



Richard Cluver Predicts

In our 27th year of service to the investing public of South Africa



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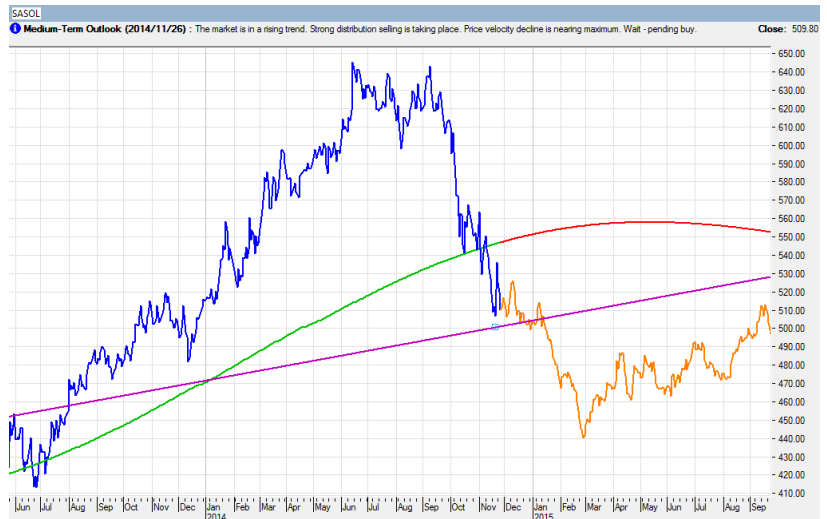
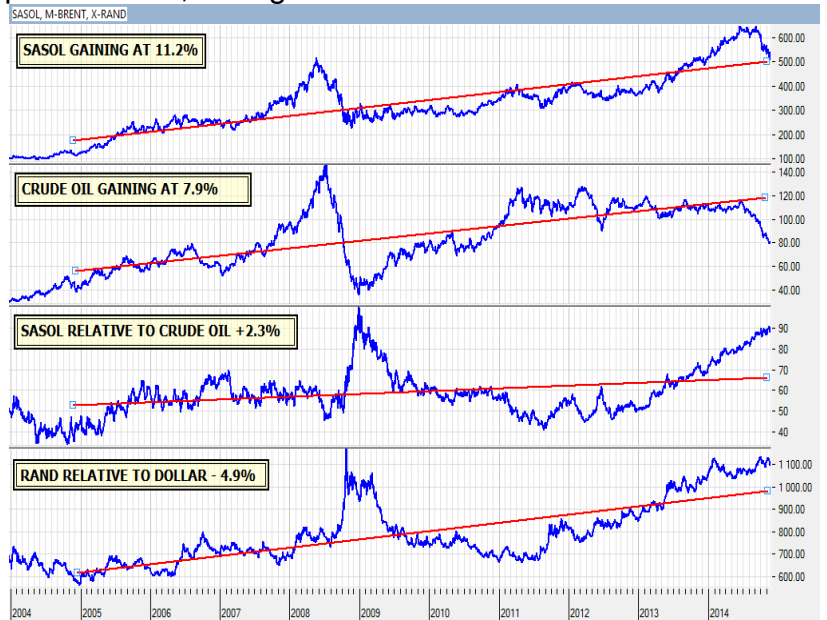
The plunging crude oil price could have significant implications for South African investors. But as always things are not quite as they seem.

So let us put things into perspective by comparing in my composite on the right the price performance of Sasol shares over the past decade, noting that investors in the shares saw their money gaining at 11.2 percent compound during that time while at the same time crude prices gained at 7.9 percent.

Seemingly then Sasol investors did relatively better until you stop to recognise that crude prices are in US dollars and Sasol shares are quoted in Rands and we thus note that over the decade the Rand lost value relative to the US Dollar at 4.9 percent annually. So subtract the Rand decline of 4.9 percent from the difference between the Sasol and Crude gains and you will note that in US Dollar terms investors in Sasol were actually losing 1.6% annually.

Now if you take a close look at a technical analysis graph of the Sasol price on the immediate right, you will note that the recent 20.48% fall in the share price since its September 5 peak has merely brought it to the level of its ten-year least squares fit trend line. In other words, Sasol is probably now about correctly priced and, if it continues to decline until the Fourier projected bottom of around 440 around the end of February it will prove to an attractive buy at that point.

Happily for those of you who took my advice and sold close to the peak price in September, February could offer a good re-entry point offering you a gain of around 31 percent on the round transaction. Note however, at a current dividend yield of 3.6% compared with a blue chip average of 2.6, the shares are already significantly underpriced though when one compares apples with apples using the ShareFinder fundamental calculations of value, Sasol is still a little overpriced. (To explain that view,



ShareFinder rates Sasol as currently 35.7% overpriced and all Blue Chips as 22.6% overpriced.)

In that vein, when comparing apples with apples in the Blue Chip list the most underpriced share is Coronation at -69%, MTN at -63% Assore at -54.4%, Compuclearing at -40.5% and Tencor at -17% while in the somewhat riskier Rising Stars collection, Italtile at -78%, Mondi at -63%, the JSE at -31% and RMB Holdings at -25% are the most underpriced.

Note, I have added a very lengthy thought piece from a Middle-East oil investment authority Jawad Mian which is well worth the time it takes to read.

The next month:

New York's SP500: I correctly predicted wrongly predicted gains until November 26 followed by a decline throughout December though a brief recovery is possible early in the new week.

London's Footsie: I correctly predicted further recovery but now I see an erratic decline throughout December.

JSE Industrial Index: I correctly predicted declines and I continue to see them lasting until late December.

Top40 Index: I correctly predicted declines. Now I see a recovery lasting throughout December.

The ShareFinder Blue Chip Index: I correctly predicted the beginning of a decline which I expect will last until throughout December.

The Rand: I correctly predicted a recovery which I now see lasting until around December 9.

Gold: I correctly predicted the next bout weakness which I see it lasting until Christmas albeit with a brief recovery between December 1 and 9.

Bonds: I correctly predicted gains that would end this week and now I see declines until December 10 followed by a very brief recovery and then further declines for the rest of the month.

The Predicts accuracy rate on a running average basis over the past 526 weeks has been 82.69%. For the past 12 months it has been 89.42%.

Richard Cluver

By Jawad Mian

Investment Observations

The precipitous decline in the price of oil is perhaps one of the most bearish macro developments this year. **We believe we are entering a “new oil normal,” where oil prices stay lower for longer.** While we highlighted the risk of a near-term decline in the oil price in our July newsletter, we failed to adjust our portfolio sufficiently to reflect such a scenario. This month we identify the major implications of our revised energy thesis.

The reason oil prices started sliding in June can be explained by record growth in US production, sputtering demand from Europe and China, and an unwind of the Middle East geopolitical risk premium. The world oil market, which consumes 92 million barrels a day, currently has one million barrels more than it needs. US pumped 8.97 million barrels a day by the end of October (the highest since 1985) thanks partly to increases in shale-oil output which accounts for 5 million barrels per day. Libya's production has recovered from 200,000 barrels

a day in April to 900,000 barrels a day, while war hasn't stopped production in Iraq and output there has risen to an all-time high level of 3.3 million barrels per day. The IMF, meanwhile, has cut its projection for global growth in 2014 for the third time this year to 3.3%. Next year, it still expects growth to pick up again, but only slightly.

Everyone believes that the oil-price decline is temporary. It is assumed that once oil prices plummet, the process is much more likely to be self-stabilizing than destabilizing. As the theory goes, once demand drops, price follows, and leveraged high-cost producers shut production. Eventually, supply falls to match demand and price stabilizes. When demand recovers, so does price, and marginal production returns to meet rising demand. Prices then stabilize at a higher level as supply and demand become more balanced. It has been well-said that: "In theory, there is no difference between theory and practice. But, in practice, there is." For the classic model to hold true in oil's case, the market must correctly anticipate the equilibrating role of price in the presence of supply/demand imbalances.

By 2020, we see oil demand realistically rising to no more than 96 million barrels a day. North American oil consumption has been in a structural decline, whereas the European economy is expected to remain lacklustre. Risks to the Chinese economy are tilted to the downside and we find no reason to anticipate a positive growth surprise. This limits the potential for growth in oil demand and leads us to believe global oil prices will struggle to rebound to their previous levels. The International Energy Agency says we could soon hit "peak oil demand", due to cheaper fuel alternatives, environmental concerns, and improving oil efficiency.

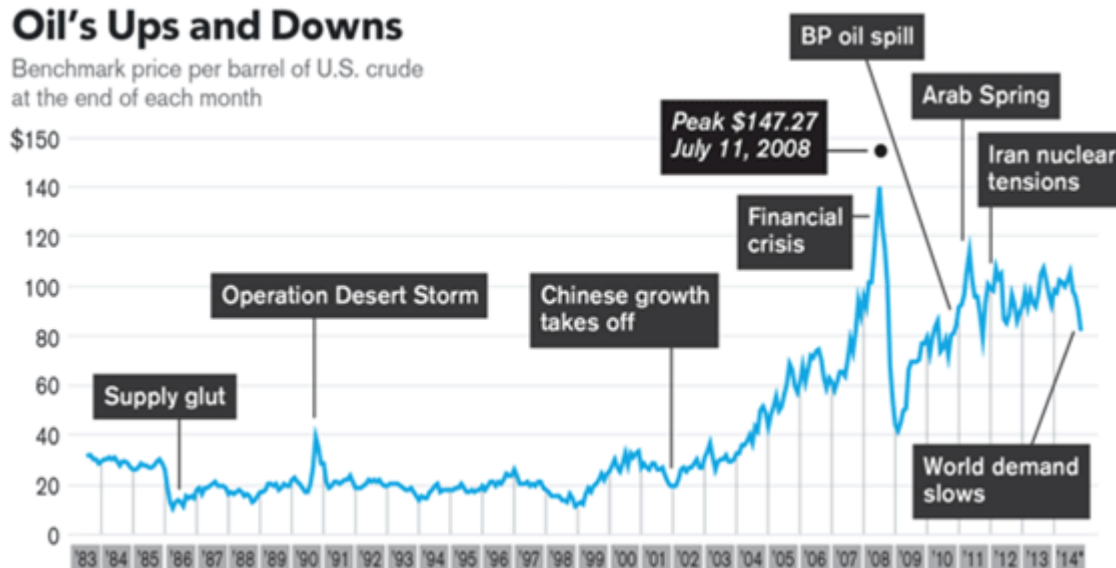
The oil market will remain well supplied, even at lower prices. We believe incremental oil demand through 2020 can be met with rising output in Libya, Iraq and Iran. We expect production in Libya to return to the level prior to the civil war, adding at least 600,000 barrels a day to world supply. Big investments in Iraq's oil industry should pay-off too with production rising an extra 1.5-2 million barrels a day over the next five years. We also believe the American-Iranian détente is serious, and that sooner or later both parties will agree to terms and reach a definitive agreement. This will eventually lead to more oil supply coming to the market from Iran, further depressing prices in the "new oil normal". Iranian oil production has fallen from 4 million barrels a day in 2008 to 2.8 million today, which we would expect to fully recover once international relations normalize. In sum, we see the potential for supply to increase by nearly 4 million barrels a day at the lowest marginal cost, which should be enough to offset output cuts from marginal players in a sluggish world economy.

Our analysis leads us to conclude that the price of oil is unlikely to average \$100 again for the remaining decade. We will use an oil rebound to gradually adjust our portfolio to reflect this new reality.

From 1976 to 2000, oil consolidated in a wide price range between \$12 and \$40. We think the next five years will see a similar trading range develop in oil with prices oscillating between \$55 and \$85. If the US dollar embarks on a mega uptrend (not our central view), then we can even see oil sustain a drop below \$60 eventually.

Oil's Ups and Downs

Benchmark price per barrel of U.S. crude at the end of each month



Source: Bloomberg

Normally, falling oil prices would be expected to boost global growth. Ed Morse of Citigroup estimates lower oil prices provide a stimulus of as much as \$1.1 trillion to global economies by lowering the cost of fuels and other commodities. Per-capita oil consumption in the US is among the highest in the world so the fall in energy prices raises purchasing power compared to most other major economies. The US consumer stands to benefit from cheaper heating oil and materially lower gasoline prices. It is estimated that the average household consumes 1,200 gallons of gasoline a year, which translates to annual savings of \$120 for every 10-cent drop in the price of gasoline. According to Ethan Harris of Bank of America Merrill Lynch: "Consumers will likely respond quickly to the saving in energy costs. Many families live "hand to mouth", spending whatever income is available. The Survey of Consumer Finances found that 47% of families had no savings in 2013, up from 44% in the more healthy 2004 economy. Over time, energy costs have become a much bigger part of budgets for low income families. In 2012, families with income below \$50,000 spent an average of 21.4% of their income on energy. This is almost double the share in 2001, and it is almost triple the share for families with income above \$50,000." The "new oil normal" will see a wealth transfer from Middle East sovereigns (savers) to leveraged US consumers (spenders).

The consumer windfall from lower oil prices is more than offset by the loss to oil producers in our view. Even though the price of oil has plummeted, the cost of finding it has certainly not. The oil industry has moved into a higher-cost paradigm and continues to spend significantly more money every year without any meaningful growth in total production. Global crude-only output seems to have plateaued in the mid-70 million barrels a day range. The production capacity of 75% of the world's oilfields is declining by around 6% per year, so the industry requires up to 4 million barrels per day of new capacity just to hold production steady. This has proven to be very difficult. Analysts at consulting firm EY estimate that out of the 163 upstream megaprojects currently being bankrolled (worth a combined \$1.1 trillion), a majority are over budget and behind schedule.

Large energy companies are sitting on a great deal of cash which cushions the blow from a

weak pricing environment in the short-term. **It is still important to keep in mind, however, that most big oil projects have been planned around the notion that oil would stay above \$100, which no longer seems likely.** The Economist reports that: “The industry is cutting back on some megaprojects, particularly those in the Arctic region, deepwater prospects and others that present technical challenges. Shell recently said it would again delay its Alaska exploration project, thanks to a combination of regulatory hurdles and technological challenges. The \$10 billion Rosebank project in Britain’s North Sea, a joint venture between Chevron of the United States and OMV of Austria, is on hold and set to stay that way unless prices recover. And BP says it is “reviewing” its plans for Mad Dog Phase 2, a deepwater exploration project in the Gulf of Mexico. Statoil’s vast Johan Castberg project in the Barents Sea is in limbo as the Norwegian firm and its partners try to rein in spiralling costs; Statoil is expected to cut up to 1,500 jobs this year. And then there is Kazakhstan’s giant Kashagan project, which thanks to huge cost overruns, lengthy delays and weak oil prices may not be viable for years. Even before the latest fall in oil prices, Shell said its capital spending would be about 20% lower this year than last; Hess will spend about 15% less; and Exxon Mobil and Chevron are making cuts of 5-6%.”

About 1/3rd of the S&P500 capex is done by the energy sector. Based on analysis by Steven Kopits of Douglas-Westwood: “The vast majority of public oil and gas companies require oil prices of over \$100 to achieve positive free cash flow under current capex and dividend programs. Nearly half of the industry needs more than \$120. The 4th quartile, where most US E&Ps cluster, needs \$130 or more.”

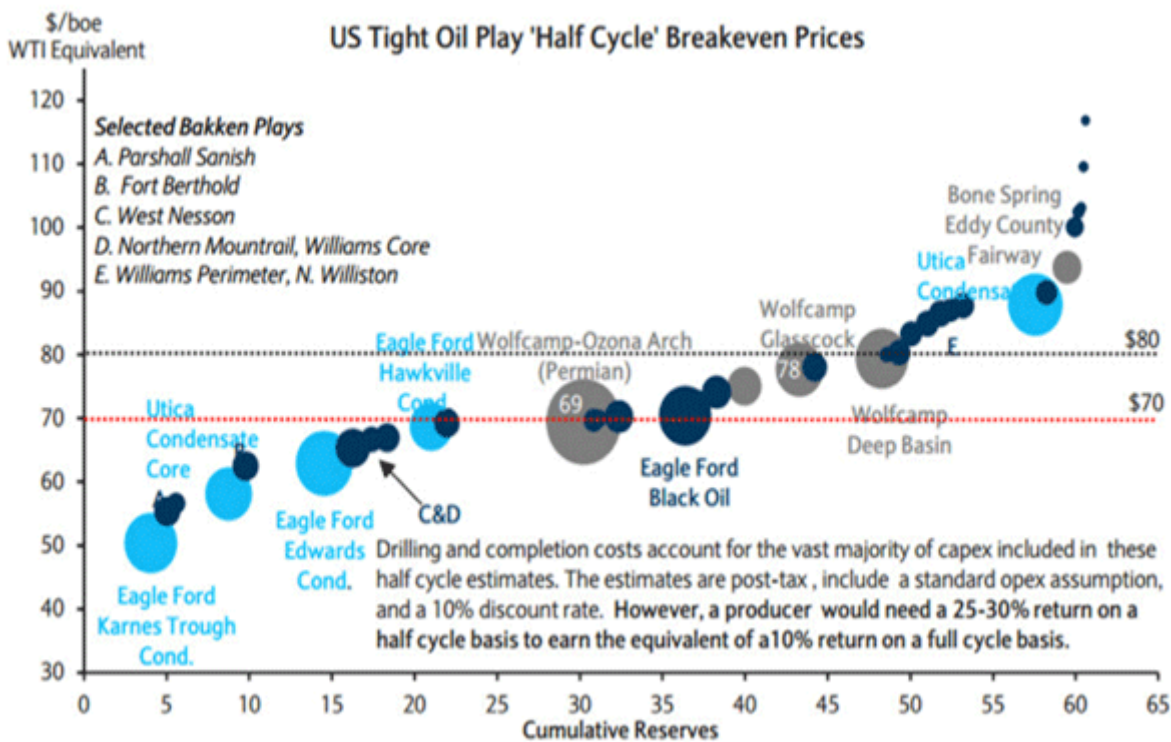
As energy companies have gotten used to Brent averaging \$110 for the last three years, we believe management teams will be very slow to adjust to the “new oil normal”. They will start by cutting capital spending (the quickest and easiest decision to take), then divesting non-core assets (as access to cheap financing becomes more difficult), and eventually, be forced to take write-downs on assets and projects that are no longer feasible. The whole adjustment process could take two years or longer, and will accelerate only once CEOs stop thinking the price of oil is going to go back up. A similar phenomenon happened in North America’s natural gas market a couple of years ago.

This has vast implications for America’s shale industry. The past five years have seen the budding energy renaissance attract billions of dollars in fixed investment and generate tens of thousands of high-paying jobs. The success of shale has been a major tailwind for the US economy, and its output has been a significant contributor to the improvement in the trade deficit. **We believe a sustained drop in the price of oil will slow US shale investment and production growth rates.** As much as 50% of shale oil is uneconomic at current prices, and the big unknown factor is the amount of debt that has been incurred by cashflow negative companies to develop resources which will soon become unprofitable at much lower prices (or once their hedges run out). Energy bonds make up nearly 16% of the \$1.3 trillion junk bond market and the total debt of the US independent E&P sector is estimated at over \$200 billion.

Robert McNally, a White House adviser to former President George W. Bush and president of the Rapidan Group energy consultancy, told Reuters that Saudi Arabia "will accept a price

decline necessary to sweat whatever supply cuts are needed to balance the market out of the US shale oil sector.” Even legendary oil man T. Boone Pickens believes Saudi Arabia is in a stand-off with US drillers and frackers to “see how the shale boys are going to stand up to a cheaper price.” This has happened once before. By the mid-1980’s, as oil output from Alaska’s North Slope and the North Sea came on line (combined production of around 5-6 million barrels a day), OPEC set off a price war to compete for market share. As a result, the price of oil sank from around \$40 to just under \$10 a barrel by 1986.

In the current cycle, though, prices will have to decline much further from current levels to curb new investment and discourage US production of shale oil. Most of the growth in shale is in lower-cost plays (Eagle Ford, Permian and the Bakken) and the breakeven point has been falling as productivity per well is improving and companies have refined their fracking techniques. The median North American shale development needs an oil price of \$57 to breakeven today, compared to \$70 last year according to research firm IHS



Source: WoodMackenzie, Barclays Research

While we don’t believe Saudi Arabia engineered the latest swoon in oil prices, it would be foolish not to expect them to take advantage of the new market reality. **If we are entering a “new oil normal” where the oil price range may move structurally lower in the coming years, wouldn’t you want to maximise your profits today, when prices are still elevated? If, at the same time, you can drive out fringe production sources from the market, and tip the balance in MENA geopolitics (by hurting Russia and Iran), wouldn’t it be worth it? The Kingdom has a long history of using oil to meet political and economic ends.**

We don’t see any signs of meaningful OPEC restraint at the group’s 166th meeting on

November 27th in Vienna. The cartel has agreed to cut crude production only a handful of times in the past decade, with December 2008 being the most recent instance. Based on our assessment, the only members with enough flexibility to reduce oil output voluntarily are the United Arab Emirates, Kuwait and Saudi Arabia. OPEC countries have constructed their domestic policy based on the assumption that oil prices will remain perpetually high and most members are not in a strong enough financial position to take production offline. Once all the costs of subsidies and social programs are factored-in, most OPEC countries require oil above \$100 to balance their budgets. This raises longer-run issues on the sustainability of the fiscal stance in a low-oil price environment. On the one hand, you have rising domestic oil consumption because there is no price discipline, which leaves less oil for the lucrative export market, and on the other hand, you require more money now than ever before to support generous budgetary spending.

How will this be resolved?

And with a much slower rate of petrodollar accumulation, what will be the implication for global financial markets, given the non-negligible retraction in liquidity?

The current oil decline has potentially cost OPEC \$250 billion of its recent earnings of \$1 trillion. Thus, it is not surprising to see OPEC production – relative to its 30 million barrels a day quota – rising from virtual compliance to one where the cartel is producing *above* its agreed production allocation. Output rose to 30.974 million barrels per day in October, a 14-month high led by gains in Iraq, Saudi Arabia and Libya. **So, it can be grasped that the lower the price of oil falls, the greater the need to compensate for lower revenues with higher production, which paradoxically pushes oil prices even lower.**

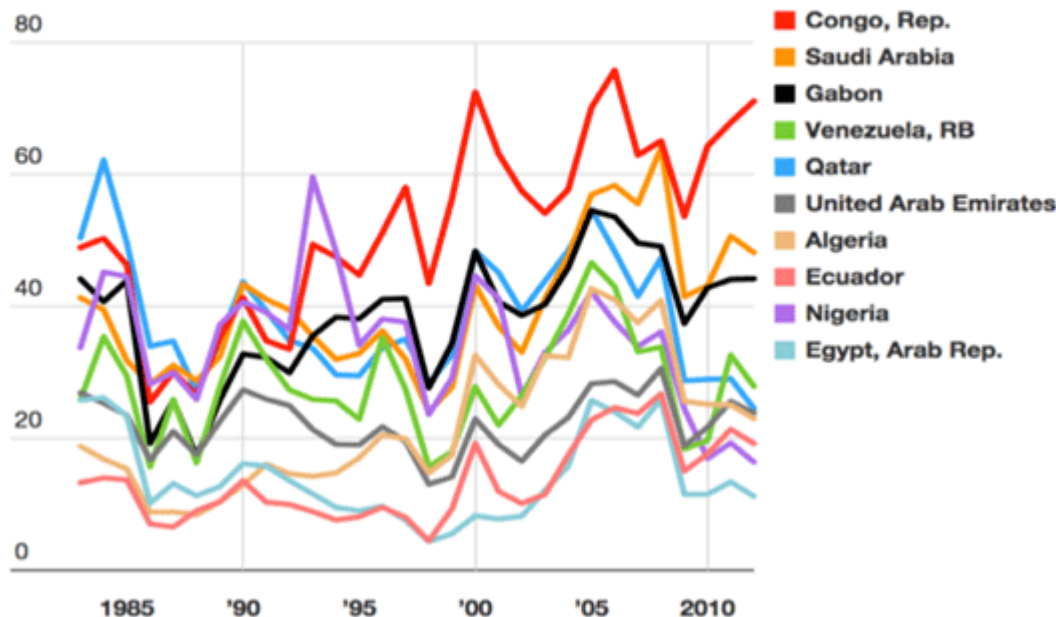
We believe the “new oil normal” will alter relative economic and political fortunes of most countries, with income redistributing from oil exporters (GCC, Russia) to oil importers (India, Turkey). We therefore exited our long position in the WisdomTree Middle East Dividend Fund (GULF) at a 14.4% gain.

Those nations with abundant oil tend to suffer from the “resource curse”. With no other ready sources of income, the non-oil economy atrophies due to the extraordinary wealth produced by the oil sector. OPEC countries are some of the least diversified economies in the world.

In an article titled “When The Petrodollars Run Out”, economist Daniel Altman wrote for the *Foreign Policy* magazine as follows: “Twenty countries depend on petroleum for at least half of their government revenue, and another 10 are between half and a quarter. These countries are clearly vulnerable to big changes in the price and quantity of oil and gas that they might sell...**So what can these countries do to bolster themselves for the future? For one thing, they might try to use their petroleum revenues to diversify their economies. Yet there's little precedent for that actually happening.** In the three decades from 1983 to 2012, no country that ever got 20 percent of its GDP from oil and gas – according to the World Bank's figures – substantially reduced those resources' share of its economy. The shares typically rose and fell with prices; there were no long-term reductions.”

Share of GDP from petroleum

Percent of GDP from gas and oil rents, 1983-2012. Estimates based on sources and methods described in "The Changing Wealth of Nations: Measuring Sustainable Development in the New Millennium" (World Bank, 2011).



Source: *Foreign Policy*

Saudi Arabia appears to be comfortable with much lower oil prices for an extended period of time. The House of Saud is equipped with sufficient government assets to easily withstand three years at the current oil price by dipping into their \$750 billion of net foreign assets. Saudi Arabia bolstered output by 100,000 barrels a day recently to 9.75 million, and cut its prices for Asian delivery for November – the fourth month in a row that it has cut official selling prices to shore up its global market share. With American imports from OPEC almost cut by half and given weak European demand, most oil-producing countries are now engaged in a price war in Asia. The Kingdom generates over 80% of its total revenue from oil sales so it may not remain immune in the “new oil normal” for long. According to HSBC research, Saudi Arabia would face a budget shortfall approaching 10% of GDP at \$70 oil and at \$50, the deficit could exceed 15% of GDP.

Russia and Saudi Arabia have opposing agendas in the Middle East. **We believe Russia would like to see Middle East burn.** This would shore up the cost of oil and keep America from geopolitically deleveraging from the region, thus allowing more room for Putin to outmaneuver his opponents in Europe. It was reported last year that the Saudis offered Russia a deal to carve up global oil and gas markets, but only if Russia stopped support of Syria’s Assad regime. No agreement was reached. It now seems the Saudis are turning to the oil market to affect an outcome.

With global energy prices at multi-year lows, Russia is facing a persistent low growth environment and an endemic outflow of capital. The \$30 drop in the Brent price translates into an annual loss in crude oil revenues of over \$100 billion. According to Lubomir Mitov, Russia’s financing gap has reached 3% of GDP, and they have to repay \$150 billion in principal

to foreign creditors over the next 12 months. Even with \$400 billion in foreign currency reserves and the Russian central bank raising its official interest rate by 150 basis points to 9.5% last month, the ruble is down 38% from its June high making foreign liabilities a lot more onerous. As per Faisal Islam, political editor of *Sky News*, “financial markets have punished Russia far quicker than Western governments.”

“It took two years for crumbling oil prices to bring the Soviet Union to its knees in the mid-1980s, and another two years of stagnation to break the Bolshevik empire altogether...” writes Ambrose Evans-Pritchard in *The Daily Telegraph*. “...Russian ex-premier Yegor Gaidar famously dated the moment to September 1985, when Saudi Arabia stopped trying to defend the crude market, cranking up output instead.” It is estimated the Soviet Union lost \$20 billion per year, money without which the country simply could not survive.

Could we see a repeat of events?

In the past, higher resource prices increased the occasions for military conflicts as nations would scramble to secure necessary supplies. Going forward, however, we firmly believe lower oil prices pose a greater risk of escalating current geopolitical challenges.

Putin is a determined and ambitious leader who wants to expand Russia’s power and influence. Since he rose to dominance in 1999, he advocated development of Russia’s resource sector to resurrect Russian wealth. In his doctoral thesis, he equated economic strength with geopolitical influence. Today, Russia needs an oil price in excess of \$100 a barrel to support the state and preserve its national security. Consequently, there is no question Putin will try to resist lower oil prices either through outright warfare or more covert economic sabotage.

Russia is the world’s 8th-largest economy, but its military spending trails only the US and China. Putin increased the military budget 31% from 2008 to 2013, overtaking UK and Saudi Arabia, as reported by the International Institute of Strategic Studies. Russia also has plans to become the world’s largest arms exporter by more than tripling military exports by 2020 to \$50 billion annually. We are convinced Putin would like to see a bull-market in international tensions. This is the biggest threat to our “new oil normal” theme.



Source: Cagle Cartoons

Turkey is a big beneficiary of lower oil prices, which provides much needed relief to the large current account deficit. As external imbalances correct and the inflation outlook gradually improves, we expect a significant shift in sentiment towards the country. Turkish stocks should do reasonably well going forward and we aim to buy the iShares MSCI Turkey ETF (TUR) on additional weakness. In our opinion, India will also continue to outperform many of its emerging market peers. Medium-term growth prospects have strengthened due to credibility of policymakers and external windfalls from lower oil and gold prices. We will initiate a position in Indian equities once the election exuberance dissipates. The market is up 23% since Modi's win.

Solar stocks have fallen 18% since oil peaked in June. It is assumed the fall in oil spells terrible news for the development of alternative energy sources, especially solar. We don't agree with this conclusion as we see the world moving toward a more sustainable economy. **We expect solar to gradually become more mainstream and less sensitive to fluctuations in the oil price.** According to a Deutsche Bank research report, solar electricity may be as cheap or cheaper than average electricity-bill prices in 47 US states by 2016. Even if the tax credit drops to 10% (if Congress allows the federal tax credit for rooftop solar systems to expire at the end of 2016), solar will soon reach price parity with conventional electricity in well over half the nation. Solar has already reached grid parity in 10 states which are responsible for 90% of US solar electricity production. We own the Guggenheim Solar ETF (TAN) as a strategic long-term holding.

According to Nordea Research, markets are pricing in a 40% chance for an interest rate cut at the Norges Bank meeting in December. This has pushed the Norwegian kroner (NOK) nearly

7% weaker than the Norges Bank's forecast for June of next year. We think markets have gone too far with an overreaction in NOK because of the Brent decline. The oil-sensitive Norwegian economy remains relatively more competitive with an average cash cost of \$43 a barrel across the whole industry. We sold our NOK/SEK position for a 6.9% profit earlier and plan on re-buying the pair from lower levels. The cross-rate is the cheapest in two decades on a PPP basis and Sweden's Riksbank cut its key interest rate to zero in October as it battles deflation.

In terms of other opportunities, we are also long the Mexican peso (MXN) versus the Colombian peso (COP). Mexico's oil exports as a percent of GDP are 4% versus 8.5% in the case of Colombia. Our position is up 4.7% so far.

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