Investment Newsletter

DRY ASSOCIATES LTD
Investment Group

SEPT—DEC 2012

Dear Investor,

"It was the best of times, it was the worst of times …" was Charles Dickens' opening line in *A Tale of Two Cities* describing London and Paris in 1859. He could have been writing about Nairobi today.

Kenya's economy is small and world events wash over it continually. The US economy, the world's largest, still hasn't recovered from its 2008 financial crisis and now heads towards another "fiscal cliff" slowing global growth. The Eurozone's Gross Domestic Product contracts monthly, ***but*** money is flowing into Africa - and Kenya in particular! African stock markets are almost all up, direct foreign investment (DFI) into Africa according to the IMF is at an all time high and Nairobi real estate prices are certainly rising faster than London and Paris.

Astonishing really because on the ground Kenya's got some issues. The country's got a very contentious presidential election in March, there's traffic gridlock throughout the capital, electricity seems to fail weekly, telephone lines don't work, the government's broke, and the judiciary doesn't work … and yet … the money still keeps rolling in! Maybe Kenya's just the best looking horse in the glue factory but then again, maybe it's all about long term economic potential!

Ithumba Camp, Tsavo East (Sept. 2nd '12, Courtesy: G. Wesolek)

A Changing Global Economy

So, as an investor, how do you invest in these murky waters? Well, keeping a global perspective is an excellent first step.

Household wealth in the US and Europe has declined dramatically over the past several years because investments were too US and Euro-centric. The average US and European investor concentrated their investment in their own national economies. Why? Because that is traditionally what's worked.

Today, however, it's certainly not about tradition. A smart investor must have a global perspective. Emerging market GDP now represents 38% of global GDP – up from 20% in 2000 according to the IMF. GDP growth is a pretty close proxy for wealth creation, and what this statistic tells us is that there's a trend here that's going to last for many years.

An angry Tree Hyrax, Keekorok Lodge, Maasai Mara (Nov. 2nd '12, Courtesy: J. Schmalzle)

What to Do?

So, a sensible portfolio today we think ought to 1) generate cash 2) provide geographic diversification 3) have exposure to some fast growing sector (s) and 4) include some insurance.

Generating cash provides incremental gain without being spectacular. Cash generating fixed income securities tend to be less risky than equities. True, the younger an investor, the more risk can be taken on, but it's still important not to be impudent at any age. As a rule of thumb, use your age as the percentage of your portfolio that is dedicated to generating cash. For example, a 30 year old ought to have about 30% of his portfolio in debt instruments.

Secondly, plan on investing about half your portfolio outside your country of domicile. Why, because first of all, it protects you against currency depreciation. It also offers exposure to a wider pool of opportunities and relatively faster growing economies than your own. Find an experienced off shore fund manager to work with. We like Franklin Templeton in particular, but there are other excellent fund managers.

Thirdly, exposure to fast growing areas of the economy is important. In Kenya, for example, real estate investment has been exceptionally profitable for some investors. Joint ventures, real estate partnerships, incorporations, and soon Real Estate Investment Trusts (REITs) are all vehicles to invest through to profit from the exploding demand for real estate development in Kenya today. Dry Associates has recently established a real estate department that offers institutional and large investors opportunities in this area.

And fourthly, insurance. By insurance we mean things like putting stop-loss triggers under your stock purchases, buying some gold and for sure, sitting down every 6 months to review your portfolio to sell losers, take profits, and rebalance.

Capturing all this in an individualized portfolio is easier with input from an investment professional, but for illustrative purposes, here's an example of such a portfolio for say, a 60 year old person managing Ksh 10 million:

Asset Class	Percent of Portfolio	Ksh Investment	Security Description	Annual Yield *(estimated)*
Fixed Income	16.25	1,625,000	Infrastructure Treasury Bond IFB2/2009/12	12.00%
Fixed Income	16.25	1,625,000	Infrastructure Treasury Bond IFB1/2011//12	12.50%
Fixed Income	10.00	1,000,000	Kenyan Bank Fixed Deposit Receipt	12.50%
Off Shore	15.00	1,500,000	Templeton Global Bond Fund ($ monthly distribution)	13.09%
Off Shore	15.00	1,500,000	Templeton Emerging Mkts. Bond Fund ($ monthly distribution)	14.47%
Real Estate	12.50	1,250,000	Part Owner – One Flat (Rent Ksh 100K per unit cost of Ksh 6.3M)	19.00%
Equities	5.00	500,000	Barclays (capital gain 17%; cash yield 9.8%), KCB (capital gain 80%; yield 6.8%)	8.30% Blended Cash Yield only
Gold	10.00	1,000,000	Capital Gain (Jan. 2012 $1,583 and Nov. 2012 $1,724)	9.72% annualized
Total	**100%**	**10,000,000**		**13.13%**

Note that this sample portfolio is <u>not</u> a suggested pension fund portfolio. A pension plan has the following maximum asset class allocations dictated by the Retirement Benefits Authority which, for example, permit only 15% investment off shore:

	Asset Category	Maximum % of Portfolio
1	Cash	5
2	Deposits with Banks	30
3	Corporate Bonds and ST Paper	30
4	Government Securities	90
5	Equity & CMA approved unit trusts	70
6	Unquoted shares	5
7	Off Shore Investments	15
8	Real Estate	30
9	Guaranteed funds	100

Kenyan Equities — Update

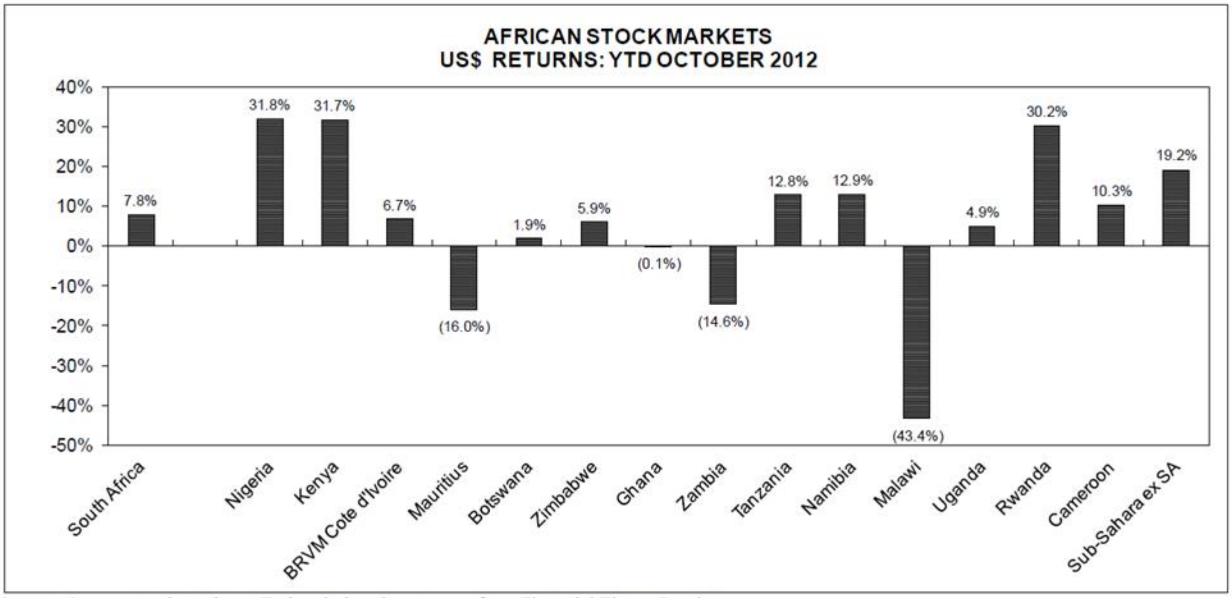
The NSE's rise has been very impressive rising some 30% since January 2012. Foreign portfolio investment is the biggest factor helped by a steady fall in interest rates.

As we noted in our last newsletter, the rising tide has not lifted all ships but has been selective. Security analysis is coming into its own in Kenya. For example, Uchumi has risen 139% in the past year, BAT 87% and Safaricom 61% but CfC Stanbic is down 9%, Centum down 19% and TPS Serena down 23%.

Amongst the banks, which almost always make money irrespective of the economy, Barclays has the highest dividend at 9.7% but that dividend represents 100% of Barclays trailing earnings per share (EPS). Housing Finance's dividend looks a little more secure with a dividend yield of 7.7% but representing only 45% of its trailing EPS.

Lions! Maasai Mara (Nov. 3rd '12; Courtesy: P. Wesolek)

Most African stock exchanges are up reflecting in large part funds flowing from developed economies to African exchanges seeking higher returns than available in the developed economies. These markets still don't represent easy marks for the average investor. We see evident rotation of price leadership amongst these securities as off shore research houses look for nuanced changes in price to book, EPS, and other ratios. Frontier mutual funds including Franklin Templeton's Frontier Market, up 14.69% in the past 12 months, is one way to participate in these markets.



Source: Country stock markets. End period exchange rates from Financial Times, London.

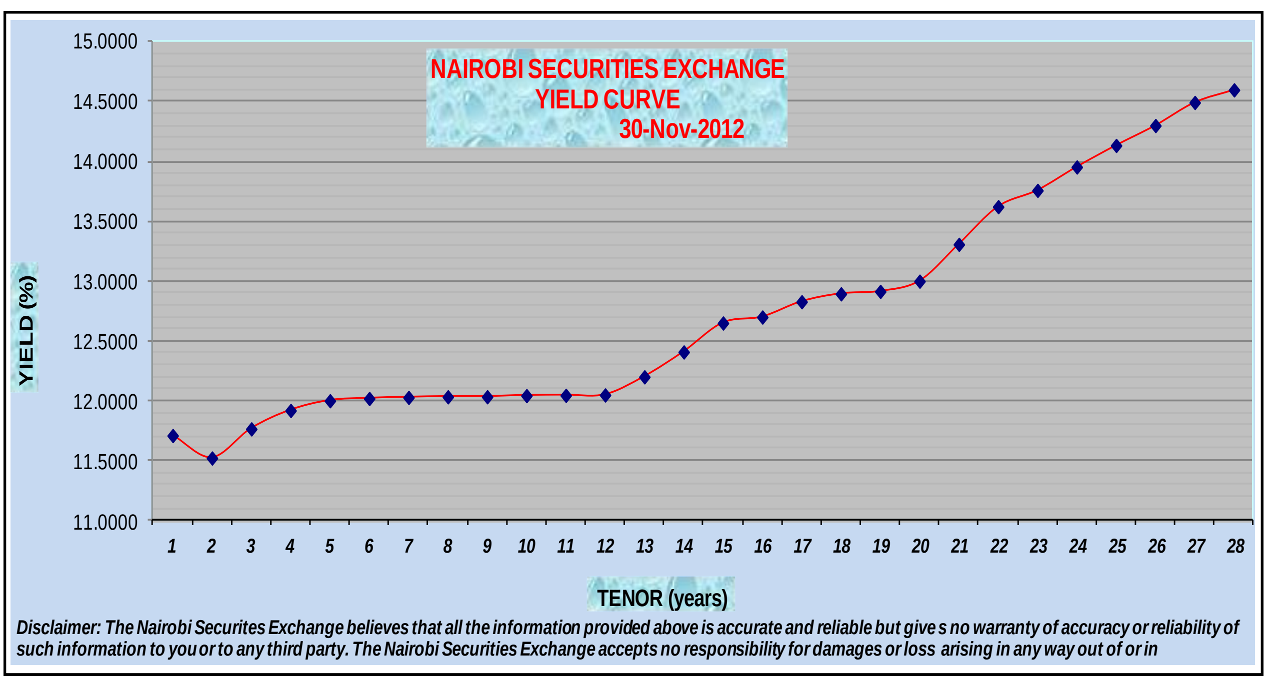
Courtesy: Christopher Hartland-Peel (www.hartland-peel.com)

Kenyan Interest Rates

Interest rates represent the current and future cost of money. It is evident, however, that Kenyan interest rates are trying to find their own level after the massive whipsawing of the Kenyan shilling/dollar exchange rate from Ksh 75/= to 103/= and back to 85/= in late 2011 early 2012.

On November 7th the CBK dropped its Central Bank Rate to 11% … from 18% in February! The most current short term rates as at 10th December are:

91-day bill	182-day bill	364 day bill
8.339%	9.080%	11.709%



Future Interest Rate

They say predicting interest rates is a fools game, but it is obvious the GOK needs money – its 2012 annual budget deficit is 5% of GDP and the total accumulated deficit now represents about 50% of GDP.

As an investor, the positive side to all this is that current rates are relatively high. In other words, current interest rates are providing a reasonable historic return and certainly more than US or European fixed income investments.

Bonds as an Investment

Before leaving fixed income investments, we'd like to remind investors of a particular attribute of bonds that bears repeating – particularly in Kenya where interest rates are so volatile. Bonds, of course, are simply fixed income securities with a maturity of one year or more. Because of this relatively longer duration, they usually trade on a secondary market. But note that when interest rates rise or fall, the value of a bond with a fixed coupon must necessarily rise and fall in inverse relationship to prevailing interest rates. In other words, if a 20-year bond with a coupon of 12.5% were issued today at Ksh 1 million and interest rates went up to 20% tomorrow, that bond would not trade at Ksh 1 million per bond but Ksh 680,741. Similarly, if interest rates fell to 5%, the same bond would trade at Ksh 1,584,593.

This fluctuation in value won't matter if you're going to simply continue to receive coupon interest payments – these will stay the same at 12.5% x Ksh 1 million. And the bond will pay back the full Ksh 1 million upon maturity. But in the interim, the bond value must fluctuate and you will only lose or gain money if you sell your bond before maturity.

Pension fund investors in particular may be aware of these fluctuations since all financial intermediaries such as Dry Associates must "mark to market" at the end of each year. This mark to market means we must report the value of all bonds as at 31 December even though the bonds will eventually be repaid at their full par value. Nevertheless, for most investors, steady cash income is paramount!

Sincerely,

Dry Associates

OUR OFFICES WILL BE CLOSED FROM 20TH DECEMBER 2012 TIL 2ND JANUARY 2013, INCLUSIVE

Contact Us

Dry Associates Ltd
Dry Associate House
Brookside Grove, Westlands
445-0521 / 445-2288
(020) 234-9651
invest@dryassociates.com
www.dryassociates.com