

**FEATURE ARTICLE**

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Interest Rate Sensitive  
SA Retail: Overvalued  
See Page 4

**BUSINESS UPDATE**

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Our latest update on  
the business

**UNPACKING JARGON**

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Investment returns  
terminology explained

**FUND COMMENTARY**

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Afena Equity Fund  
Afena Managed Fund

# AFENA INSIGHTS

Quarter ended June 2011

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## CONTENTS

- 02 Business Update - *Tebogo Naledi*
- 04 Interest Rate Sensitive SA Retail: Overvalued - *Khaya Gobodo*
- 09 The Inside Story - *Tebogo Naledi*
- 12 Unpacking Jargon - *Sandile Sokhela*
- 15 Afena Equity Fund Manager Commentary - *Khaya Gobodo*
- 17 Afena Managed Fund Manager Commentary - *Andrew Joannou*



**Tebogo Naledi**  
*Chief Executive Officer*

We have passed the mid-point of the year as the winter chills intensify their bite. A year ago, around this time, we were in the final stages of the FIFA World Cup football tournament and a month long South African party was about to come to an end. For the South African equity market, the 12 months since the World Cup have been characterised by two halves.

The first half (from July to December 2010) saw the FTSE/JSE All Share Index (ALSI) rise a very healthy 24% over that period, whilst the second half (January to June 2011) has seen the ALSI generate a reasonably flat return of 0.5%. This seemingly flat performance masks a continuation of the heightened volatility that has come to be a feature of financial markets over the past four years. Two of the past six months saw the ALSI rise more than 2% (February: 2.8% and April: 2.2%) whilst another two months saw the ALSI decline more than 2% (January: -3.5% and June: -2.0%).

This market volatility has been driven by the unfolding of a number of key events including Greece and the overall European debt crises, deteriorating economic data, the Chinese attempt to slow down their economy and the US economy and its own debt issues. The cumulative impact of these themes has been volatility and lacklustre equity returns year to date, both in South Africa and abroad.

The short term performance across our equity portfolios is showing an improved picture from that seen in 2010. The SWIX relative composite portfolios have returned 1.2% over the six months to June 2011 which is 60 basis points above the FTSE/JSE Shareholder Weighted All Share Index (SWIX). Whilst it is pleasing to note this short term improvement, the more meaningful performance for us, and our clients, is the longer term three year annualised performance. Over this period (three years to 30 June 2011) the SWIX relative composite portfolios returned 11.7% annualised which is 4.1% above the SWIX which returned 7.6% over the same period. These are very pleasing returns in line with, or in excess of, client expectations.

Our multi-asset portfolios have also continued to deliver excellent returns: The Afena Managed Fund has delivered a return of 9.1% annualised above benchmark since inception. The Fund returned 22.6% annualised over the 26 months to 30 June 2011 compared to the benchmark (Median of Domestic Prudential Variable Unit Trust Equity Sector) return of 13.4% annualised.

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## BUSINESS UPDATE

Afena Capital has recently become a signatory to the United Nations Principles for Responsible Investing (UNPRI). In becoming a signatory to the UNPRI we have committed to a programme that will see us incorporate environmental, social, and corporate governance (ESG) issues more formally in our investment decision-making. We have set ourselves a reasonable timeline to implement our responsible investing strategy and, in line with one of the principles, we will report on our activities and progress towards implementing the principles on a continuous basis. This is an exciting development in the evolution of the investment management industry globally as we join over 900 signatories around the world. These signatories represent asset owners, investment managers and professional service partners who are all in pursuit of better aligning investors with the broader objectives of society. We are also excited by the formal launch this month (July 2011) of the Codes for Responsible Investing in South Africa, which we fully endorse. A new era of institutional investing has begun in South Africa and it is important that we all play our part.

On the staffing front, it is my pleasure to welcome Mila Mafanya to Afena Capital. He joined our investment team on 1 July as an Investment Analyst. Mila has, for the last three years, been Assistant Portfolio Manager in the Toros Equity Boutique at OMIGSA. Prior to that, he was a small cap and industrials analyst at Sanlam Investment Managers where he spent four years. He is a graduate of the University of Cape Town and holds a Bachelor of Business Science degree in Actuarial Science. In addition, Mila is also a CFA charterholder.

Mila is an experienced and highly qualified individual. We look forward to his contribution to the investment process and I wish him a long and successful career at Afena Capital.

I also wish to announce the resignation of Funeka Beja who will leave Afena Capital at the end of July to join a competitor. Funeka has been with the firm for four years as an analyst. We wish her well in her future career.

Whilst it is never pleasant to lose any member of a team, the depth and structure of the Afena Capital investment team is such that our clients can be assured that the impact on the quality or continuity of research will not be negatively impacted. Funeka's research responsibilities will be comfortably absorbed by the current team, including new staff who have joined and those who will be joining shortly.

A few months ago we embarked on a process to further strengthen both the depth and structure of our investment team in our continuous pursuit to becoming a truly world-class investment management firm. This process is well underway and we look forward to shortly making further announcements regarding the further strengthening of the investment team.

Tebogo Naledi



**Khaya Gobodo**  
*Head of Equities*

In this article we will focus our discussion and analysis on a group of shares that have done very well over the last two years and whether they should continue to form an important part of one's portfolio. The shares in question are the South African retailers. The emphasis of the analysis will be on the valuations of these stocks based on their underlying economics and sustainable operating performance.

The South African retail sector is world class and is in fact one of the best in the world. This is in terms of its operating income growth, the high level of gross margins, operating income margins and the returns generated on invested capital. These are the ultimate measures of the quality of a retail operation. As a result, South African retailers have received an increased level of attention from international investors. This attention was also highlighted by the perception of where they are in their operating cycle.

The period starting at the beginning of 2009 to date represents an environment ideal for a consumer. Interest rates came down to 6.5% from 15.5% resulting in a significant interest saving for consumers. In addition to that, wage settlements were above inflation, resulting in real wage increases. The combination of these two forces generated very strong growth in disposable income available for consumption.

Furthermore, retailers took advantage of a strengthening Rand. South African retailers import a significant proportion of what they sell. A strong Rand has meant that their cost of sales has fallen and as long as they are able to maintain their price points, they can convert the cost of sales benefit into gross profit margin expansion.

Add the solid sales growth to improving gross profit margins and you have very profitable sector. This strong profit growth was an important driver in the strong share price performance delivered by the sector since the beginning of 2009.

However, a good business with good earnings prospects is only one facet/component that leads to an attractive investment opportunity. The other, and more important one for us, is valuation. That is, what you are being asked to pay for this business, because that will ultimately determine the returns you are likely to enjoy in the long term?

For this exercise let's simplify valuation into two parts:

1. The current level of earnings relative to what the company can deliver on a sustainable basis
2. The current price per unit of current earnings of the company

Logically, the most attractive valuations are found when the company's current profits are below normal and the share price per unit of those low earnings is also low. The converse also holds true. For the purposes of the analysis of the retail sector earnings level, we have compared the historical level of operating margins and return on assets.

### Sector Average EBIT Margin



Source: Bloomberg

### Sector Return on Assets



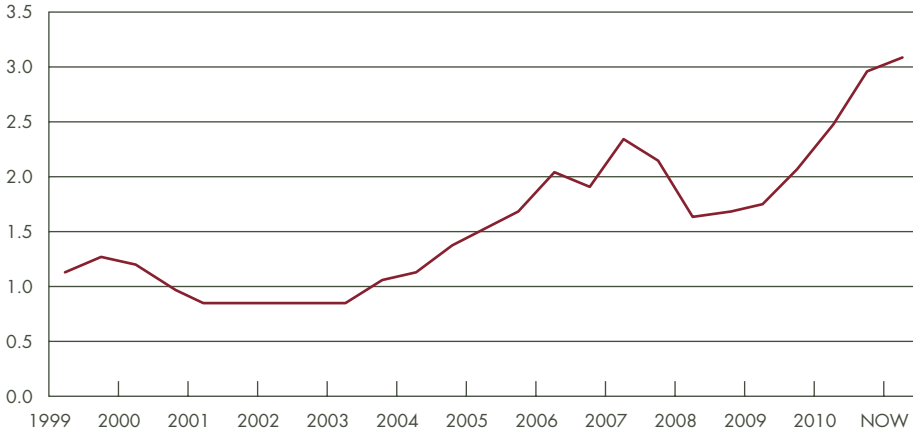
Source: Bloomberg

There is a very important observation to be made from the charts above. The level of profits per unit of revenue and assets is very high and is at levels not seen in the last 12 years. One can reasonably draw the inference that profitability levels are high relative to the past. The thing about operating margins and returns on capital is they cannot continue to rise indefinitely. Economic laws simply don't allow that. For example food retail margins, globally and across time, tend to range between 3% and 6%.

The very high levels of profitability within the retail sector don't in themselves suggest the individual shares in the sector are trading above fair value. To determine the valuation, we would have to look at the share prices per unit of profitability in conjunction with the level of profitability.

The first picture we will look at for the sector is the simple Price Earnings multiple, which is in the chart below. The sector price earnings multiple is as high as it has been in the last 12 years. Read in conjunction with prior evidence that sector earnings may also be above normal, this begins to suggest overvaluation in the sector.

Sector Price Earnings Multiple



Source: Bloomberg

The second picture is one that looks at the sector’s market capitalisation (cap) to assets. Finance theory tells us there is a strong pricing relationship between the market cap to assets and the return on assets that an enterprise generates. Put simply, the higher the returns, the higher the market cap to assets should be as well.

This is depicted in the chart on the next page. The sector’s market cap to sales is as high as it’s been in the last 12 years. This happens to coincide with the elevated levels of the sector’s returns on assets. However, this leaves no margin of safety. The very high current returns only imply a market cap of 2.5x and not the 3x the sector is currently trading on. In other words, to justify the currently very high market cap to asset prices, you would have to believe the sector’s return on invested assets will continue to rise and remain elevated indefinitely.

### Market Cap on Assets



In this analysis we may not have definitively determined the valuation of the South African retail sector, but we have been able to demonstrate that the sector is generating profitability that is in all likelihood way above normal levels. In order for this level of profitability to persist, the favourable economic conditions - low interest rates, improving disposable income and the strong Rand – would have to continue to be favourable. In addition, we have been able to show that the sector is on average trading at earnings and asset multiples not seen in the last 12 years. These two things point to a sector that is in all likelihood extremely overvalued and likely to generate poor prospective returns. As such, our client funds have very little exposure to this sector.

This is the type of thinking that we apply in our analysis and in making investment decisions. We are far less concerned about how favoured individual shares or sectors are by the market at any point in time. We focus our attention always on the valuation based on sustainable operating performance.

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## THE INSIDE STORY



**Tebogo Naledi**  
*The Inside Story*

**Seven years ago, you were an executive director at one of the largest specialist third party investment management firms in South Africa, a member of the global executive committee and you built a solid Botswana investment management business for them in a short period of time. You stepped out of a fairly comfortable place where you had achieved a lot. You left that to start something new. Why?**

I was driven by a deep desire to see a South African investment management firm that was singularly focused on investment excellence, which delivered a clear value proposition for clients, and that was representative of our society at all meaningful levels and in all meaningful structures of the firm. Six years ago when we started Afena Capital, such a firm was non-existent and today such firms still remain very rare. My partners and I felt that we had the necessary skills, experience and talent to execute this vision and decided to take on the risks and responsibilities of doing so. We, along with the rest of the team, continue to be inspired by this vision.

### **Five years from today, where will you be and what will Afena Capital look like?**

Our vision is to build a truly world class investment management firm. I am dedicated to spending the next five years, and beyond, continuously working with the amazing team we have in realising this vision.

With respect to the firm, in five years time I hope to see Afena Capital as an established investment partner of choice for investors wanting to grow their capital. Whilst I hope to see further growth and the introduction of a number of exciting innovations in the firm over the next five years, the essence of Afena Capital must continue to be the pursuit of excellence, professionalism, dedication and most importantly, integrity.

### **What are the fundamental principles that you believe will enable Afena Capital to deliver the best results consistently.**

There are three core ingredients I believe are essential to the delivery of consistent investment results. At the core is an investment belief system, what is often referred to as philosophy, which is rational, tested and that you have a wholehearted belief in its ability to add value over time. Secondly it is having a team of skilled, experienced and qualified investment professionals who are passionate about investing and are truly talented in the science and art of investing. Lastly, it is having an organisational and incentive structure that ensures complete focus on clients and the long term alignment of interests between the owners, managers of the firm and clients. I

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## THE INSIDE STORY

believe that by consistently focusing on, and strengthening, the above elements, Afena Capital will continue to deliver superior results for our clients.

### **Where is Afena Capital today? What are your thoughts on the progress made to date?**

In six years we have built an investment management firm that manages R18 billion of third party client assets. We have consistently delivered benchmark beating returns for clients over rolling three year periods. The core team that started the firm has remained together and strong and we have, over the years, been joined by amazing people who possess the same passion for excellence and professionalism as us. The South African institutional investor community has been very supportive of our firm and I believe we are developing a great reputation in the market. All in all I am pleased, and humbled, by the progress made to date. I thank our clients and the team for their respective contributions to date.

This, however, does not mean we must become complacent. To sustain the levels of excellence that will take us from here to becoming a truly world class investment management firm requires that we see our progress to date merely as a foundation upon which we need to continuously make ourselves better. We are an ambitious team and there is still a long way to go.

### **If you could go back from the beginning, the very beginning of your career and change something, do something differently what would it be? And Why?**

To date I have had some really wonderful opportunities and experiences that have contributed to an exciting and stimulating career. It is honestly hard for me to say there is anything I would go back and change. Of course, life is not perfect and there are situations and issues one always looks back at and says "I could have done that differently". However, in the bigger scheme of things, I am privileged that my career has so far been a wonderful and rewarding journey.

### **Who is the most inspirational person in your life?**

It is hard to pin-point any individual as a singular source of inspiration. Professionally, I am continuously inspired by my colleagues at work, some of the clients and industry people I have met. In life, I am inspired by family members, friends and people from various walks of life that I have come across.

In terms of a common thread, I guess I am inspired by people who believe in hard work, honesty, dedication and giving their best in whatever they're pursuing.

**What are your most memorable things in your life growing up and why?**

I grew up in a number of countries (Botswana, the UK, Zimbabwe and South Africa) and from each I gained different perspectives and experienced different things that have collectively shaped my world outlook. Because my family lived in a number of places, I have many memories of meeting and befriending people of different cultures and nationalities. I am grateful for this as I believe it has given me a greater appreciation of diversity.

**Advice for young professionals in the investment management industry who are starting their careers and have little understanding at this point of what they got themselves into?**

I believe that the passion for investing and hard work are the keys to success as an investment professional. In the 13 years I have been in the investment management industry, these are the two common themes I have observed with those who have achieved the greatest success, and are also the elements I have found consistently missing with those that don't achieve as much success. The investment management industry is a highly stimulating, exciting and rewarding industry in which to build a career, but it is also a very stressful industry where the responsibilities we have to our clients and society are immense. Young people who want to build a career in this industry need to understand that true passion for the profession is critical.

**Your personal investment style/approach – what is it and why?**

I believe in having a diversified portfolio with each asset's inclusion based on one or more of three objectives - long term capital growth, short term capital preservation or income yield. Investing is about achieving the right balance of these elements depending on your own specific circumstances and I try to keep this simple framework in mind when making or reviewing my personal investment decisions. I think of myself as a conservative investor with a bias towards absolute value.



**Sandile Sokhela**  
Head of Institutional  
Business

The investment community approaches the task of investing from a broad spectrum of disciplines and each determines the fundamental behaviour in investing patterns of different investors. In this issue we look at terms often used to describe market direction or market events that are related to how the market, or particular stock, is trading.

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### Support Level

### *Explained*

The price level which historically a stock or stock index has had difficulty falling below. It is thought of as the level at which a lot of buyers tend to enter the stock. It is a price level that may prompt a net increase in buying activity.

*If the price of a stock falls towards a support level it is a test for the stock: the support can either be reconfirmed or wiped out. It is reconfirmed if a lot of buyers move into the stock, causing it to rise and move away from the support level. It is wiped out if there is continued selling of the stock and the stock falls below the support.*

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### Resistance Line

### *Explained*

A price or index level which investors feel marks a boundary which they are reluctant to cross, since beyond that boundary the price would be too high or too low. The price is more likely to “bounce” off this level rather than break through it. It is a price level that may prompt a net increase in selling activity.

*Resistance levels relate to sentiment, if a share is selling at R2.95, and does not rise, it may be that investors see the price of R3.00 as a point above which the share is overvalued; if the price ‘breaks through’ the R3.00 barrier, then it may continue to rise rapidly, as the resistance level has been broken.*

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**UNPACKING JARGON****Market Crash***Explained*

A major decline or steep fall in financial markets that takes prices well below levels that can be rationally justified - it is the opposite of a bubble.

*Crashes are substantial and lingering. To be considered a crash, the market decline must be evidenced as a 20% drop in an index's total value. A crash is not just a sharp downward movement, but a large one from which the market takes a long time to recover. A crash is often seen as a buying opportunity by cool headed investors.*

**Bubble***Explained*

When a particular investment (or class of investments) performs particularly well, this tends to draw the attention of investors. This in turn leads to more money being put into the investment which causes further price rises. This leads to an upward spiral that can take prices far above the levels which can be justified by any rational assessment of the real value of the future cash flows an investment may generate. This is an investment bubble.

*Even investors who are aware that there is a bubble, and prices are too high to justify on fundamentals, buy into bubbles, because they may not want to miss opportunities that others are taking. For private investors this is likely to be merely the fear of being left out. In the case of professionals, such as fund managers, those who stay out of a bubble will be seen to be under-performing the market.*

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**UNPACKING JARGON****Market Cycle***Explained*

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A market cycle is the movement from a period of increasing prices and strong performance, or bull market, through a period of weak performance and falling prices, or bear market, and back again to new strength.

*Cycles recur periodically, though not on a predictable schedule. The length of each full cycle, and each phase within it, varies from several months to several years. The top of a cycle is called a peak and the bottom, a trough. A market cycle generally runs ahead of the concurrent economic cycle. For example, investors begin to sell stocks because they anticipate a recession, or turn bullish in the early stages of a recovery. However, not all sectors of a market operate on the same schedule. Similarly, the stock market tends to operate on a different cycle than the bond or commodities markets. These overlapping but distinct cycles are the basis of the investment strategy known as asset allocation.*

References: Afena Capital, Wikipedia, Investopedia



**Khaya Gobodo**  
Head of Equities

## MARKET PERFORMANCE

The South African equity market had another volatile quarter, but ultimately ended flat. The uncertainty that crept into the market was driven by the unfolding of a number of key events - Greece and the overall EU debt crises, deteriorating economic data and whether it's a soft patch or a double dip, the Chinese attempt to slow down their economy and whether they will have a hard landing and, finally, the US economy and their own debt issues. The cumulative impact of these themes has been volatility and lacklustre equity returns year to date, both in South Africa and abroad.

Even though the overall market ended flat, the individual sectors had divergent performances. Resources ended down 5.7% as a result of the decline in commodity prices and the general decline in risk appetite. Financials performed in line with the market whilst Industrials were the outperformers. This was especially true of the defensive sectors within Industrials.

## FUND PERFORMANCE

The Afena Equity fund performance more or less matched the flat performance of the market in the quarter ending 30 June 2011. There continues to be an improvement in the year to date performance relative to the benchmark, with the fund outperforming the benchmark by approximately 0.6%. Over three years the fund has handsomely out-performed the benchmark by 3.9% per annum.

## Positions that did well

- Metorex (MTX) received an offer from Vale over the quarter resulting in a 22% increase in the share price. MTX has since received competing offers which have driven the share price even higher. The latest offer is significantly above our valuation of MTX and we are selling our holding as a result.
- Pretoria Portland Cement (PPC) and Afrox (AFX) bounced off the very low levels after a disappointing first quarter. Both are yet to show a sustainable improvement in their operating prospects, which we believe is an important catalyst to drive the share prices further towards our valuations.
- Vodacom (VOD) and MTN continue to show solid performances and increased 10% and 5% respectively over the period. This performance was driven by solid operating performance in both companies and the increased payout of free cash flows to shareholders.

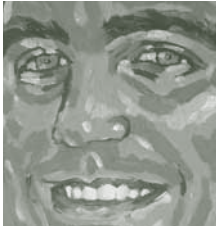
### Positions that have yet to deliver on expectations

There were a number of our key positions that have not yet delivered to expectations. JD Group (JDC) and Pick n' Pay (PIK) had a very disappointing performance over the quarter falling 13% and 11% respectively. They both produced disappointing operating performance relative to market expectations.

Steinhoff (SHF) also declined about 10% during the period, mostly as a result of the debt issues in Europe. There is a fear that these will result in a slow down in consumer activity, which would be negative for SHF's earnings prospects. SHF continues to be an attractive investment for us. It is trading on a PE of 8x forward and on operating margins we believe are slightly below normal. Our Resource holdings Sasol (SOL) and Anglo American (AGL) also had a tough quarter as a result of the decline in commodity prices and the general reduction in risk appetite. Both shares are down approximately 10%. They remain the most attractive holdings from a valuation point of view within the Resource sector.

### CONCLUDING REMARKS

In conclusion it is worth reminding our readers that as a long-term bottom-up stock picking investment house, we are far less concerned about how favoured individual shares or sectors are by the market at any point in time. We focus our attention always to the valuation based on sustainable operating performance. This, we believe, is an approach to constructing client portfolios that will deliver long-term outperformance.



**Andrew Joannou**  
*Portfolio Manager*

The last quarter saw the Afena Managed Fund perform exceptionally well. The key drivers of this performance were a number of individual stock picks coming to fruition and the sale of the fund's Brait Nil Paid Letters at a very attractive price. These factors, combined with a generally conservative equity allocation, enabled the fund to post a healthy positive gain over the quarter while the general equity market was flat.

Some of the individual positions that did very well over the quarter were Taste Holdings (TAS), Metorex (MTX) and Gold One International (GDO). TAS is a new holding in the fund and performed very well from the start of its inclusion (up almost 70% over the quarter). While it is still a small company we believe it is both attractively priced and on the cusp

of benefiting from its strategy to vertically integrate its food manufacturing. Both MTX and GDO are the targets of corporate action and therefore performed well as their market price moved closer to the proposed take out price. Both shares increased by more than 20% over the quarter.

The fund's equity positioning continues to be cautious with both the equity allocation being low (the local equity weight is only 37%, with an additional 18% sitting in international equity) and the stock selection within the equity space being defensive. There are two primary reasons for this guarded stance. One, we do not think the current equity valuations are attractive and two, we are unsure how the current global economy will unfold.

As was the case in previous quarters, very attractively priced investment opportunities are rare and the general market's valuation is fair to unappealing. We estimate the market's "Normal PE" (its price to earnings ratio based on what we consider to be sustainable earnings) to be somewhere between 12 and 14 times. While this is not an excessively high multiple it is still at the top end of what we would consider fair for the South African equity market. The market would therefore have to decline by a reasonable amount before we could become excited (in general) about its prospective returns. We therefore continue to focus on stock picking and trying to find the individual ideas and strategies that can generate above average profit.

The global situation is a tenuous one. Sovereign debt levels are still unacceptably high in many of the world's developed markets and the rolling of the debt is not really a long term solution. The eventual solution will have to entail spending cuts, increased taxes and potential defaults on obligations. This makes the future prospects for global growth and stability difficult to predict and increases the investment risk going forward. We do not think we are being adequately compensated for this risk given the valuation levels discussed above and therefore prefer to have limited exposure to equity in the fund.

We think the next period could once again be a difficult one. The fund at present is therefore still more concerned with capital preservation than capital growth. That being said, we do however still hope to find good individual ideas and therefore still believe we can make acceptable profits going forward.

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**THE AFENA PROMISE**

As stewards of our clients' capital, we will act with integrity and honesty at all times. We will always be consistent with our greatest asset - our investment philosophy and process.

We will run our firm with excellence, professionalism, dedication and innovation and will always respect the individual, be transparent and offer clear reward.

We will be cognisant of the needs and requirements of society and endeavour to play an active role in the upliftment and development of the community.

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