Sanlam Investment Management

INVESTOR CONFIDENCE INDEX

TWELFTH PUBLISHED REPORT

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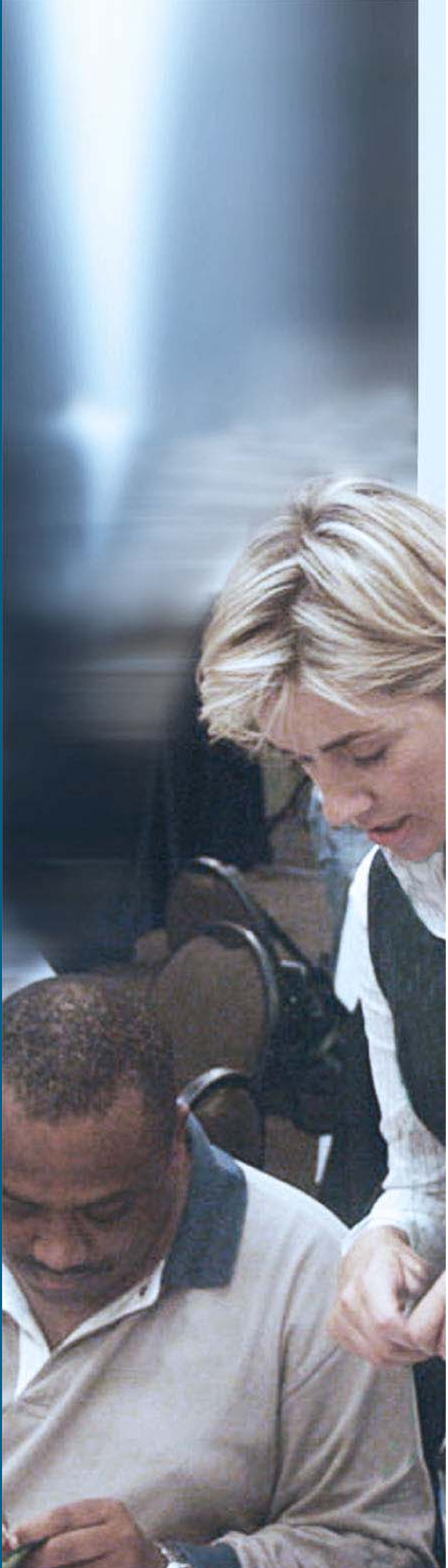
What a month! From 15 September to 15 October global equity markets lost almost a quarter of their value![1] At first glance the JSE All Share index (ALSI) did relatively well by losing only 20 percent during that period, but to some extent it was masked by the weakness in the currency. When compared in same currency terms (US$), the ALSI actually lost almost 40 percent of its value!

At the root of all this market turmoil is a loss of confidence. After the shock collapse of some major players, global financial institutions don't want to risk lending money to each other (or anyone else) because they cannot judge the counterparty risk. Investors don't know how to forecast the impact of tighter and more expensive credit - combined with a constrained consumer (whose behaviour or spending they can't forecast either) - on corporate earnings.

While this financial crisis is taking place, economic growth everywhere is slowing down rapidly and surprising to the downside. Credit extension and a well operating financial system are key components of a normal economic recovery mechanism and with them 'out of order' (or as the world's central banks would say/hope 'under repair'), there is even less visibility than normal on the prospects for, or timing of, any recovery. Consequently the default risk on all corporates has risen. Given all this uncertainty, investors are demanding a much higher equity risk premium, but are struggling to figure out how much.

With the severity of the problem highlighted by global central banks and making daily news headlines and with more and more commentators comparing the current situation to the Great Depression, it was not surprising to see the SIM crash confidence index deteriorate again, setting yet another new low. For the first time ever more than half of all respondents (57 percent) deemed the probability of a "1930s type" market crash to be more than 10 percent, with the average probability of such a crash estimated at 25 percent - a one in four chance - and up from 19 percent a month ago. Again it was the institutional investors who were especially worried about the possibility of a crash. Within this group 77 percent deemed the probability of a crash to be above 10 percent, with the average probability estimated at 33.3 percent – i.e. a one in three chance. Bad odds indeed!

From a certain perspective one could ask whether we haven't already seen a crash that is comparable to that of 1929, as in US$ terms the peak to trough decline in the JSE All Share index over the last year has been a massive 60 percent. This is a major crash in any investor's book. The initial drop in 1929 saw markets



down 40 percent in just over two months, very similar to the market movements we have experienced recently. The sad reality is that the 1929 crash in the US lasted almost three years and saw stocks decline 89 percent peak-to-trough[2]. To match such a move after a 60 percent decline would require another 73 percent decline from current levels.

The October survey also saw a big increase (to 68 percent, from 42 percent) in the number of respondents considering the market to be too cheap. However, despite this positive development with respect to valuation, investors are not yet getting more positive on the returns they expect from the equity market. Over a one year period the market is expected to rise just less that eight percent. This conservative expectation when the market is deemed to be cheap - and has just fallen severely - illustrates investors' awareness of current forecast risks and an inability to ascertain how long the economic decline will last.

Investors have, however, turned much more positive on the short-term returns expected from the market, with especially the institutional investors increasing their short-term expected returns very materially. More than 75 percent of institutional respondents expect the market to rise over both the three month and six month horizons. On a three month basis, they expect the market to rise by 5.2 percent and on a six month basis by six percent (the average for all respondents is 3.3 and 4.3 percent respectively over the time periods). These rises are very optimistic relative to the rise expected on a one year basis. It suggests that there is a significant group of investors who expect a relief rally in the next couple of months but, in line with the unclear future, no sustained rise thereafter.

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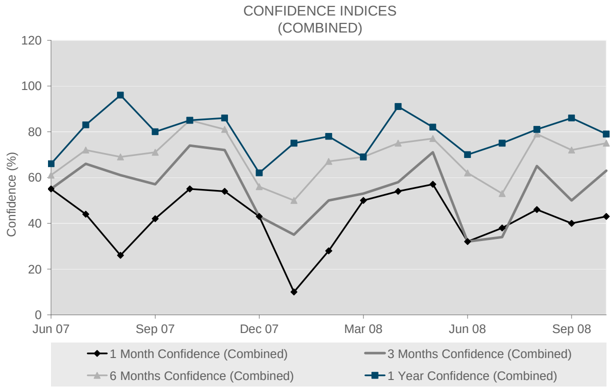
[1] MSCI world index down 23.2 percent, S&P500 index down 23.9 percent, both in US$

[2] On 3 Sep 1929 the Dow was at 381, on Nov 11 it was down to 228, by Jul 1932 it had fallen to 42

1. One-Year Confidence Index

Question: How much of a change in percentage terms do you expect in the JSE All-share Index during the following periods: one month, the next three months, the next six months and the next year?

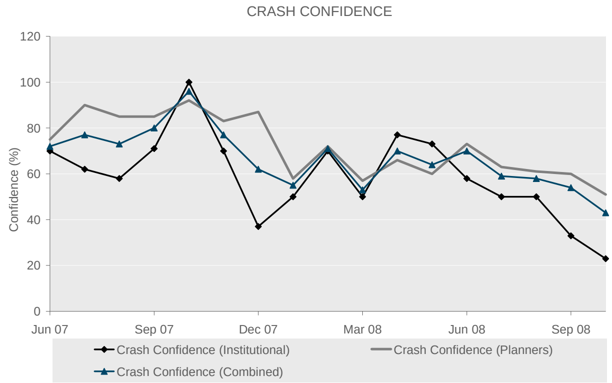
The index is calculated as the number of respondents giving a number strictly greater than zero for the “In one Year”. The index therefore reflects the percentage of the sample that expects the JSE All-Share Index to end positive over the next X months.



3. Crash Confidence Index

Question: What do you think is the possibility of a catastrophic market crash (like 28 October 1928) occurring during the next six months?

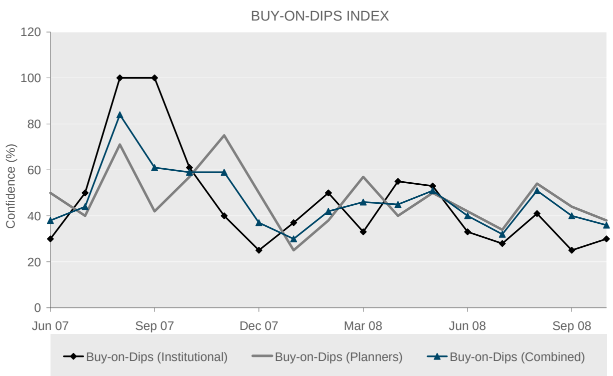
An answer of between 0% and 100% may be given, with 0% meaning it will not happen and 100% it is sure to happen. The index is the percentage of respondents who think that the probability is less than 10%. Therefore shows the percentage of respondents who attach little probability to a stock market crash in the next 6 months.



2. Buy-on-Dips Confidence Index

Question: If the All-Share were to drop by 3% tomorrow, what would you think the All-Share would do the day after tomorrow?

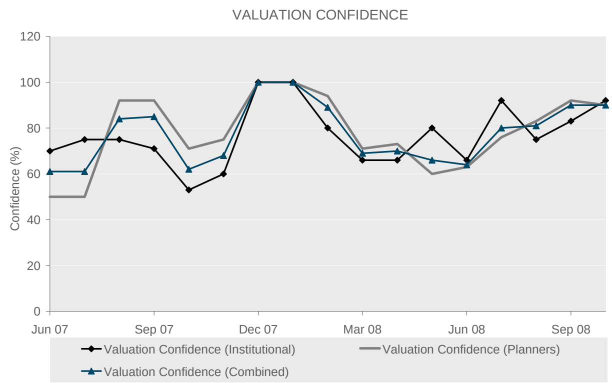
Three options are available namely Increase (%), Decrease (%) or stay the same. The Buy-on Dips Index is the number of respondents that choose an Increase as a percentage of the total number of respondents. The index therefore shows the percentage of the respondents expecting a rebound the next day should the market drop by 3% in one day.



4. Valuation Confidence Index

Question: Stock prices in South Africa, when compared with measures of true fundamental value, are too low, too high, or just right?

The valuation index is the number of respondents who choose too low or just right as a percentage of the total number of respondents. It therefore reflects the number of respondents who think that the market is not too high.



Report methodology

Confidence in the equity market is more complicated to ascertain than consumer confidence, since thejudgments people make about the share market are multi-dimensional and influenced by a number of complex motivations. One of the complications is that people who are interested in the stock market often view themselves as “playing a game” against other share market investors, trying to guess when shares will do well before others do, so that they can profit from this knowledge. Many people who follow the financial markets will watch the numbers every day, and their observations and conclusions may be coloured by the many divergent business reports that appear in the media. Thus, there is likely to be more complexity to people’s views about the share market than there is about their decisions about, for example, whether to save more or to buy a new car, which consumer confidence indices emphasise. It should also be recognised that investor confidence is only one of many forces on the market. Share prices are of course determined by supply and demand, and there are numerous factors that affect these: fundamental factors, legal, tax-related, demographic, technological, international, as well as other psychological factors related to attention, regret, anchoring, and availability.

If investor confidence is such a complex construct, is it at all possible to measure it? Research conducted by the Yale International Centre for Finance at Yale University in the USA has certainly shown that it can be measured, but the measurement must reflect the multi-dimensional nature of the construct. For this reason the confidence index is not expressed in just one figure, but the “index” actually consists of a collection of indices.

It must further be noted that the indices of investor confidence that we have derived do not all move in the same direction through time, or even approximately so. Forming a simple average of the different indices to produce one overall share market confidence index would thus be arbitrary. Instead, we report here different investor confidence indices. Each is measured in %, as a % of respondents who report holding a certain view.

Sample

The Sanlam Investment Management Investor Confidence Index is conducted monthly among abroad group of investment professionals, these include economists and portfolio managers from institutions as well as financial planners whose main focus is investments. The number of respondents is between 80 and 120 each month. Responses are submitted by a consistent set of investors to a consistent set of questions which makes comparisons between different time periods possible and accurate.

Data

A questionnaire is send the second Monday of every month to a sample of investment professionals. These include economists and portfolio managers form institutions as well as financial planners whose main focus is investments. Respondents need to answer 4 questions only by indicating in what direction and by what percentage they think the market will change. The questions are shown below as well as an indication of how the index is calculated.

1. One-Year Confidence Index

Question: How much of a change in percentage terms do you expect in the JSE All-share Index during the following periods: one month, the next three months, the next six months and the next year?

The index is calculated as the number of respondents giving a number strictly greater than zero. The index therefore reflects the percentage of the sample that expects the JSE All-Share Index to end positive over the next 1, 3, 6 and 12 months.

2. Buy-on-Dips Confidence Index

Question: If the All-Share were to drop by 3% tomorrow, what would you think the All-Share would do the day after tomorrow?

Three options are available namely Increase (%), Decrease (%) or stay the same. The Buy-on Dips Index is the number of respondents that choose an Increase as a percentage of the total number of respondents. The index therefore shows the percentage of the respondents expecting a rebound the next day should the market drop by 3% in one day.

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