

STANLIB

# Weekly Focus

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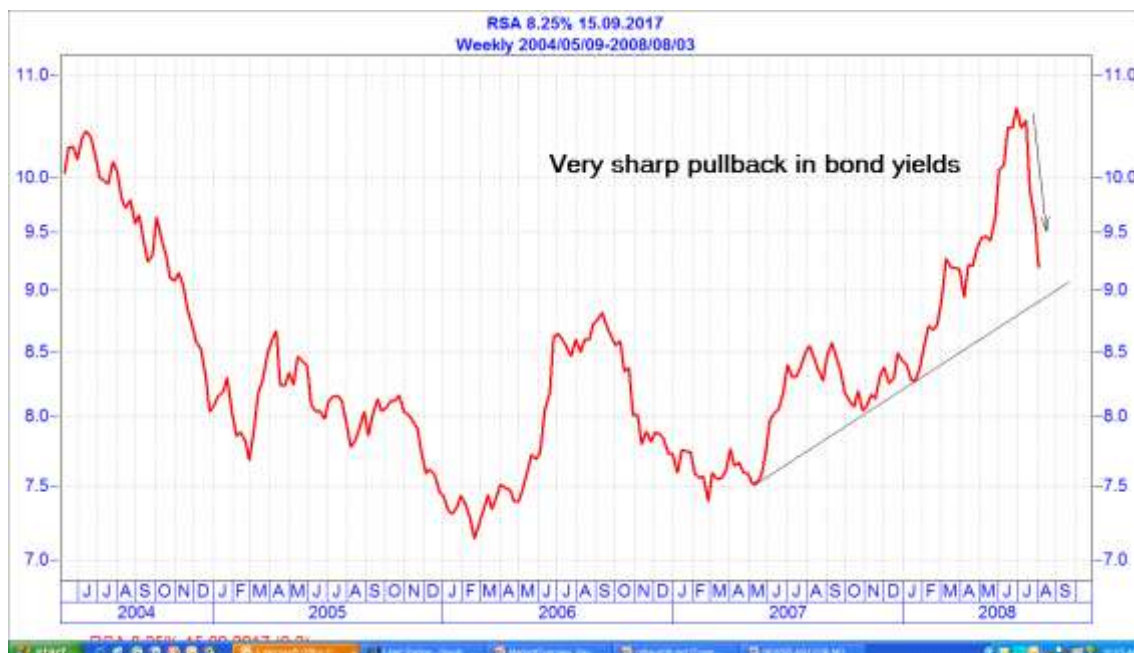
4 August 2008



Items covered: Interest-rate sensitives end their bear market, Resources, Snippets of Info

### AMIDST THE RESOURCES CORRECTION ARE SOME BIG POSITIVES

- Although the sharp (and somewhat expected) correction in resource shares – on the back of weak economic numbers in the US and Europe - is creating the impression of a weak stock market (just as the opposite occurred for much of the year), some key positives have emerged of late.

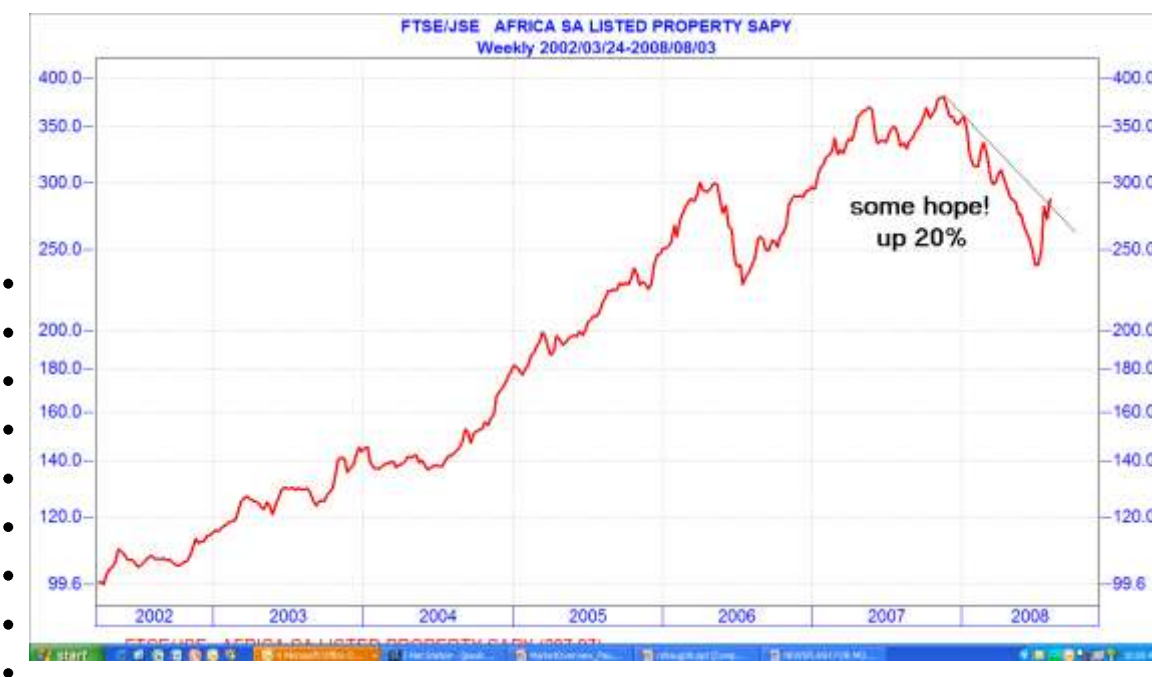


Source: I-Net Bridge

- Firstly, the tremendous rally in the SA bond market, which has seen the 2017 RSA bond yield tumble from 10.9% in early July to 9.3% last week (right in the midst of huge doom-and-gloom about inflation

and interest rates) has had a very positive effect on the much maligned interest-sensitive sectors, namely the listed property shares, retailers and banks.

- All three sectors are already up 20% from their lows! Those are decent moves!



Source: I-Net Bridge

- The point is that all three of these sectors had been sold down to extraordinarily cheap levels, ie had reached extremes in terms of undervaluation. We discussed the bank sector's extreme undervaluation a few weeks ago.
- Now there is a better-than-even chance that the bear or down markets in all three are over, even though we obviously could still see some downward moves, ie a retraction of some of the 20% upmove is quite likely, but we very much doubt that the previous lows for the year will be exceeded.
- Even the JSE Small Cap and JSE Mid Cap Indices are showing signs of turning. These sectors are typically also sensitive to changes in interest rates. They seem to offer great buying opportunities at present (STANLIB Small Cap Fund).

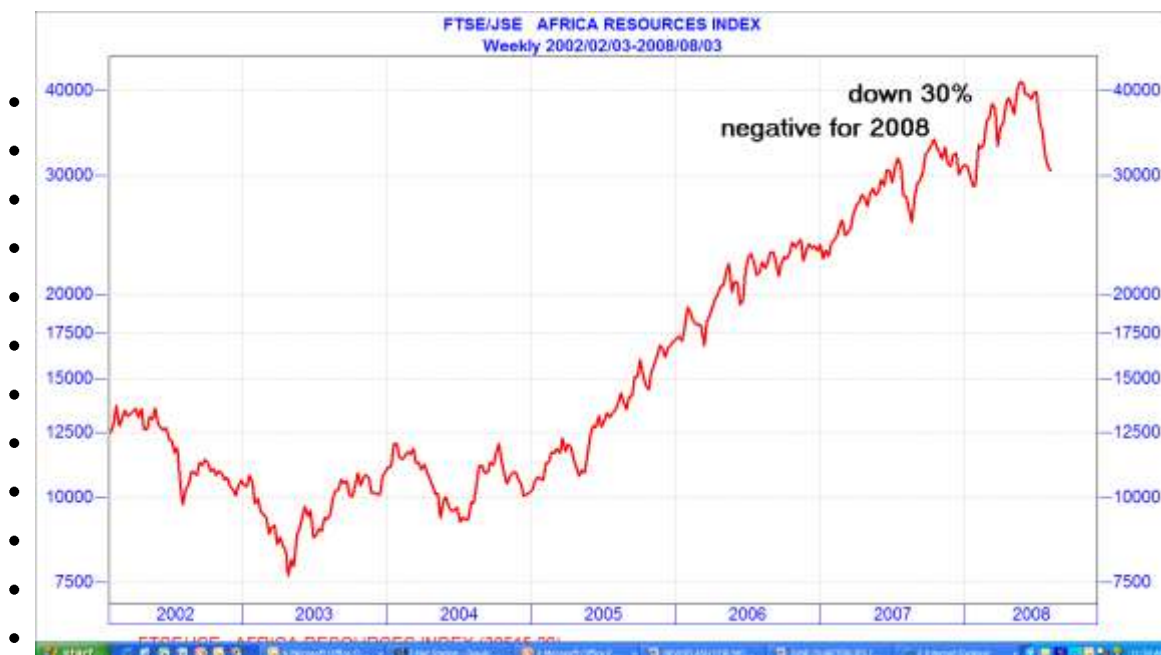
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- These sudden turnarounds are typical of markets. They happen when least expected, amidst enormous doom-and-gloom and they move quickly.
  - That is why we have repeatedly recommended that investors avoid where possible selling out of their funds because typically they do this at just the wrong time, close to the bottom! The reason is because the crescendo of negative news reaches a peak and all seems lost. However, that is precisely the time to be buying more! As we've stated before, the time of maximum fear or pessimism is ironically also the time of maximum opportunity.
  - As Sir John Templeton said in 1992: "People always ask me where the best prospects are. That's the wrong question to ask. Rather ask where are prospects the bleakest?" Why? Because the prices of properties and shares will reflect those prospects and investors would be far better off buying low (prospects bleakest) than buying high (prospects brightest).
  - Sadly we have seen plenty of money flowing out of our funds, even our risk-profiled funds that hold all four asset classes (cash, bonds, property, equity) and it seems that most of the outflows have occurred during the past six weeks, which was probably the best buying opportunity.
  - This is not to say that world markets are 'out of the woods'; not remotely, what with the property crisis and associated credit crisis in the US still ongoing, the European economy slowing sharply and oil prices still too high.

## **RESOURCES: BUBBLE OR NOT?**

- The sharp declines in resource shares of late – and in the price of platinum and palladium (both down close to 20% in the past three weeks) – have heightened fears of the resource "bubble" bursting, similar to the TMT bubble bursting in 2000.
- Signs of further weakness in the US and European economies have emerged (US unemployment up from 4.4% to 5.6%) and the demand for oil in the developed economies is declining by 1-2%, although so far this seems to be more than offset by increased demand from the developing economies.
- Clearly there is uncertainty. Will economy after economy begin to dip sharply like Europe appears to be doing and therefore buy fewer and fewer commodities like copper, iron ore, platinum etc?
- So far this looks unlikely in that the developing economies are set to spend \$2.2 trillion on infrastructural projects over the next three years. In many instances, such as in SA, this spending is immune to rising

interest rates. The spending has to occur because there is a shortage of electricity, water, etc. In turn this spending requires commodities like cement, steel, iron ore, copper etc.

- However, the JSE Resources index has tumbled by 30% since its peak in May (see below) and is now negative for the year-to-date (-2.4%)!!



Source: I-Net Bridge

- Our initial impression is that this is probably creating another great buying opportunity, but of course there is uncertainty and risk, something that has always characterized resources.
- So far all the big mining companies and the global metal analysts have stated that on the whole stocks-on-hand remain very low (for example, copper) and demand has remained reasonably firm to-date.
- Anglo and Billiton are both down 30%, which are hefty smacks although neither has yet reached the lows seen in January, Sasol is down 26%, Impala Platinum is down a huge 43% and Amplats 38%. These are major corrections, no question.
- So is this a case of panicking or are the shares telling us that the world economy is on the skids?

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- It appears that it's a case of panicking, which is creating opportunities. However, the uncertainty is there so buyers would need to be bold.

## **SNIPPETS OF INFO**

- Of course, the sudden sharp jump in the rand is hurting our resource shares too. Of note the SA Rand (up 6.5%) was the best performing currency in July. Take that! Why? Partly because of the "carry trade" where one can borrow for 0.5% in Japan or 2% in the US and invest for 13% in SA and partly because of rumours of big corporate deals like Vodafone buying more shares in Vodacom.
- The strong rand is, however, very good for our inflation and interest rates.
- Although the JSE All Share Index lost 8.7% in July, the All Bond Index gained 8.5%, which was an exceptional return. Banks gained 21% in July, as did General Retailers, while Platinums lost 23%. How's that for a turnaround??!
- Year-to-date to end July, emerging markets have shed 14.9% and developed markets 12.4%.

**Paul Hansen**

**(Group Director, Retail Investing)**

## Economic Update

*Last week proved to be as eventful as promised with a deluge of economic data released both locally and in the US. On home shores; the better than expected PPI (producer inflation) combined with a small trade deficit in June, confirming the slowdown in consumer activity; as well as a further decline of the Investec PMI (Purchasing Managers Index) reflecting that our manufacturing activity is under significant pressure; adds more weighting to STANLIB current interest rate view that rates will remain on hold at the next August meeting.*

*However, there still are pressures in the pipeline which would argue for another 50bps hike. These were strengthened by June CPI and CPIX (consumer inflation) coming out higher than expected, although hopefully we are nearing the peak of the inflation cycle; as well as credit growth and money supply which remained stubbornly high in June, therefore not showing a convincing slowdown that the Reserve Bank would need to keep rates on hold.*

*In the US, although Q2 GDP (gross domestic product) showed growth of 1.9%q/q after a fantastic pick up in exports, the broader economy remains under severe pressure. Unemployment worsened to 5.7%/y after an additional 51 000 jobs were lost in July; and US house prices declined further in May, now down at 15.8%/y with more bad news expected given the large inventory overhang. These releases were not received well by global markets.*

### SOUTH AFRICA

#### BETTER THAN EXPECTED PPI

- **In June 2008, SA Producer Inflation (PPI) increased by 2.6%m/m**, taking the annual rate of change in PPI inflation up to 16.8%/y from 16.4%/y in May. This was actually below market expectations for a rise to 17.0%/y, and the first time in a while that inflation has been below expectations. The better than expected outcome was mainly due to a surprise decline in coal and metal ore prices. In contrast, **electricity prices jumped by 44.4% in the month**, which is part of the normal switch from summer to winter tariffs. There will be a further relatively large increase in electricity inflation next month.

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- **The latest PPI inflation reading is the highest since April 1987, or the highest in 21 years!**
  - **Agricultural prices** are extremely volatile and very difficult to forecast from month-to-month with any meaningful certainty. For example, this month grain prices jumped by 13.2% in the month, while fruit prices declined by 8.8%. Looking at the chart on international food prices there remains some further upside risk to agriculture and manufactured food inflation. It is however; very encouraging that SA agricultural inflation has moderated very significantly in a relatively short period of time. In June 2008 the rate of growth was recorded at 2.0%/y/y, slightly up from 0.7%/y/y in May.
  - **Almost 60% of the current PPI inflation rate is caused by three categories**, namely mining products (including coal, and metal ores), refined fuel, and basic metal products (including iron and steel). Interestingly, agriculture and food prices now account for slightly less than 10% of the PPI inflation, which is significantly less than a year ago. Electricity prices explain 4.2% of the current inflation rate.
  - **In 2007 PPI inflation averaged 10.0%**. PPI has now been above 6% for two years and is expected to average at least 15.5% in 2008. The new definition and measure of PPI does imply increased volatility month-by-month given the inclusion of many more commodity prices changes, which are significant in weight.

## **SOUTH AFRICA'S TRADE ACCOUNT RECORDED A FURTHER IMPROVED DEFICIT OF ONLY –R0.18BN**

- We suspect that the trade deficit has started to stabilise, at least relative to 2005 to 2007, and is actually likely to improve during 2008/2009 if commodity prices hold-up and the domestic economy continues to slow. There is clear evidence that consumer activity is slowing sharply (especially motor vehicles, furniture and appliances) and that fixed investment spending will not experience as much growth as last year. This should be reflected in a modest improvement in the trade balance during 2008/2009, and hence some improvement in the current account deficit.

## **SA INVESTEC PMI FELL FURTHER IN JULY**

- The PMI index *had* bounced back sharply after the Q1 2008 electricity related decline in output. However, this is the third consecutive month that the index has been below 50, and a worrying trend. At

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42.8 the index is clearly pointing to a **severe and broad-based slowdown in manufacturing production**. There are a number of factors that have contributed to the most recent slowdown in manufacturing, including a slump in consumer spending on the back of high interest rates, excess inventories, higher input costs and weakening housing activity.

- The trend in the overall PMI manufacturing index is clearly pointing to a slump in manufacturing business activity; which is partially already reflected in SA's manufacturing sector performance. The combination of a slowdown in activity levels and an increase in prices paid would point to an element of stagflation and margin pressure in SA industry.
- **From an interest rate perspective, this is further confirmation of the weakening domestic economy and hence another reason to keep interest rates on hold when the Reserve Bank next meets in August.**

## **CPIX (CONSUMER INFLATION) HIGHER THAN EXPECTED IN JUNE**

- In June 2008, headline CPI inflation rose by a substantial 1.3%*m/m*, with the annual rate rising to 12.2%*y/y* from 11.7%*y/y* in May. This was higher than market expectations for a rise to 12.0%. **CPIX inflation also rose by a significant 1.1%*m/m* in June, with the annual rate increasing to 11.6%*y/y*, from 10.9%*y/y* in May.** This was above expectations for a rise to 11.4%*y/y*. This is the 15th consecutive month that CPIX inflation has been above the target range of 3% to 6% and the highest level of CPIX recorded since the inception of CPIX.
- The main reason for the increase in CPIX during June was again food and transport costs. Together these two factors accounted for almost all of the monthly increase in CPIX. CPIX excluding food and fuel is still trending higher and above 6% at around 6.3%*y/y*.
- There is a very clear risk that the longer CPIX stays above the target, inflation expectations and wages will be impacted negatively. Already some wage demands are being settled well above 10% while the average wage increase is probably closer to 8.5% and moving higher.
- In addition, a breakdown of CPIX by income group shows that for very low income earners (as defined by Stats SA); inflation is now up at 14.7%! The main reason is that food alone accounts for 51% of the basket! This could reflect in ongoing protests about the high food/fuel/electricity price as well as much higher wages demand.

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- **Looking forward**, CPIX inflation is expected to continue to rise to at least around 13%/y in the short-term. This is not only due to the current cost pressures in the system but also due to the latest increase in electricity prices as well as further upward pressure on processed food inflation.
  - The effect of this is to keep CPIX inflation well above 10% for the remainder of 2008. Going into 2009, the re-weighting combined with the high base effect should create a more favourable outlook for inflation. This is especially the case if the international oil and food prices can hold-onto recent downward trends. **At this stage it is entirely possible the CPIX inflation moves back-inside the target range by the end of 2009, which should allow for interest rates cuts during the course of 2009.**
  - **For 2007 as a whole CPIX averaged 6.5% but is now forecast to average 11.2% in 2008.**
  - **In terms of the real economy**, while the latest GDP growth estimate is heavily impacted by the electricity outages in Q1 2008, which should partly rebound in Q2 2008, the outlook for the next few quarter's points to growing evidence that the broader economy is slowing. Having said that, South Africa is unlikely to experience a recession. Motor car, furniture and appliance sales are firmly negative on an annual basis. Cement sales and building plans have also moderated meaningfully, while manufacturing production is slowing. A while back we revised our 2008 growth rate down to 2.7%, from 3.2% anticipated a year ago. On the plus side, the agricultural season is surprising on the upside, while fixed investment activity remains relatively robust.

## SA CREDIT GROWTH REMAINED STUBBORNLY HIGH IN JUNE

- In June 2008, SA growth in broad **money supply (M3)** was recorded at 20.28%/y, down fractionally from 20.9%/y in May. In June, claims on the private sector rose by a substantial R38.2bn. M3 growth remains high, although there is some evidence to suggest a slowdown in the months ahead.
- The growth in **private sector credit** rose disappointedly to 20.3%/y in June, up from 19.7%/y in May. Markets were expecting a modest slowdown.
- Mortgage credit growth was recorded at 19.9%/y in June, down from 20.6%/y in May and over 30%/y at the start of 2007. Credit card debt is slowing more noticeably; now down at 11.2%/y from over 40%/y in the middle of 2007. (Household credit growth slowed to 21.0%/y in June from 21.7%/y in May).

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- In contrast, 'other loans and advances' – which is mostly corporate credit – accelerated to 26.2%/y/y from 24.9%/y/y in May.
  - While it is clear the credit demand is slowing, **the slowdown is still relatively modest given how fragile the consumer activity has been recently.** In part, this could be due to continued distress credit, although it is unlikely that distress credit fully explains the current trend. It could also be due to the impact of higher inflation. In other words, while credit growth is slowing only fractionally in nominal terms it is, in fact, slowing far more noticeably in real terms. It is also clear that new applications for credit have slowed substantially and that a lot of the growth in credit is coming from existing facilities that have been in place for some time.
  - In real terms (adjusting for inflation), the growth in private sector credit (excluding investments) is now growing at only around 8%/y/y, well down from the recent peak of 20.8%/y/y in February 2007. During that time inflation has risen from 5.7% to 11.7%, a rise of 6 percentage points.
  - On a trend basis, the annual growth in credit demand is clearly showing signs of slowing, albeit very slowly. There is evidence that the prior increases in interest rates, the introduction of the NCA, and slowdown in disposable income growth is having a moderating impact on overall demand for credit as well as consumer and housing activity. This is expected to continue throughout the remainder of this year and well into 2009.
  - Unfortunately, we suspect that the Reserve Bank would ideally want to see a much more convincing slowdown in credit demand in order to be comfortable with leaving rates unchanged in August.
  - **From an interest rate perspective,** the Reserve Bank is likely point-out that inflation expectations have increased significantly and are no longer anchored within the inflation target range. They are also likely to highlight that there is mounting upward pressure on wages, while private sector credit continues to grow at over 20%/y/y. CPIX excluding food and fuel is still above 6% and trending modestly higher. However, the recent moderation in the oil price coupled with the firmness of the exchange rate, a softening in agricultural prices, the CPIX re-weighting windfall, a better than expected PPI reading, and further clear evidence of a sharp slowdown in consumer activity could allow them to keep interest rates on hold when they next meet in August.

## USA

### US Q2 2008 GDP GREW BY 1.9%Q/Q, ANNUALISED

- This compares with a marginally revised growth rate of 1.0%q/q in Q1 2008. The market was expecting growth of 2.3%q/q. A breakdown of the data reveals **that net exports contributed a substantial 2.42% to the quarterly performance**. This was due to the combination of a decline in imports and an increase in exports. If net exports had remained unchanged in the quarter, US GDP would have declined by around 0.5%q/q.
- **Fixed investment spending in the US remains under pressure**. There was a further decline in investment spending on equipment and software as well as residential property. The overall decline residential property activity has been dramatic since at least the beginning of 2006. For example, over the past four quarters the building of residential property has declined by an average of 22%q/q in real terms.
- **Overall consumer spending remains positive**, although there is a clear decline in the purchase of durables goods in the form of cars, furniture and appliances. Consumer spending was helped by the tax relief in Q2 2008. **Personal taxes decreased by a substantial \$178.9 billion in the second quarter, in contrast to an increase of \$20.7 billion in the first quarter**. The sharp downturn reflected the recent rebates to individuals.
- Overall, while the GDP performance is far from satisfactory it does not suggest that the US is about to experience an outright recession over an extended period of time. The tax relief in Q2 2008 was clearly a benefit to the economy (reflected in a substantial boost to personal disposable income in the quarter), but the performance of the export sector has to be applauded
- **Overall, we continue to forecast US GDP growth of 1.7% in 2008, down from a revised 2.0% in 2007. In 2009, we expect the US to slow to a growth rate of around 1.4%.**

### US HOUSING RECESSION CONTINUES

- **In May US house prices declined by 15.8%/y/y, as measured by the S&P CaseShiller Home Price Index**. This compares with a revised decline of 15.2%/y/y in April. The market was expecting a decline of 16%/y/y.

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- US house prices has been under pressure for a considerable time. In fact, US house prices have now declined year-on-year for 17 consecutive months, and are expected to continue to fall in the months ahead.
  - This is mainly due to the fact that home inventories remain extremely elevated. New home inventories are currently at 10 months of current sales, slightly below the peak level of 10.4 months recorded in May 2008; **while existing home inventories are at 11 months, which is the highest in decades!**
  - According to the IMF (International Monetary Fund), "at the moment a bottom for the housing market is not visible".

Kevin Lings and Melissa Rankin

STANLIB Economics and Group Retail Investing

## Rates

The following yields are calculated using an annualised seven-day rolling average as per the unit trust industry standard. These rates are expressed in normal and effective terms and should be used for indication purposes ONLY.

### **STANDARD BANK MONEY MARKET FUND**

Nominal: 11.66% per annum

Effective: 12.30% per annum

A constant unit price will be maintained. Past performance is not necessarily a guide to future performance. A schedule of fees and charges and maximum commission is available on request from the Manager. Commission and incentives may be paid and if so, are included in the overall costs. The yield is calculated using an annualised seven-day rolling average as at 1 August 2008.

### **STANLIB CASH PLUS FUND**

Effective Yield: 12.67%

This is a current yield as at 1 August 2008.

## Glossary of Terminology

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	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.
Collective Investments	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.
Compound Interest	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.
Dividend Yields	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.
Dividends	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.
Earnings per share	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.
Equity	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.
Financial Markets	Financial markets are the institutional arrangements and conventions that exist for the issue and trading of financial instruments.

Financial Sector Funds	These funds invest in financial services companies, including banks, insurance companies, brokerage firms and other companies whose principal business operations involve the provision of various financial services or where at least 50% of their earnings are derived from the provision of such financial services.
Fixed Interest Funds	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.
Gross Domestic Product (GDP)	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.
Growth Funds	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.
Industrial Funds	Industrial funds invest in selected industrial companies listed on the JSE, but excluding all companies listed in the resources and financial economic groups.
Investment Portfolio	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.
JSE Securities Exchange	The primary role of the JSE Securities Exchange is to provide a market where securities can be freely traded under regulated procedures.
Price to earnings ratio	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.
Property	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.
Resources and Basic Industries Funds	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.
Smaller Companies Funds	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.
Value Funds	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.

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