ETF Note: SATRIX 40

JSE Code: STX40	**Tracks:** JSE TOP40 Index	**Last updated:** 20 May 2010
Issuer: Satrix	**Risk level:** High, equity	**Performance YTD:** -3.44%

Characteristics:

The aim of this **ETF** is to give the investor direct exposure to the JSE's Top 40 Index. The Top 40 index tracks the performance of the 40 largest shares on the JSE as measured by their market cap.

Due to SA's rich mineral resources and well developed mining industry, the Top 40 index includes many resource based companies, some of which are the world's largest and most well-known: Anglo American, Anglo Platinum, Anglo Gold and BHP Billiton for example. For this reason, the Top 40 index is heavily skewed to resource companies, with approximately 43% of the index being exposed to mining companies.

This means that the performance of the index will be disproportionately affected by how these companies perform as well as the commodity prices they are linked to.

As international commodity prices are based in US Dollars, there is a natural rand hedge element to this ETF, which means that any depreciation in the Rand/Dollar exchange rate will lead to resource companies earning larger profits in Rands, which will logically boost their share prices.

Owners of the ETF are entitled to their share of all the dividends that flow from these companies during the term of their investment. These dividends are collected and distributed to owners four times a year.

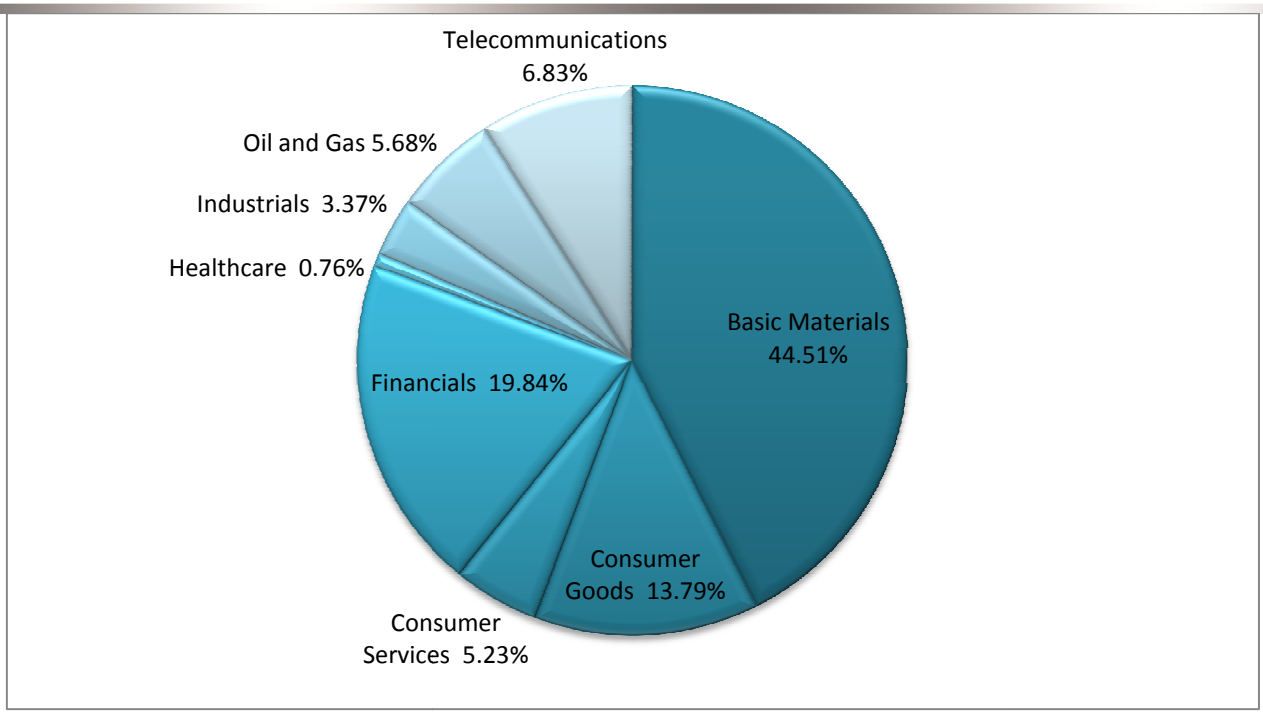
The current dividend yield is 1.47%. When compared to historical levels, the Top 40 index looks relatively expensive at the moment. I would encourage investors to use caution if they are planning to invest a large chunk of their savings in one go. It would be more prudent to make smaller investments over a period of months, as the future direction of the market is uncertain.

What the bulls say:

- Gives exposure to SA's largest blue-chip companies.
- The Top 40 index has a large exposure to mining and commodities, and the growth of China is based on the supply of these resources.
- SA is expected to resume robust GDP growth of 5% p.a. in the years ahead.

What the bears say:

- The performance of Eskom and the price of electricity weighs heavily on industrial output, this is likely to have a negative impact on the economy.
- SA is dramatically affected by what happens in the rest of the world.



Constituent industries in the STX40 ETF

Fundamental View

Key to forming an idea of how this will ETF perform in the future, will be to examine the prospects for the South African economy as a whole. This is due to the size of the companies involved and the vast array of commercial activities they participate in.

SA GDP GROWTH:	*Source Stats SA&Trading economics*
2000	4.20%
2001	2.70%
2002	3.70%
2003	2.90%
2004	4.60%
2005	5.30%
2006	5.60%
2007	5.50%
2008	3.70%
2009 Q1	-0.08%
2009 Q2	-2.60%
2009 Q3	-2.10%
2009 Q4	-1.40%
2010 forecast	2-3%

As can be seen from the table adjacent, the South African economy entered into a higher growth trajectory from 2004 when GDP started averaging growth rates around the 5% p.a. mark. This was rudely disrupted by the financial crisis, which unleashed itself during the course of 2008.

SA's position as a small and very open economy, (the Rand is the world most actively traded emerging market currency) inevitably led us to being affected by events overseas especially since many of these countries – the UK, EU and USA are our biggest trading partners.

As a result the strong performance waned in 2008, and then outright recession caught hold during 2009.

On the back of this consistent economic growth the Top 40 index has averaged an annual return including dividends of 17.4% over the last 10 years.

In tandem with world markets, the Top 40 index receded from its high of 31,210 pts on the 19th of May 2008, all the way down to close at 16,812 on the 6th of March 2009, a drop of 46%. Fortunately Central Banks and Governments in the Western world pumped enough money into their financial systems to avoid a complete disaster, and this has enabled a rapid recovery. The Top 40 has since risen to its current levels around the 27,000 pts mark, up 60% off its low.

So what does the future hold?

Forecast and fortune telling are infamously inexact sciences, so I attempt to highlight key trends that may define the path ahead.

An independent Reserve Bank still focused on price stability: The appointment of Gill Marcus as Reserve Bank Governor is an excellent step in keeping the Bank independent. Ms Marcus is also very competent and highly regarded. Equally importantly is the fact that her mandate is still very much in place, which will keep the Bank's focus on price stability and curbing inflation.

The new Finance Minister, Pravin Gordhan, also seems equally as competent as his predecessor, and his conservative approach should see SA follow a path of financial prudence – which means he will be unwilling and unlikely to allow Government borrowing to reach epidemic levels like those seen in Europe and America.

The higher profile and legacy that will accompany the **successful hosting of the FIFA world cup** are also major positives for the country in the years that lie ahead, as is the Government's R389bn infrastructure programme will ensure that the platform for sustainable economic growth is in place. These factors collectively make the chances of SA returning to 5% GDP growth p.a. quite feasible.

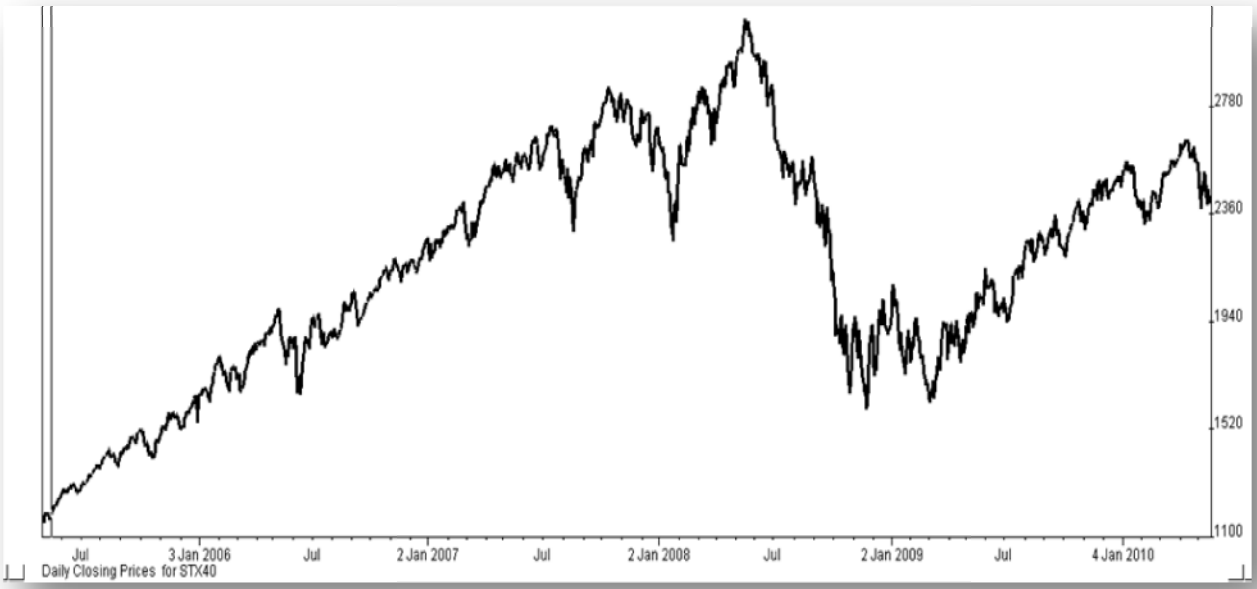
However there are a few serious challenges that could derail these assumptions:

The first of these is **Eskom and the supply of electricity**. South African's as a whole have only been too well informed of the tremendous efficiency and competency with which the majority of SA's public enterprises have been run. Eskom, SAA and the SABC all come to mind, but its Eskom that can do the real damage. In terms of economic output, it is estimated that Eskom alone, through the escalating costs of electricity, could shave a total of 1.5–2% off SA's GDP growth over the next 3 years.

This and the sporadic outbursts of economic populism (running bigger budget deficits and nationalising certain industries) may test the resolve of the nation's economic and financial authorities to stick to a path of prudence and discipline. Any serious unravelling of Governments financial policy and framework could have detrimental effects on the level of investment and economic activity the country currently enjoys.

The third element relates to SA's role with her trading partners, largely split between the East and the West. The sheer size and appetite that the likes of China and India have for raw materials and resources, has been a boon for SA's economy. The large mining houses sell a whole lot of commodities to China, and this is expected to continue for many years to come.

But with South Africa's economy being so open, we are in many cases, the unwilling passenger on a sometimes sinking ship. Whatever happens in Beijing, New York or London will be sure to spill over to SA. This can be bad as well as good, as the events of the last two years suggests. It is therefore imperative to keep an eye on the bigger picture.



5 Year performance of the Satrix 40. We're at levels last seen in April 2007.

Portfolio construction:

Investors looking for exposure to South Africa's premium stock index would use this product as the anchor for any exposure to the JSE. By buying this ETF you are implicitly betting on the long-term growth prospects of South Africa, as well as, to a lesser degree, on the future direction of world commodity markets. This instrument is comparable to the aims of the FTSE 100 index in London, and the S&P 500 index in the States. It is also SA's first ETF.

The idea would therefore be to use this product as the core holding of any equity portfolio in SA.

The instrument can be purchased directly on the JSE through a stockbroker, or monthly in smaller amounts through an investment scheme run by Satrix or ETFSA.

If you decide you would like to invest in this ETF through the investment scheme, there will be some additional costs involved. These include:

Monthly debit order fee of R4.50

For acquiring the ETFs: 0.1% of the monthly amount.

Then there is an ongoing /management fee based on the value of your total portfolio.

For selling your ETFs: 0.1% of the value of the transaction.

Fees and alternatives:

This ETF competes head on with the RMB BIPS40, as they track exactly the same index. Like for like, the TER (Total expense ratio) of the BIPS40 is 0.23% against the Satrix 0.45%. This doesn't sound like a whole lot but over years this can make a huge difference.

The product also competes with the RAFI strategies, which construct their version of the Top 40 index based on financial metrics other than just size alone. Research produced by the developer of the RAFI strategies – Research Affiliates – indicates that RAFI techniques will perform better that the traditional methods of index construction (as represented by BIPS40/Satrix 40) by a margin of 5-7% p.a.

RAFI which is licensed to Satrix and eRAFI (licensed to ABSA Capital) have only recently been introduced to SA, and therefore meaningful comparison and measurement is still to take place.