Dry Associates Investment Newsletter

JAN—MAR 2014

INSIDE THIS ISSUE

- U.S. MARKET
- FRANKLIN TEMPLETON
- FLAT RATE VS. ANNUAL RATE
- KENYAN EQUITIES
- KENYAN FIXED INCOME

Dear Investor,

In our last newsletter issued in mid-December 2013, we stated that the US stock markets would continue rising. At that time, the Dow Jones Industrial Average (DJIA), an index of 30 of the largest US companies traded on the New York Stock Exchange, was at 15,884. Today, April 15 2014, the DJIA is at **16,183** so there is continuing confirmation of this upward trend.

Similarly, the Euro Stoxx 50 Index, a composite of 50 blue chips stocks trading across the Eurozone countries, was 3,106 on December 16, 2013. It is now **3,131** - also slightly higher.

Over the past year, we have shifted considerable client portfolio investment from the emerging markets into the US and European securities markets. In retrospect, this has been a wise move. Nevertheless, investment strategies require continual review.

Stark-Condé Wine Estate, Stellenbosch, South Africa (1st Mar. 2014 — Courtesy P. Wesolek)

Are US securities markets overvalued?...

The obvious question to ask is whether to stay the course. In other words, is the US market overvalued?

There are many ways to evaluate market valuations. One basic way is to compare the historical Price/Earnings ratio of the DJIA to the current Price/Earnings ratio. The Price/ Earnings ratio is simply the price of a stock divided by the prior years after tax earnings.

Continued…

We know that the average Price/Earnings ratio of all the companies in the DJIA since the Great Depression of 1929 has averaged about 15. Of course, during these past 85 years it has varied considerably from a low of 5 to a high of 40 during the dot.com bubble of 2000.

Today the average P/E ratio of the Dow is 16.30. So, it's above the average 15 mark but not by much. So let's guesstimate a point at which the Dow is overvalued. Knowing that stock markets tend to swing too much in either direction, we would suggest that if the average P/E ratio were to rise to say, 20, which is 27% higher than the historical norm, we might be at risk of a substantial correction. A 20 P/E ratio equates to a DJIA of **20,348** versus 16,183 where we are now. Consequently, staying the course appears to make sense to us.

Franklin Templeton

"In investments, most things are temporary, the question of which securities to invest in, or which nation, or by which method to select securities"

- Sir John Templeton, July 1987

1. **Recommended US Funds:**
    - Franklin US Opportunities Fund
    - Franklin US Small-Mid Cap Growth Fund

2. **Recommended European Investment Funds:**
    - Franklin Mutual European Fund

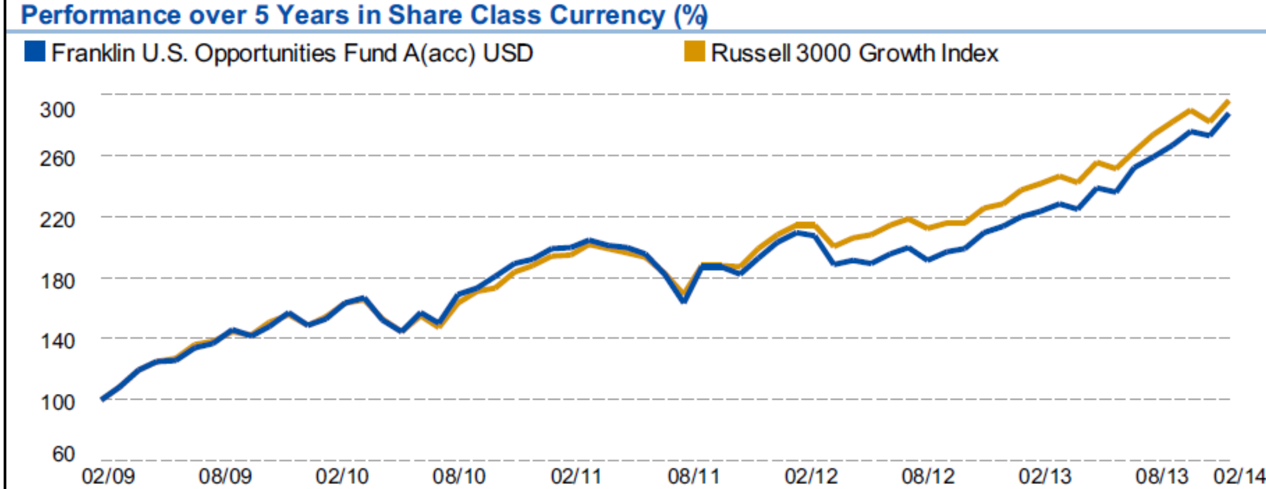
Franklin Templeton Investment Funds

Franklin U.S. Opportunities Fund

FRANKLIN TEMPLETON INVESTMENTS

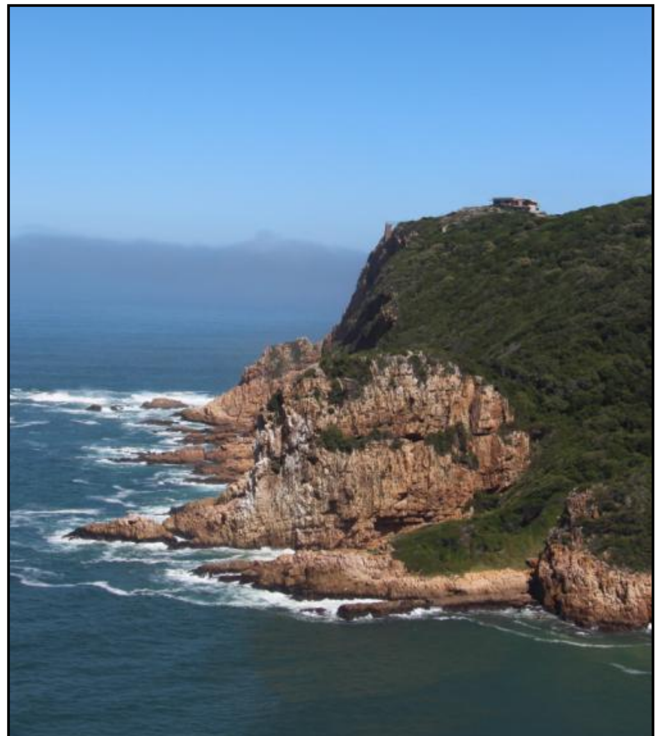
Performance

Performance over 5 Years in Share Class Currency (%)



Performance in Share Class Currency (%)

	Cumulative									Annualised
	1 Mth	3 Mths	6 Mths	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Incept	Since Incept
A(acc) USD	5.20	7.70	21.83	4.14	34.72	44.52	188.30	142.10	13.30	0.90


"The Heads", Knysna, South Africa (Mar. 5th 2014)- P. Wesolek)

Obviously, Price/Earnings valuations are only rough guidelines and most of our offshore investors have no stomach for testing the limits. Somewhere between here and 20,348 we should be looking for new undervalued opportunities.

One area that we are monitoring is emerging market bond funds. The reasons are several. Firstly, there has been an across-the-board, almost irrational exodus from these markets. Bond yields of upwards of 10% can be earned in the local currency of some of these high quality bonds as well as yields of 4-6% in US dollars.

The major concern here, of course, is whether the underlying currencies of these emerging markets will hold their value going forward versus hard currencies. The mass exodus out of emerging markets bonds over the past 9 months into the developed economy markets of the US and Europe have contributed to the depreciation of these local currencies. Putting aside the economies of the so called "Fragile Five" – South Africa, Turkey, Brazil, India and Indonesia – and now let's add Russia – there are emerging markets whose underlying economic fundamentals are very strong. It is these countries relatively high yielding bonds that are beginning to attract our attention.

Flat Rates vs. Annual Percentage Rates

Some of our clients surprise us – corporate as well as retail! We've recently heard remarks like "The flat rate on this installment loan is only 7%" or some such nonsense. Be careful. There is a huge difference between "flat rates" and the actual annual percentage rate (APR) you are paying.

As a reminder, in finance always convert any quoted interest rate to an APR. A 7% flat rate on a loan to be repaid in 12 months is the same as a 12.7% APR. The reason is that a flat rate charges interest on the original amount borrowed until it is totally paid off - even though the principal balance is reducing. You should only pay interest on the outstanding principal of any loan! For instance, the interest you pay on a fixed rate house mortgage is calculated each month on the declining balance of the principal owed. This is so even though your bank will tote up all the interest over the life of the mortgage together with the reducing principal and then divide through by the number of months of the mortgage so you pay one set amount every month.

In the US, all interest rates quoted in commercial transactions for credit cards, mortgages, etc must be stated as an Annual Percentage Rates (APR). We should do the same in Kenya.

Kenyan Equities

There is almost universal agreement that Kenya's long term economic future is bright, particularly one including oil and gas. In the meantime, however, there are strong headwinds. The ballooning budget, high interest rates, corruption, insecurity, poor electrical , road and municipal infrastructure are front and center. These impediments to growth must be dealt with in a systematic and consistent way otherwise they have the potential to choke off Kenya's growth story.

India, South Africa and China's fall off in GDP growth have lessons for Kenya. It is also evident that Kenya's GDP growth rates persistently trail its neighbors. The World Bank estimates Kenya's GDP growth for 2013 at 5%. Estimates of GDP growth in surrounding countries are all higher – Uganda 5.6%, Ethiopia 7%, Tanzania 7% and Rwanda 7.5%.

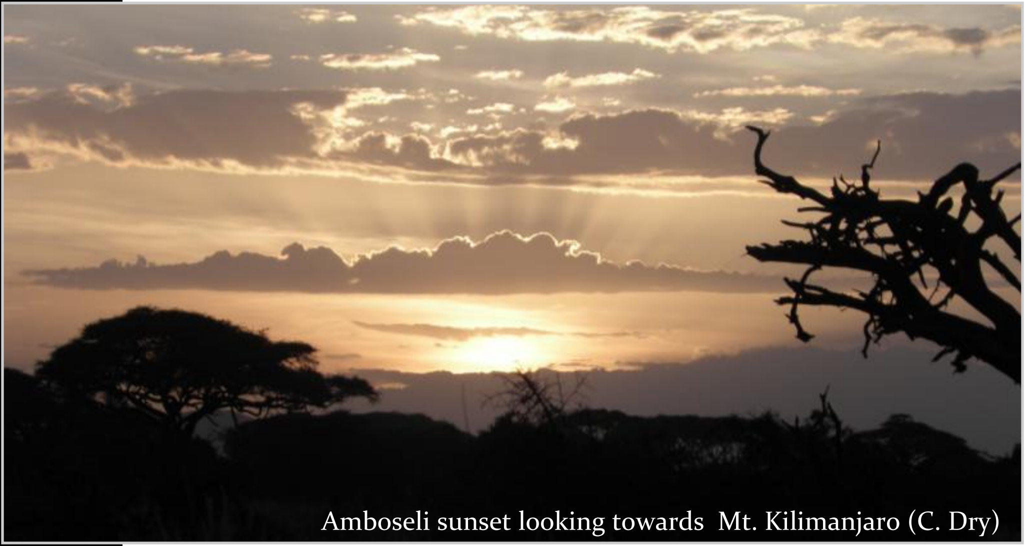
The Kenyan equity market, after the US Fed's decision to "taper" and subsequent exodus of foreign funds over the past several months, appears to have stabilized and is attracting renewed foreign and domestic investment. The NSE 20 Share Index was 4911 on January 2, 2014 but essentially flat at 4909 three and a half months later after much volatility per the following:

The following counters look attractive to us for long term appreciation: Safaricom in the telecom space, Jubilee and British American in the insurance sector and East African Breweries in manufacturing.

Kenyan Fixed Income

The most current 91, 182 and 364 day Treasury bills paid 8.8%, 9.8% and 10.3% respectively. Treasury bill interest rates have come down slightly over the past three months but the interest rate regime in Kenya still remains very high per the following:

Average Commercial Bank Lending Rate:	17.06%	[Source: CBK]
Average Commercial Paper Lending Rate:	12.25%	[Source: Dry]
Average Deposit Rates (with Dry Assoc. partner banks)	10.50%	[Source: Dry]
Average 3 and 6 month Treasury Bill Rate:	9.30%	[Source: CBK]
Average Commercial Bank Deposit Rate:	6.67%	[Source: CBK]


Amboseli sunset looking towards Mt. Kilimanjaro (C. Dry)

The long anticipated $2 billion US dollar denominated Kenyan sovereign bond is still in the works. It is generally expected to carry a plus or minus 7% coupon but will be higher the longer it takes to issue. As the bond is being issued in Europe, it should not initially affect exchange rates in Kenya but should reduce the government's "crowding out" effect in bond and forex markets. The bond has the potential to reduce interest rates and strengthen the shilling, but in light of the government's ballooning fiscal deficit, any such benefits will be short lived.

Dry Associates celebrated its 20th birthday on February 24 this year!

Below are a few Company milestones:

Jun 2013	Arranger & Placing Agents KES 300M Alios Finance Kenya Private Note Program
Mar 2012	Arranger & Placing Agents KES 300M ASL Credit (Ramco Group) Private Note Program
July 2011	Arranger & Placing Agents KES 1 Billion Athi River Mining Private Note Program
Mar 2011	Arranger & Placing Agents KES 250M KK Security CP Program
Nov 2010	Arranger & Placing Agents KES 250M (1st Tranche) of KES 500M Fina Bank 7-year Notes
Jul 2010	Arranger & Placing Agents KES 300M IPS Private Note Program
Mar 2010	Arranger & Placing Agent KES 300M Car & General Private Note Program
Feb 2010	Renewal of KES 100M Davis & Shirtliff Commercial Paper (CP) Issue
Nov 2009	Arranger & Placing Agent KES 200M (1st Tranche) of KES 1 Billion TPS Serena 5-year Notes
Nov 2008	Voted Best Investment Advisor for 2008 by Think Business
Feb 2008	Arranger & Placing Agent KES 100M Davis & Shirtliff CP Issue
Oct 2007	Arranger & Placing Agent KES 500M K-Rep Bank CP Issue – 1st Commercial Bank CP Issue
Oct 2006	Arranger & Placing Agent KES 250M Nakumatt Private Note Program
Aug 2005	Arranger & Placing Agent KES 100M Synergy Industrial Credit guaranteed CP Issue
Jun 2002	Arranger & Placing Agent KES 50M Athi River Mining CP Issue
Oct 2001	Signed Distribution Agreement with Franklin Templeton
Jul 2000	Arranger & Placing Agent KES 200M Crown-Berger CP Issue
Sep 1999	Arranger & Placing Agent KES 100M TPS Serena CP Issue
Sep 1999	Arranger & Placing Agent KES 150M Express Kenya CP Issue
Jul 1999	Arranger & Placing Agent of KES 350M CMC Motors CP Issue
Feb 1999	Arranger & Placing Agent KES 100M IPS (Aga Khan Group) CP Issue

Looking back over these last two decades, one thing is certain. You, our clients, each and every one of you, are the only reason we're here. We take this opportunity to thank you for your trust and your patronage and we look forward to working with you for another 20 years … and beyond!

Sincerely,