounded on a monthly, quarterly, half-yearly or other basis.
<b>Dividend Yields</b>	The dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. The higher the yield, the more money you will get back on your investment.
<b>Dividends</b>	When you buy equities offered by a company, you are effectively buying a portion of the company. Dividends are an investor's share of a company's profits, given to him or her as a part-owner of the company.
<b>Earnings per share</b>	Earnings per share is a measure of how much money the company has available for distribution to shareholders. A company's earnings per share is a good indication of its profitability and is generally considered to be the most important variable in determining a company's share price.
<b>Equity</b>	A share represents an institution/individual's ownership in a listed company and is the vehicle through which they are able to "share" in the profits made by that company. As the company grows, and the expectation of improved profits increases, the market price of the share will increase and this translates into a capital gain for the shareholder. Similarly, negative sentiment about the company will result in the share price falling. Shares/equities are usually considered to have the potential for the highest return of all the investment classes, but with a higher level of risk i.e. share investments have the most volatile returns over the short term. An investment in this type of asset should be viewed with a 7 to 10 year horizon.

<b>Financial Markets</b>	Financial markets are the institutional arrangements and conventions that exist for the issue and trading of financial instruments.
<b>Fixed Interest Funds</b>	Fixed interest funds invest in bonds, fixed-interest and money market instruments. Interest income is a feature of these funds and, in general, capital should remain stable.
<b>Gross Domestic Product (GDP)</b>	The Gross Domestic Product measures the total volume of goods and services produced in the economy. Therefore, the percentage change in the GDP from year to year reflects the country's annual economic growth rate.
<b>Growth Funds</b>	Growth funds seek maximum capital appreciation by investing in rapidly growing companies across all sectors of the JSE. Growth companies are those whose profits are in a strong upward trend, or are expected to grow strongly, and which normally trade at a higher-than-average price/earnings ratio.
<b>Industrial Funds</b>	Industrial funds invest in selected industrial companies listed on the JSE, but excluding all companies listed in the resources and financial economic groups.
<b>Investment Portfolio</b>	An investment portfolio is a collection of securities owned by an individual or institution (such as a collective investment scheme). A funds ' portfolio may include a combination of financial instruments such as bonds, equities, money market securities, etc. The theory is that the investments should be spread over a range of options in order to diversify and spread risk.
<b>JSE Securities Exchange</b>	The primary role of the JSE Securities Exchange is to provide a market where securities can be freely traded under regulated procedures.
<b>Price to earnings ratio</b>	Price to earnings ratio or p:e ratio, is calculated by dividing the price per share by the earnings per share. This ratio provides a better indication of the value of a share, than the market price alone. For example, all things being equal, a R10 share with a P/E of 75 is much more "expensive" than a R100 share with a P/E of 20.
<b>Property</b>	Property has some attributes of shares and some attributes of bonds. Property yields are normally stable and predictable because they comprise many contractual leases. These leases generate rental income that is passed through to investors. Property share prices however fluctuate with supply and demand and are counter cyclical to the interest rate cycle. Property is an excellent inflation hedge as rentals escalate with inflation, ensuring distribution growth, and property values escalate with inflation ensuring net asset value growth. This ensures real returns over the long term.
<b>Resources and Basic Industries Funds</b>	These funds seek capital appreciation by investing in the shares of companies whose main business operations involve the exploration, mining, distribution and processing of metals, minerals, energy, chemicals, forestry and other natural resources, or where at least 50 percent of their earnings are derived from such business activities, and excludes service providers to these companies.
<b>Smaller Companies Funds</b>	Smaller Companies Funds seek maximum capital appreciation by investing in both established smaller companies and emerging companies. At least 75 percent of the fund must be invested in small- to mid-cap shares which fall outside of the top 40 JSE-listed companies by market capitalisation.
<b>Value Funds</b>	These funds aim to deliver medium- to long-term capital appreciation by investing in value shares with low price/earnings ratios and shares which trade at a discount to their net asset value.

*Sources: Unit Trust and Collective Investments (September 2007), The Financial Sector Charter Council, Personal Finance (30 November 2002), Introduction to Financial Markets, Personal Finance, Quarter 4 2007, Investopedia ([www.investopedia.com](http://www.investopedia.com)) and The South African Financial Planning Handbook 2004.*

# Disclaimer

The price of each unit of a domestic money market portfolio is aimed at a constant value. The total return to the investor is primarily made up of interest received but, may also include any gain or loss made on any particular instrument. In most cases this will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of reducing the capital value of the portfolio. Collective Investment Schemes in Securities (CIS) are generally medium to long term investments. The value of participatory interests may go down as well as up and past performance is not necessarily a guide to the future. An investment in the participations of a CIS in securities is not the same as a deposit with a banking institution. CIS are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from STANLIB Collective Investments Ltd (the Manager). Commission and incentives may be paid and if so, would be included in the overall costs. Forward pricing is used. TER is the annualised percent of the average Net Asset Value of the portfolio incurred as charges, levies and fees. A higher TER ratio does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TERs. Portfolios are valued on a daily basis at 15h30. Investments and repurchases will receive the price of the same day if received prior to 15h30. Liberty is a full member of the Association for Savings and Investments of South Africa. The Manager is a member of the Liberty Group of Companies.

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