Dry Associates Investment Newsletter

MAR—MAY 2012

INSIDE THIS ISSUE

Dear Investor,

Financial Planning – Starting Early!

In 2010, the US Social Security Administration conducted a survey and found that out of 100 people who start working at age 25, by age 65:

- 1 person is wealthy
- 4 persons have adequate capital stowed away for retirement
- 3 people are still working
- 63 are dependent on Social Security, relatives or charity
- 29 are deceased

That's not a pretty picture to say the least. Ironically, a little planning and determination early on in life can result in almost anyone achieving financial independence.

By early, we mean age 25 or thereabouts. Sure this is the time when there are so many things to buy, little income and all the while trying to nail down academic and professional degrees. Nevertheless, it's also the time to put the PLAN in place.

In fact, there's an excellent mechanism available to everyone that almost assures financial independence if begun early in one's career. And that is the pension plan!

7a.m. over the "fairy chimneys" of Göreme, Cappadocia, Turkey , April 15 2012 (S. Dry)

Here are some facts.

In Kenya, earned income is taxed at 30%. Yes, that is very high so when the government offers to exempt up to Ksh 20,000 per month of a person's salary from income taxes (or Ksh 240,000 a year) – do it!

Do it because in addition to paying no taxes on that amount, all the returns on that money – dividends, interest, capital gains - are exempt from taxes and compound tax free as long as the funds are in the plan. And if you wait until you're 65 to draw it out, there are no taxes levied on the withdrawal.

Continued …

So, if you placed Ksh 20,000 per month into a pension plan earning 10% per year from age 25 to 65, you'd have accumulated Ksh 126,481,591. That's more than 1.5 million dollars. And a 10% return is not an unreasonable return in Kenya. The Government of Kenya 25-year Treasury bond today, for example, is yielding 14.50%. As Bernard Baruch, the US financier reportedly said when asked if he knew the Seven Wonders of the World, "No," he answered, "but I know the 8^{th} wonder – compound interest."

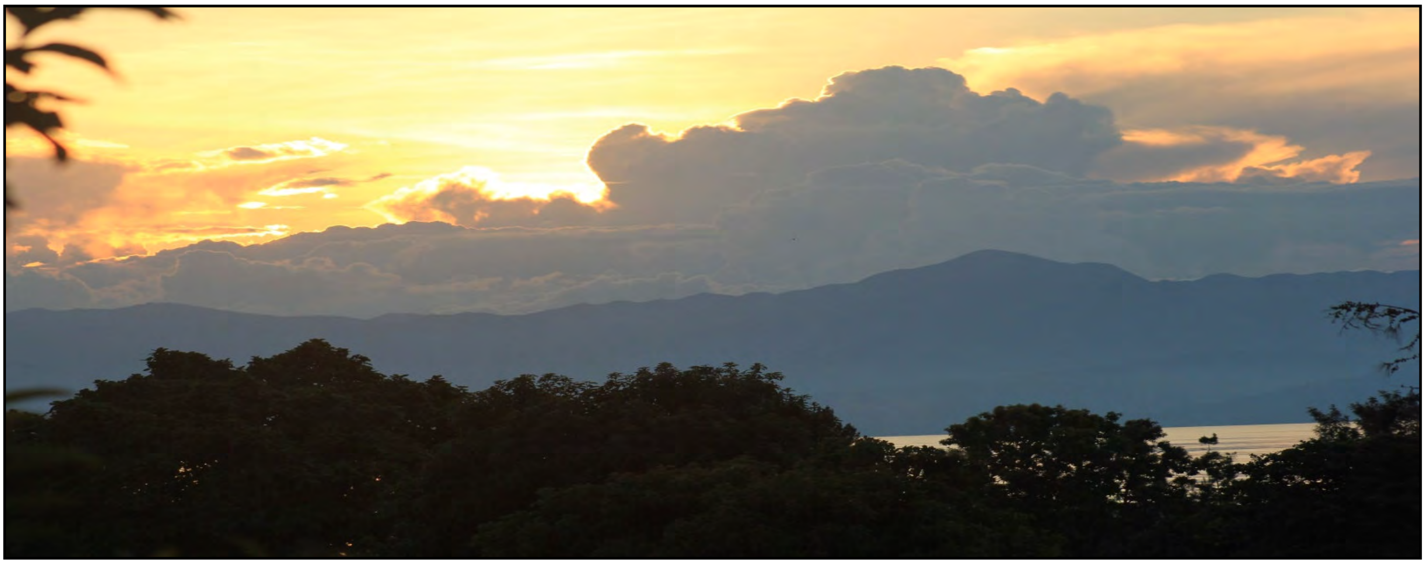
Now, there are a number of very good pension plans in Kenya today. But if you're just coming to the party, you might want to consider joining the new **Dry Associates Personal Provident Plan** recently approved by the Retirement Benefits Authority (RBA). Dry Associates will be the Fund Manger and the plan is structured to allow individuals to contribute with or without contributions from an employer.

While Dry Associates manages other pension plans including stand alone occupational pension plans for private companies, this new plan will have minimal running costs as the Fund Manager, Trustee, Administrator and Custodian costs will be spread out over all the participating individuals and companies. The interests of the participants will also be aligned with the Fund Manager's interests as Dry Associates is migrating its own in-house pension plan into the new plan. The Dry Associates pension plan earned 23% in 2009 and 21% in 2010. The 2011 results have not been audited yet; however, they are expected to be flat this year as the principal value of bonds, in particular, fell in 2012 because of exceptionally high interest rates. Bonds held to maturity, however, which is the intent of most bond investments will all mature at full value so any current reduction in bond value will be recouped in the future.

For background, pension plans are of two types: provident plans or pension plans. A provident plan pays out a lump sum on retirement and the so-called pension plan permits a small lump sum withdrawal at retirement and the balance must be used to purchase an annuity.

As with all registered pension plans in Kenya, the Fund Manager (Dry Associates) directs the purchase and sale of securities in the plan, the Administrator (Kingsland Court) provides fund accounting, a Trustee (Kingsland Court) ensures investments are within RBA and Trustee guidelines and a Custodian (Co-op Bank) holds all cash and titles of assets.

So, once you've got the pension plan in place, it's time to start working on that 3^{rd} million!



Sunset over Lake Kivu, Goma, the Democratic Republic of Congo, November'11 (Courtesy: A. Duncanson)

New Ideas in Finance ... CoCo's & Crowdfunding

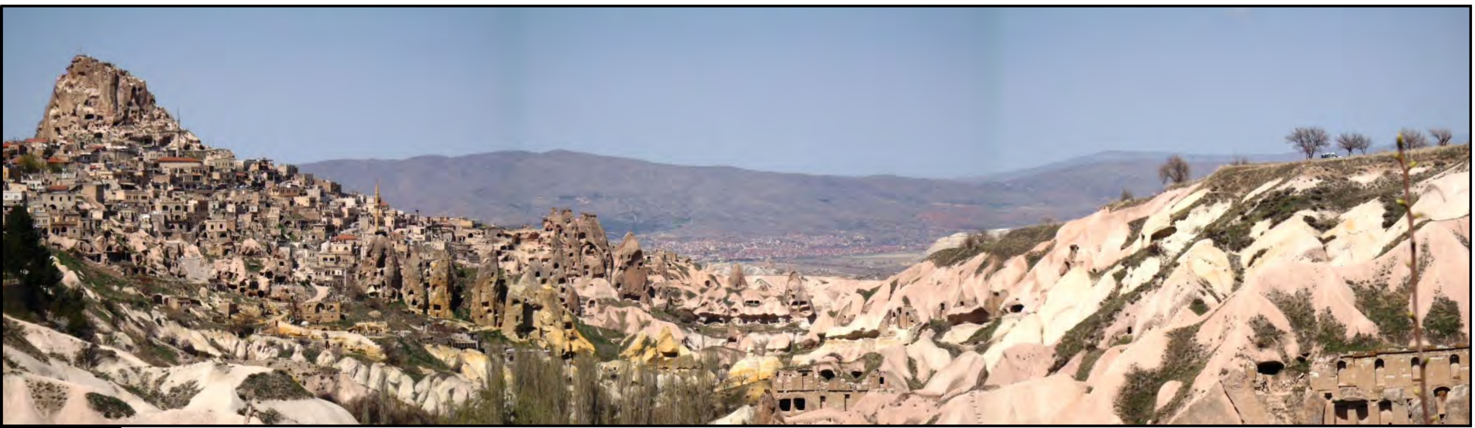
Remember that old expression "it's money in the bank". It seems to have lost its cache. In the wake of the worst global banking crisis in decades, no one's using the expression much anymore.

The first line of defense to fall in the 2008/2009 financial crisis was the rating agencies. They rated banks and they rated the instruments banks sold. Moody's and Standard & Poor's had been confidently credit rating mortgage backed securities AAA for years until in July 2007 they suddenly downgraded 90% of all these securities issued in 2006 and 2007. That set off panic selling by pension funds and investors worldwide setting in motion the global financial crisis. So, credit rating agencies were not the firewall they were intended to be.

Even so, regulators all along had required that banks adhere to strict capital adequacy ratios such as those laid out in the Basel II Accords. These ratios were built on the best thinking of central bankers and stipulated that commercial banks maintain total capital above 8% of a bank's risk weighted assets. Problem was, it wasn't enough. Citibank and Bank of America each needed $45 billion in government bailouts and in the UK the Royal Bank of Scotland, Lloyds and HBOS needed similar amounts. So, static capital ratios weren't the answer either.

But capitalism is nothing if not innovative, and now we have the Basel III Accords. Part of the thinking behind Basel III is to make investors in banks and not the taxpayer pick up the pieces in the event of bank failure. So in addition to increasing Tier 1 capital (basically equity in a bank) from 8% to slightly more than 10%, Basel III takes a bank's Tier II capital (basically long term debt in a bank) and uses that debt to absorb losses or convert the debt to equity if certain capital ratios are breached.

Swiss bank UBS has recently issued $2 billion of the loss absorbing bonds. Credit Suisse the other large Swiss bank has issued similar bonds but these convert to equity when triggered. No doubt, the Gnomes of Zurich are hoping that these *CoCo's* or Contingent Convertible bonds might just bring back some of the shine in that old expression "it's money in the bank".



Uchisar, Cappadocia — until as recently as 50 years ago, many residents of this ancient town lived in caverns carved out of sandstone chimneys — Uchisar's current inhabitants live among the chimneys in modern houses, April 15 2012 (S. Dry)

American Capitalism ... still on the move!

President Obama last week signed into law the Crowdfund Act. This law will permit US companies to publically or privately raise up to $1,000,000 from the public over a 12 month period using the internet and social media. The funds must be raised through a third party's intermediary platform, but the law permits companies for the first time to solicit the public directly without an expensive public offering. The amounts that can be raised from investors depend on an investor's net income or net worth.

Purchase thresholds depending on investor's income or net worth will be periodically adjusted based on the Consumer Price Index. The informational requirements are much less onerous than formerly. For instance, a capital raising of less than $100,000 doesn't require much more than the most recent financial statements certified by the firm's principal officer. Issuances between $100,000 and $500,000 require that financials be certified by a CPA while audited accounts are required for issuances up to $1 million.

The travertines of Pamukkale, Turkey — what looks like snow is in fact calcified rock! April 17 2012 (S. Dry)

In addition, as part of the new Jobs Act also expected to be signed into law, companies may now solicit unlimited funds from "accredited investors" using their own website. Accredited investors are high net worth investors defined by the US Securities and Exchange Commission typically having a net worth greater than $1 million.

Kenyan Fixed Income Securities

Interest rates in Kenya remain historically high. The Central Bank of Kenya Rate, the rate at which the CBK lends to other banks, has been held at 18% since December 2011 although the 91-day Treasury bill rate is trending down at 11.38% this week with the 182-day rate at 13.07%. Month-on-month inflation, that is, April 2012 consumer prices compared to April 2011 is still high at 13.06%.

Ancient Roman Baths at Hierapolis (modern day Pamukkale), Southern Anatolia, Turkey—April 17 2012 (S. Dry)

We believe interest rates will continue to come down slowly over the coming weeks and months if the exchange rate holds. In the end, this is a balancing act between interest rates and exchange rates.

As we've noted in this newsletter many times, Kenya is a net importer and petroleum represents about a quarter of the import bill. If interest rates fall too fast, the exchange rate will probably start to slip and the import bill will rise dramatically pushing up inflation even more.

Kenya's growing domestic budget deficit is also a part of the inflation equation. Kenya's government debt is now approaching 60% of GDP. While that level is generally considered manageable with a growing economy, Kenya is also taking on additional external debt representation some 30% of GDP. Kenya has committed to borrowing an additional $600 million this year through a syndicated loan. The loan will carry a coupon of 7% which is lower than shilling rates, but any slippage in exchange rates means these external loans to the extent they are not covered by remittances and export earnings will be that much more expensive to service and repay.

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In the meantime, Dry Associates fixed income department continues to offer its clients a wide range of fixed income products - from Kenyan Treasury bills/bonds to bank Fixed Deposit Receipts to promissory notes issued by large corporations to offshore bond funds. Most Kenyan securities are currently yielding 15 – 20% per annum. The offshore bond fund (emerging market) returns are currently in the 5-10% range (in USD). Some of these products are appropriate for retail investors while others are more appropriate for institutional investors. Please call us for details.

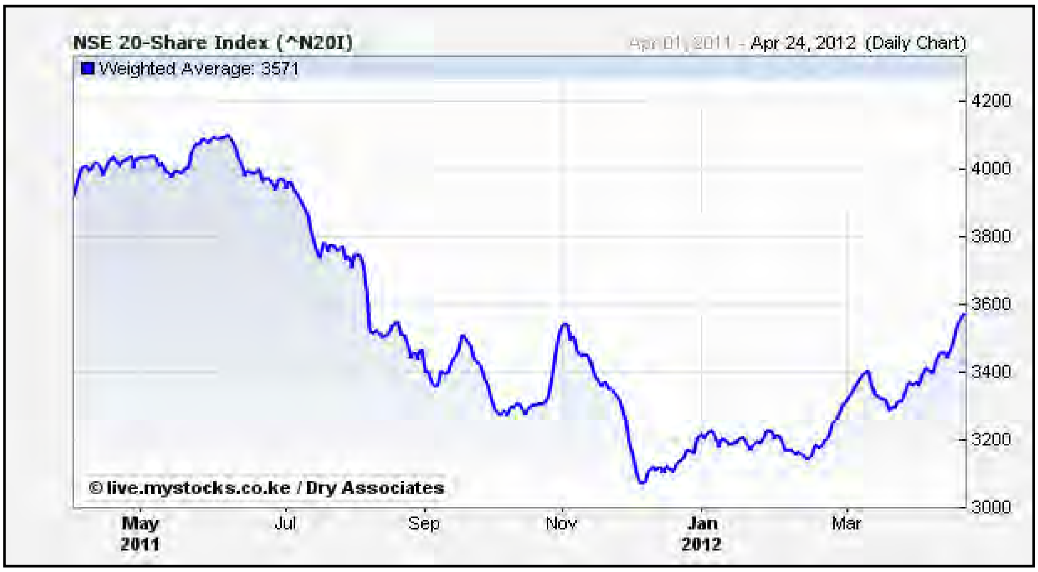
In the manufacturing sector, East African Breweries is up 22% since mid-February while Carbacid is up 13% but BOC Gases is down 5%.

In the construction sector, since mid-February Athi River Mining is up 29% and Bamburi up 11%, while EA Portland is up 7% and Crown Berger 6%.

Kenyan Stocks

The NSE 20 Index is up 11% since January 1st 2012. However, as the graph below indicates, the market went sideways during January and the first half of February. The market is impressively up 14% since 15 February.

Taking a closer look, however, this rising tide has not raised all ships. The rise has been quite selective. For example, in the banking sector, year to date, KCB is up 41%. Equity is up 24%, Diamond Trust up 12%, StanChart up 4% and Barclays down 2%.



So, whilst the market's rise of 14% since mid-February is impressive and all the more so in the midst of the highest interest rate environment in Kenya in a decade, its not across the board. Rather it seems to us, carefully targeted accumulation of particular securities largely attributable to foreign portfolio buying.

Generally, however, the NSE's overall Price/Earnings ratio is historically low at some 8.5X which is, for example, about half the current average P/E ratio of the New York Stock Exchange's Dow Jones Industrial Average. So **from a value investing point of view, the equities market is offering long term value.** On the other hand, as Kenyan elections approach, the equities market is expected to experience volatility, but without risk – well, there's no profit!

Sincerely,

Dry Associates

MAY 11th 2012

LICENSED BY THE CAPITAL MARKETS AUTHORITY AS A FUND MANAGER

LICENSED BY THE RETIRMENT BENEFITS AUTHORITY AS A PENSION FUND MANAGER