DRY ASSOCIATES INVESTMENT NEWSLETTER

June — August 2012

Dear Investor,

A Portfolio for Today

Some investment managers today are more worried about a return of their capital than a return on their capital. Hence the so-called "flight to safety". The 10-year US Treasury bond is paying a lowly 1.50% and the 10-year German bond half that much. In fact, short term government notes in six European countries - Germany, Finland, Denmark, Switzerland, the Netherlands and Austria – are all paying negative yields. Investors are paying these governments to hold their money!

Warren Buffet's quip "The first rule of investing is not to lose money. The second rule is to remember the first rule" comes to mind. Investment managers with traditional US- or European-centric mind sets are caught in the headlights between the Eurozone crisis and falling growth rates in the developed economies. Indeed, the World Bank estimates global GDP growth at 2.5% in 2012 down from 2.7% in 2011.

From where we sit, however, things are not that bad. In fact, we believe a balanced global investment perspective dictates a very different portfolio with real returns and currency appreciation to boot. Let us explain.

"The first rule of investing is not to lose money. The second rule is to remember the first rule..."

- Warren Buffet

In This Issue

Looking out from the 5th Floor of Marina View Towers, Dubai, UAE July 2012 (Courtesy: J. Dry)

In the Midst of Global Uncertainty

We think an investment portfolio today must take a truly global perspective. It should exploit regional economic differences around the world. Yes, the world is flattening with globalization and correlations of asset classes converging, but some countries have significantly better macroeconomic and microeconomic infrastructure in place than others. We're talking not only about the BRICs, but other emerging economies like Chile, South Korea, Indonesia, Malaysia, Turkey, and Mexico. These are countries that have a framework in place which supports private sector development.

Many of these emerging economies are not burdened by unfunded welfare programmes, bloated government bureaucracies, ballooning pensions, high taxes, and a sense of entitlement resulting in high debt-to-GDP (Gross Domestic Product) ratios. Many have debt-to-GDP ratios significantly below 25%. Chile has zero! They say a country's currency is a reflection of its economic health and that is often the case in these countries. These countries have stable currencies laying the groundwork for lower taxes, lower inflation and a predictable environment in which the private sector can thrive. The chart below shows emerging market debt-to-GDP ratios compared to those of "advanced" economies:

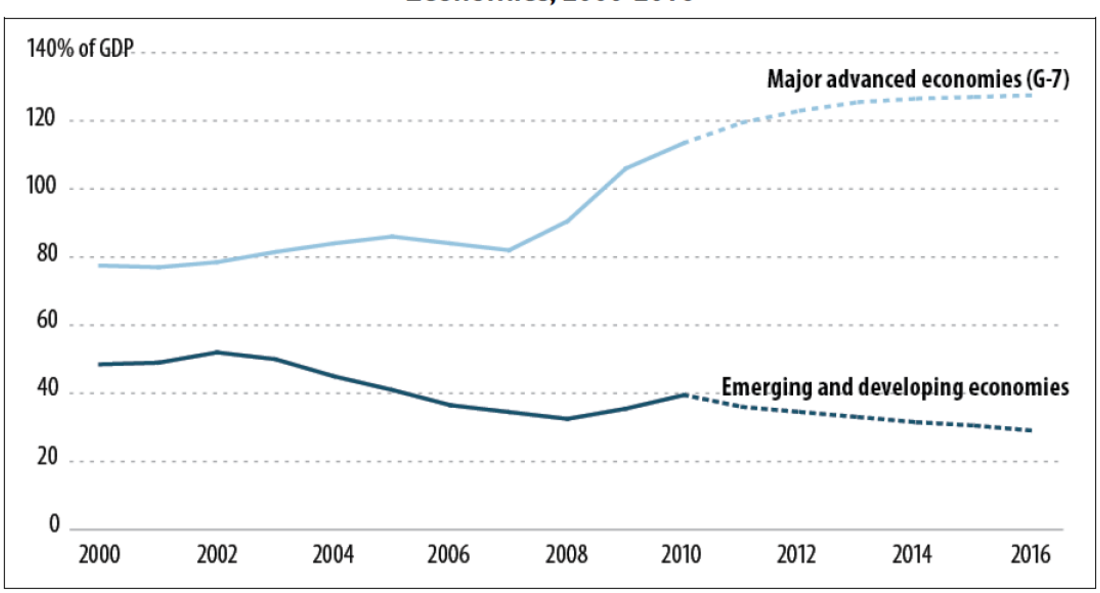
A Winning Portfolio

An investment portfolio structured with a global perspective would certainly not focus on Euro or Dollar denominated debt paper yielding negative returns. To the contrary, it would be focused on high quality emerging market sovereign debt with yields in the 7-8% range. The portfolio would also have some lesser exposure to equities with relatively high dividend yields and low Price/Earnings ratios.

Note that such a portfolio is not ignoring global economic uncertainty. Rather, it's acknowledging uncertainty by taking less risk. Such a portfolio would contain up to 75 or 80% in sovereign emerging market debt and the balance in equities. Individual portfolios, of course, need to be customized to reflect risk profile, investment horizons, and other factors. Kenyan investors should also have exposure to some Kenyan Treasury bond debt including the tax free Infrastructure bonds currently yielding 12-13%.

Looking forward, it could be 2 or 3 years before we have closure on the eurozone debacle so we believe it is better to emphasize yields in currencies that will hold their value and even appreciate against the hard currencies while we wait out the return to more sane economics. We say 2-3 years but it might even be longer before eurozone leaders begin the inevitable consolidation of fiscal and monetary policies and a throttling back of the welfare state of Europe, and increasingly the US.

Figure 2. Gross General Government Debt in the G-7 and Emerging and Developing Economies, 2000-2016



IMF World Economic Outlook,

September 2011.

We continue to think that the offshore fund manager Franklin Templeton offers emerging market bond funds that capture much of the criteria discussed. One such fund is illustrated below:

FRANKLIN TEMPLETON INVESTMENTS

TEMPLETON EMERGING MARKETS BOND FUND

A SUB-FUND OF LUXEMBOURG-DOMICILED SICAV

30 June 2012

	YTD	3-MO	6-MO	1-YR	3-YR	5-YR	10-YR	SINCE INCEP.	*SINCE INCEP.
A(Qdis)USD	5.01	-2.12	5.01	-2.03	38.16	43.84	171.50	644.58	10.04

TEN LARGEST HOLDINGS (SECURITY)	%
Government of Indonesia, FR40, 11.00%, 9/15/25	2.96
Government of Mexico, 9.00%, 12/20/12	2.88
Cemex SAB de CV, senior secured note, Reg S, 9.00%, 1/11/18	2.69
Government of Uruguay, senior note, Index Linked, 4.375%, 12/15/28	2.28
Government of Argentina, senior bond, 7.00%, 10/03/15	2.12
Government of Romania, senior note, Reg S, 5.25%, 6/17/16	2.05
Government of Ukraine, Reg S, 7.75%, 9/23/20	1.95
Nota Do Tesouro Nacional, Index Linked, 6.00%, 5/15/15	1.66
Government of Mexico, 9.00%, 6/20/13	1.63
Dubai Electricity & Water Authority, senior note, 7.375%, 10/21/20	1.60

COUNTRY	%
Mexico	7.92
Ukraine	7.00
Hungary	6.50
Nigeria	6.39
Malaysia	5.84
Brazil	5.64
Russia	5.51
Poland	5.10
Indonesia	4.26
Other	41.61

Euroland & Germany

The euro crisis began in late 2009 and continues. National interests still dominate but we think it likely Germany will eventually support efforts for a common fiscal union.

The 17 eurozone members ratified a treaty earlier in 2012 to create a permanent European Stability Mechanism (ESM) to be based in Luxembourg. It will be capitalized at 700 billion euros. It would replace the temporary bailout funds that expire in 2013. The legality of Germany participating in the ESM, however, has been challenged in Germany's Constitutional Court. A ruling will be made on September 12, 2012.

Assuming Germany's participation is affirmed, new fiscal constraints and policing guidelines will be imposed on all eurozone members regarding domestic annual fiscal deficits and debt-to-GDP ratios. The sooner the better!

Greece on the other hand …

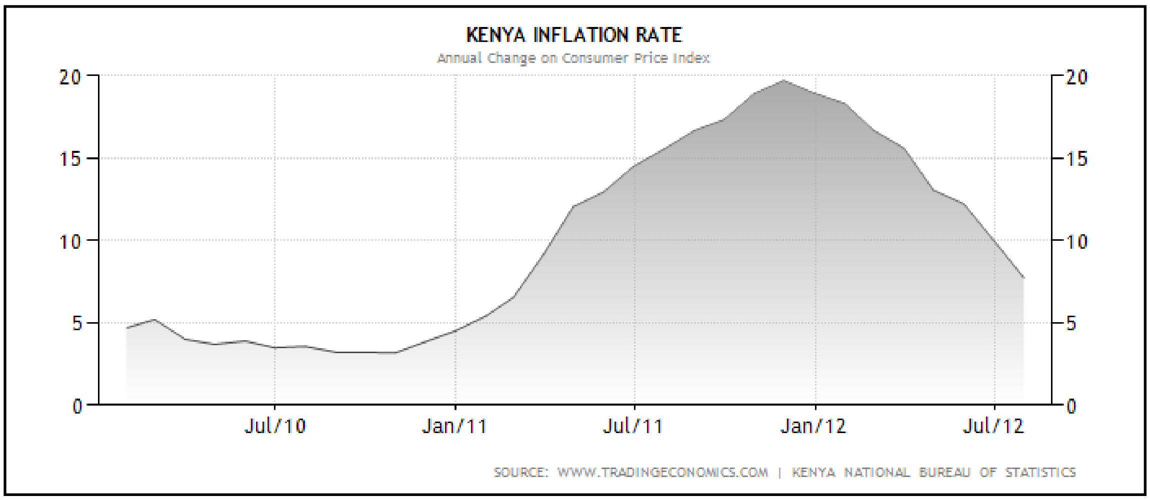
Whether Greece will remain in the euro or not is a tough call. If it remains, its debt will be continually rolled over and refinanced. It simply does not have the tax revenue to meet its debt obligations and eurozone members are increasingly balking at requests for more bailouts.

Exiting the euro may be the better option. Greece only represents some 2% of eurozone GDP and while the transition will be difficult, it seems the only way to re-set that economy. The fear that Greece's exit might begin a domino exit from the euro appears to have lessened as it becomes evident that Greece is in a class of its own in terms of economic train wrecks.

The Kenyan Debt Market

Interest rates in Kenya remain at historically high levels as the Central Bank of Kenya reins in inflation. The average price of goods and services in the Kenyan Consumer Price Index (CPI) is 15.97% higher in June 2012 than June 2011. The average inflation over the last 12 months is a lower 10.05% which means there is steady progress in bringing inflation under control.

The two traditional indicators of interest rates in Kenya – the Central Bank Rate (CBR) and Treasury bill rates have perversely moved in opposite directions over the past couple months. The CBR which is the rate that the CBK lends to banks has come down from 18% to 16.5% over the past two months while the 91 and 182-day Treasury bills have both risen from about 10% to 13% today.



Jim Dry, MD, Dry Associates on a recent CNBC Broadcast

The CBR appears to us more of a symbolic rate than Treasury bill rates since treasuries are determined by auction and actually represent the cost of money to the government. One can argue that t-bill auctions are not entirely market determined since the CBK can reject or accept bids, but it is reasonable attempt at determining rates. The reason they've moved in opposite directions is probably because the CBK was out of the t-bill market temporarily and was able to drop rates but it did not prove realistic in light of its continuing requirements for money.

High interest rates are a blunt instrument and while it is reducing inflation it is also reducing economic growth. GDP estimates for 2012 are all reducing from earlier estimates of 4.5% to some 3.5% - considerably less than the 10% growth rates needed to reach Vision 2030 goals.

Interest rate management is monetary policy and what Kenya needs is to look beyond that to a healthy fiscal policy. In light of the above commentary on debt-to-GDP rates, Kenya is crossing the 50% mark. It's a good place to stop. Any higher and we risk burdening the country for years with unproductive interest costs and problems that a bloated public debt bring with it like higher taxes, systemic inflation, and a drag on the private sector.

Kenyan Equities

The NSE 20 Share Index is up 5% in the last two months and 20% since the beginning of the year. Stock markets usually rise when interest rates fall but the slight fall in interest rates cannot account for the 20% rise in the market. Something else is going on.

We believe the very low earnings multiples on the NSE has attracted considerable foreign portfolio bargain hunting as the year began. The NSE became a value play for offshore fund managers moving into frontier markets. In addition, the lack of investment opportunities in western markets combined with the stable shilling made Kenya an attractive alternative. This, we believe, has created its own momentum and Kenyan as well as foreign fund managers are now cautiously rebuilding positions in certain counters.

As a value investor, we continue to recommend companies that are trading below their historical P/E ratios, provide a reasonable dividend, and have good management. Some of the companies that meet this criteria are:

Sector	Security	Price	P/E Ratio	Dividend Yield
Agriculture	Rea Vipingo	16.85	2.13x	6.53%
Banking	KCB	24.75	6.59x	7.47%
Banking	HF	15.65	5.80x	7.67%
Construction	Bamburi	176	12.40x	5.68%
Manufacturing	BAT	399	12.88x	7.64%

Overall, we are reassured that in this uncertain world, Kenya has shown the discipline to successfully regain control of its currency and bring down inflation. This is a prerequisite for private sector growth. These efforts, combined with future budgetary constraint, will be the best signs yet that Kenya can and will deal constructively with its economic future.

Sincerely,

Dry Associates

Gold dispensing machine at the Atlantis Hotel, Dubai, UAE, July 2012 (Courtesy J. Dry)

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