

# LIBERTY HOLDINGS LIMITED

15 MAY 2009

Speaker

Narrative

**Operator**

Good afternoon and welcome to the Liberty Holdings conference. All participants are now in listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. If you should need any assistance during the conference, then please signal an operator by pressing star and then zero. I would now like to hand the conference to Bruce Hemphill. Please go ahead, sir.

**Bruce Hemphill**

Thank you and good afternoon to everybody who is on the call. I have got with me Steven Braudo, Russell Harte, the CFO. Stuart [unclear] you will know is our senior in LibFin, Bobby Malabie, head of Marketing and Distribution and Rex Tomlinson, who I am sure you will know. I am not sure that it is worthwhile reading the trading update. Now doubt you have all seen it and you would have had an opportunity to digest it and the three key take-away points for me are that the capital position remain strong at 2.5 times car cover. We have also been able to free up additional economic capital despite throwing away an R850 million dividend.

The underlying businesses are performing more or less in line with expectation and the sales are holding up reasonably well under the circumstances and what we are in the process of doing is deliberately de-risking our balance sheet and we took a decision that in the light of the extreme uncertainty in markets and the huge exposure that we have to market risk that we needed to begin a process of de-risking the balance sheet and last year we began with de-risking the interest rate position with a view to de-risking the equity position and the currency position during the course of this year and halfway through the quarter global markets started to look decidedly worse and we took the view that in the interests of preserving capital strength we needed to de-risk.

That is the decision we took. We think it was the right decision and as a consequence if markets continue to deteriorate the balance sheet will be protected and we are of the view that this crisis is over despite the fact that we are seeing what would appear to be and what are referred to be the green shoots of a recovery globally. I think we are of a view that whilst the financial crisis may have passed for the time being, if unemployment

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	<p>continues to deteriorate and US house prices fall further the financial system is going to come under additional pressure and we would rather be comfortable with our balance in those circumstances and I think what we have done ensures that we have that comfort. So that is kind of by way of an introduction. I am sure that there are lots of questions that you all have so please feel free to start asking them.</p>
<b>Operator</b>	<p>Thank you very much. Ladies and gentlemen, at this time if you would like to ask a question please press star and then 1 to join the queue. If you then decide to withdraw your question please press star and then 2. Our first question comes from Risto Ketola of Ketola Research. Please go ahead, sir.</p>
<b>Risto Ketola</b>	<p>Hey, I am a winner. I actually want Giles to answer. Now the equity exposure, now you guys were not hedged, so what happened happened and you just [unclear] but the interest rate I thought we had better hedged going into this quarter. I just wanted to hear from Giles how does he explain interest rate layers loss.</p>
<b>Giles Heeger</b>	<p>The bulk of it is a really, really large book in absolute size and we have used as much as possible. We have used natural offsets that we have before we look ahead in the position. So we have used all the natural offsets we have in the organisation and to put it quite simply, some of the natural offsets are valued against the swap curve and some against the bond curve and those two curves have drifted apart a bit during the last quarter and those curves do tend to move away and together from time to time. They have a strong tendency to mean revert and we are reluctant to hedge that risk. We would rather look over time at bringing all our evaluation bases onto the same basis so that we do not have that type of basis risk within our naturally occurring business. So the view we are taking is not to hedge that but to wear base it as and when it arises and in some cases it is going to be quite a difference for us and in some cases it will be negative.</p>
<b>Risto Ketola</b>	<p>Now the component that have a natural hedge, are you just simply long bonds?</p>
<b>Giles Heeger</b>	<p>Yes, it is a mix between the guarantee contracts which are largely going with the swap curve. The shareholders</p>

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<p><b>Risto Ketola</b></p>	<p>bond holdings and the negative rand reserves which are valued off a bond curve.</p> <p>All right, I will try and decipher all that, but the basis number seems quite... the basis risk is quite material.</p>
<p><b>Giles Heeger</b></p>	<p>The number is large but in the context of the overall position, I mean, let me just do some quick maths with my calculator here... ja, it is just under a percent on the overall position and I guess most importantly and look, hindsight may turn out to suggest differently, but over the last seven or eight years that type of basis risk is centre to mean revert every 90 to sort of 180 days and the cost of hedging it are quite prohibitive. So for the moment, unless hindsight proves that to be aggressive, we will be comfortable that that is the market number that will reverse and it will probably go the other way and then come back at us, you know, over time.</p>
<p><b>Risto Ketola</b></p>	<p>At least you have got the time. Okay.</p>
<p><b>Operator</b></p>	<p>Our next question comes from Larissa van Deventer of Deutsche Bank. Please go ahead.</p>
<p><b>Larissa van Deventer</b></p>	<p>Thank you, good afternoon. A couple of questions related to the market to market equity losses. If you can give a little bit of colour as to how is that hedged and then also to... because I understand that it is short on the SFIX if I am not mistaken, and then the extent to which your shareholders portfolio correlate to the SFIX, to the effectiveness of that hedge.</p>
<p><b>Bruce Hemphill</b></p>	<p>This I will let Giles answer that.</p>
<p><b>Giles Heeger</b></p>	<p>In respect of the portfolios, the majority of the portfolios are benchmarked against the SFIX, so I guess in relation to the previous question as well we would still have some basis exposure to the portfolio managers who were anyway significantly underperformed with the SFIX index. And then at the time of the publication, at the quarter end the majority of the hedges were indeed through futures or forward contracts, but the choice of instrument does to some extent reflect prevailing market conditions at the time and cost benefit ratios. It does not necessarily suggest we would retain them for all time within future or forward contracts.</p>

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<b>Bruce Hemphill</b>	Larissa, if I can just add as well and then you are right in saying the shareholders, what we would call the first balance sheet is still pretty much [unclear] related to manage to that basis and the balance of the derived exposure is basically [unclear] SFIX index.
<b>Giles Heeger</b>	We have hedged the shareholders' portfolio.
<b>Larissa van Deventer</b>	Oh, have you not hedged the shareholders' portfolio?
<b>Bruce Hemphill</b>	No, this is the message we have got to get across. We have left the shareholder position open, but the derived exposure, the derived balance sheet that you pick up as a result of 50 years of sales of badly priced options is what we are managing.
<b>Larissa van Deventer</b>	Okay. So the 500 million loss, is that then Liberty's portion of the policy holder book to 90/10 and the rest?
<b>Bruce Hemphill</b>	Correct. It is the entire basket. It is 90/10, it is derivatives, it is the whole equity position.
<b>Larissa van Deventer</b>	Is there any long dated duration on those hedges and do you plan to change the strategy?
<b>Bruce Hemphill</b>	I think there is probably a difference between the overall strategy and a technical strategy and the overall strategy would certainly continue and that is to contain the volatility to those books or positions. From a more tactical viewpoint two comments I get, the type of hedging instrument available does depend on market conditions and your time frame and that certainly will probably evolve over time, so it may not be the instrument of choice in the long term. It is solely a features contract and the quantum of residual exposure risk that we are prepared to wear would probably also contract or increase depending on what the overall market environment and outlook appears to be.
<b>Larissa van Deventer</b>	Okay, thank you.
<b>Operator</b>	Our next question comes from David Danilowitz of Merrill Lynch. Please go ahead.
<b>David Danilowitz</b>	Afternoon, all. Giles, we can keep going with you. Do you believe that the utilisation of the derivatives of the forwards and the future that you applied over the long

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<p><b>Bruce Hemphill</b></p>	<p>term will achieve better than just investing in cash for those portions? I know we are not talking about the shareholder portfolio here, but do you believe that is a better use of the outlook? Is that obviously the other alternative?</p> <p>Actually it is not really. The books that we are trying to manage, we actually cannot invest in cash. So I think it goes back to Bruce's earlier point that we are not about managing the risk on the shareholders' portfolio. We are talking about managing the risk associated with the embedded derivatives in 90/10, the derived exposures. Those exposures do not have, if you like, an underlying asset position. So our choice is either to run those exposures open or to reduce those exposures. There is not a cash alternative available where we could choose to say instead of being exposed to embedded derivatives, for example, we would choose to close that down and reallocate that exposure to cash.</p>
<p><b>David Danilowitz</b></p>	<p>I mean, I hear what you are saying, I guess there are certain times when you could, if you are just short and cash yields are high you could be theoretically putting in cash to close the gap there, but I hear what you are saying, probably over the whole book it will make sense. I guess maybe the other way of posing the question is one of the strategies here with capital management which clearly it appears that you have achieved and it have been successful and that. The other side is earning stability. Do you think earnings would have been left had you not employed these strategies?</p>
<p><b>Bruce Hemphill</b></p>	<p>I think the question is, it is not a question that you can answer looking over a three month period. You have to take a longer term view. You have to look back at it over a kind of two year period, I would have thought, so putting that aside for a moment, if the idea is that you are going to run the portfolio on... let us just for the moment argue that we are not going to go the route and we are going to run it on a strategic allocation basis, but you have got all this additional exposure that you are picking up through a derived balance sheet, if you are not employing this balance sheet management the earnings volatility that you are going to see coming through the derived balance sheet is going to be almost impossible. I mean, it is just going to be very, very difficult to predict and what we are kind of saying is it is</p>

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	<p>very high level, is if you can neutralise the embedded derivative earnings volatility through the strategies we are adopting and then get the return out of the shareholder base you are going to have a much more predictable earnings base.</p>
<b>David Danilowitz</b>	<p>Thanks, Bruce.</p>
<b>Operator</b>	<p>Our next question comes from Colin Hundermark of Credit Suisse. Please go ahead.</p>
<b>Colin Hundermark</b>	<p>Greetings, all. A couple of questions just on what are the expiry dates of the contracts and also when was it implemented on the hedging? Was that end of February, given markets ran in March? Second question, what is the cost of the hedging and where will that be reflected and just a third point on the life of the business and persistency, could you comment on the experience in the quarter the second half of last year?</p>
<b>Giles Heeger</b>	<p>If I could pick up the first couple of questions. In terms of the date, I think from the PNL numbers the date to be roundabout late February in terms of managing that equity exposure. Most of the contracts would expire during the course of this year although the nature of the contracts are such that they are fairly easy to roll if we consider market conditions to still look pretty uncertain and volatile out there. The costs, we substantially reduced our total earnings volatility arising from the derived portfolio. Not the shareholders' portfolio, but from derived portfolio. The earnings has been significantly reduced through a fairly wide range of equity levels and I guess suffice to say that within the ranges that we have been seeing over the last eight months being kind of entirely predictable as kind of potential outcomes. In the cost of achieving that it is what you have seen in the update as a net cost of trying to see that from [unclear] again.</p>
<b>Bruce Hemphill</b>	<p>We put a lot of effort [unclear] and it is early days still but there is certainly no further deterioration in persistency since the year end and indeed the comparable period in 2008.</p>
<b>Colin Hundermark</b>	<p>Thanks.</p>
<b>Giles Heeger</b>	<p>Just going to something Dave was touching on earlier, I</p>

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	<p>mean before we started doing this we kind of flashed back and we look at the monthly earning volatility. During the second half of last year monthly earning volatility was about 200%, doing 200% swings. So I think what people perhaps do not appreciate is that when we saw the kind of aggregate size of optionality that this business has sold over the last 20 or 30 years, whatever the time period is and you have taken all the option premium, paid away in profits and now you are going to manage this in a market to market environment, you are going to have massive volatility unless you start to manage it and when you start to manage it you are going to have to incur some cost.</p>
<p><b>Colin Hundermark</b></p>	<p>Thanks.</p>
<p><b>Operator</b></p>	<p>Our next question comes from Francois du Toit of JP Morgan. Please go ahead.</p>
<p><b>Francois du Toit</b></p>	<p>Just on the hedging, so you are not hedging your shareholder portfolio. Can you tell us then what is the current equity market exposure more or less in your shareholders portfolio? I put it at about R3 billion at the start of the year. Is it still at that level, obviously adjusting for market movements? That is question 1, and question 2, if you are actively hedging out your equity market risk in your balance sheet and your imports book, can you still value your equity risk premium? I mean, it seems like your value of imports, the very aggressive values especially now on the European embedded methodology where you have a 3.5% equity risk premium. Is the cost of hedging most of that out eating up just about all of that and what would be the impact if you fully account for that cost?</p>
<p><b>Bruce Hemphill</b></p>	<p>I will deal with the first question. I mean obviously we cannot say what is in the [unclear] but we have not significantly reduced the exposure that we are running in the shareholders' portfolio. That is the first point. The second point I will hand over to Steven[?]</p>
<p><b>Steven Braudo</b></p>	<p>Ja, I think just on the equity risk premium, obviously yourself and ourselves have had discussions around the equity and I think there is a difference of opinion. I think the reality is on one side you might take an equity risk premium into a discount rate but you are also going to assume that in your equity return. So I think the impact</p>

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	<p>in the 2008 earnings from those different components with the net R50 million which is actually quite small and immaterial. So I think we still see it as appropriate and I see every turn and it is required by PGN107 to review the appropriateness of the equity risk premium and the risk discount rate that we apply some better value and each reporting period to see whether we still feel it is valid and we still believe that it is that, so we stick by that at the moment, but as the statement requires you to do, we re-evaluate each report.</p>
<p><b>Francois du Toit</b></p>	<p>Okay, thanks. One further question, on the 350 million operational earnings that you have guarded for, if you suffered the losses on your hedges and it is predominantly at least reducing your 90/10 losses, does that 350 million inequity or expected normal 90/10 earnings or is that 350 million your life earnings excluding 90/10 plus your other subsidiaries?</p>
<p><b>Steven Braudo</b></p>	<p>No, it includes the 90/10 expected. I think the one thing to bear in mind, I picked that up with discussions that I have had with various people this morning, just the technical issue relating to STC, we paid STC of 60 million in the first quarter of this year where we did not pay STC last year and although it was a capital reduction it was paid out of premiums that are for tax purposes redeemed to be a dividend. The STC of 60 million was incurred. Currently there is no premium at Liberty Holdings level so any future capital reductions should it go that route will be free of STC charges. So I do think the run rate on operational earnings is north of the level that we disclosed this morning. Having said that at some stage way into the future we disclose the untainted share premium account has a balance of around about R8 billion.</p>
<p><b>Francois du Toit</b></p>	<p>Okay, and just coming back to the question that was not fully answered, can you disclose more or less what sort of life flows there were? I know your 1Q08 flows were substantially higher in the second half of last year compared with the first half of last year and I think your management statement this time says that your net life flows were better than your 1Q08 flows.</p>
<p><b>Steven Braudo</b></p>	<p>Ja, our net cash flows for the quarter was positive for the retail side, roundabout 500 million.</p>

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<b>Francois du Toit</b>	No, this is specifically on the life side.
<b>Steven Braudo</b>	Ja, retail life, the net cash flows are roundabout 500 million for the quarter and it is obviously a combination of a number of things, but we certainly believe that the fall of the market, I mean, in the same way when the markets went up there was a freeze on cash flows because payouts were increased and their rates higher than premium growth and in this case markets have fallen more than premium rates have fallen. So I think we have got a benefit on the downside of the market. Clearly having said that we would prefer the market [unclear]
<b>Francois du Toit</b>	Thank you.
<b>Operator</b>	Our next question comes from Jacques Conradie of Peregrine Capital. Please go ahead.
<b>Jacques Conradie</b>	Can I also just ask a question on the equity hedging? I just want to run through how I see it and then you guys must tell me if I am interpreting it correctly. It is basically on your embedded derivative portfolio. Obviously when the equity markets fell in January/February you saw some losses there and basically end of February decided we are going to hedge that portfolio and that kind of had the effect of locking in any losses to date but since the hedging I would have assumed that the correlation has been quite high and those things have been tracking quite closely. Is that kind of the correct understanding?
<b>Bruce Hemphill</b>	That is largely correct. The correlation is fairly good with a fairly wide range, but I guess if you had to take the absolute imaginable extremes of the current trading rate we have seen over the last nine to 10 months, if you had to pierce the far side of that range that correlation start to break down a little bit.
<b>Jacques Conradie</b>	Okay, and then just on the hedging, do you see this having a long run cost of maybe a percent or two of the hedging portfolio per year or kind of would it be just cost neutral and have the effect of equity type returned into a cash type return?
<b>Giles Heeger</b>	I think realistically we have to accept that it will have an ongoing cost in order to manage this kind of position.

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	<p>We will be looking to in future be far more careful as to our ability to track the cost back through to the original onboarding of the business, so to speak. So where it is new business we should be able to track the cost right through to the point of sale and allocate it against the revenue amount where historical business may not be as easy to actually attribute in that manner.</p>
<b>Jacques Conradie</b>	<p>The historic business, many of those profits would have been almost booked in the past and not kind of properly accounted for and so those would kind of a new hedging cost whereas new business would be priced in.</p>
<b>Giles Heeger</b>	<p>Unfortunately, yes.</p>
<b>Jacques Conradie</b>	<p>Okay, thank you very much.</p>
<b>Bruce Hemphill</b>	<p>I mean, the point you are making is you cannot mismanage these things. You have massive books so if you do not manage them in a market to market world you run real risk from an insolvency perspective so you do not really have a choice.</p>
<b>Giles Heeger</b>	<p>If I could just also add on to that to say that long run, although we would certainly hope the costs are small there are going to be some cost just arising out of the reality of what we are trying to hedge in that as someone mentioned earlier for example we would need to hedge against the SFIX where the actual managers may under or over-perform the SFIX and we are also limited by the tenor of the tenor of the contracts available in the market which are largely of a shorter date than many of the contracts we have actually sold to our customers.</p>
<b>Operator</b>	<p>Ladies and gentlemen, a reminder that if you would like to ask a question please press star and then 1. Our next question comes from Risto Ketola of Ketola Research. Please go ahead, sir.</p>
<b>Risto Ketola</b>	<p>I am just trying to think of the practicality here and I quite like this derived balance sheet which you guys talk about. You get the rand reserves and you have got the IGR there. Now what happens on your policy about switching the Moneymarket funds and the end products? How quickly do you pick that up in your reporting systems? Is there a real risk or are these allocations very stable?</p>

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<b>Giles Heeger</b>	At the moment we are getting the data roughly on a monthly basis and for the moment the speed of change relative to the size of the book suggests that time delay is not material at all. Obviously we have got a fair amount of bills and we still have not placed and it is going to take us some time but we would certainly like to get their time frame not just on that bit of data but on various other bits of data that we need as well to be far faster than on a monthly basis.
<b>Risto Ketola</b>	But would you not argue that maybe there is a bit of a natural hedge there because you would expect people to reduce their equity allocations in environments like this?
<b>Giles Heeger</b>	Absolutely and it means that we will have to readjust. As we get updated indications of what the overall position is, we will need to adjust and that will have some cost impact going forward. We will still anticipate that that cost impact is substantially less than not trying to manage the book.
<b>Risto Ketola</b>	And then everybody talks of the 90/10 book. Those policy holders, do they have a variety of investment choices on those products or is there a single portfolio backing them?
<b>Giles Heeger</b>	No, they have [unclear]
<b>Risto Ketola</b>	Okay, so even a 90/10 profit, the stability of it can change very much on the whim of the policy holders.
<b>Giles Heeger</b>	Ja, but it is has been pretty stable. As Bruce said earlier, that is an old book and they are not actively trading the policies. They were invested for the long term.
<b>Bruce Hemphill</b>	[Unclear] cash.
<b>Risto Ketola</b>	Ja, believe me, it is one of the things we thought about. We also thought about writing a letter to all of our policy holders to tell them that maybe should think about selling us their options.
<b>Giles Heeger</b>	Just a thing on the 90/10 [unclear] and as we disclosed in the past we estimated that it will run off at around 2% per year into normal markets. Those never seem to

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	<p>happen in normal markets. So it is probably until 2007 it probably did not run off as quickly as we expected given the bull market and the volatility by and large exists on the equity positions that the policy holder choose. The balance of the investment portfolio is broadly speaking fairly stable. I mean, obviously bonds last year were highly stable but that is what they are supposed to be.</p>
<p><b>Risto Ketola</b></p>	<p>I mean, that book is still surprisingly big. It is over 30 billion.</p>
<p><b>Bruce Hemphill</b></p>	<p>That is right, but [unclear] is about 170.</p>
<p><b>Risto Ketola</b></p>	<p>Ja, you do not want to give an end of month number on the 90/10 book.</p>
<p><b>Bruce Hemphill</b></p>	<p>No.</p>
<p><b>Risto Ketola</b></p>	<p>Okay, I will put in my last guess her, 34 billion. Last question, I promise. Giles mentioned the risk on the IGI valuation versus the rand reserves. Now why do you not just value on the same rate? I mean, is there a guidance not forcing you to value the one on the swaps and the one on the bond deal?</p>
<p><b>Bruce Hemphill</b></p>	<p>At the moment my understanding is that that decision largely lies with the statutory actuary that has to go through a fairly in-depth process as to what are the implications for the policy holder before you could change that valuation basis, but my very broad understanding is that is achievable if we go through the appropriate process and we assess that there is not disbenefit to any party.</p>
<p><b>Risto Ketola</b></p>	<p>And the IGI interface you use [unclear] as the bond yield.</p>
<p><b>Bruce Hemphill</b></p>	<p>Yes, you are 100% correct. I mean, what has happened in a nutshell, especially off the back end of the South African interest rate curve, bonds are actually trading above swaps for the first time in about five years.</p>
<p><b>Risto Ketola</b></p>	<p>Thank you.</p>
<p><b>Operator</b></p>	<p>Ladies and gentlemen, a final reminder that if you would like to ask a question, please press star and then 1. Our next question comes from David Danilowitz of Merrill</p>

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<b>David Danilowitz</b>	In terms of the fact that you guys have done a great job at particularly capital, you are sitting with a fair amount of excess, you spoke about the green shoots earlier, has the current environment had any implications to your thoughts and how to utilise that capital going forward?
<b>Bruce Hemphill</b>	You mean in terms of acquisitions?
<b>David Danilowitz</b>	Acquisitions, buy-backs. You are answering it.
<b>Bruce Hemphill</b>	No, look, it is early days so we are fortunate that we have got the capital. My personal view is that yes, [unclear] When they do that I think US banks are going to be under additional stress and the stress test that they have just been through have to be re-examined and you are going to have a situation where there will be additional stress and they have not even done stress tests, so I am not convinced that this thing is over and as I said earlier, I think we have seen a relief [unclear] So are we earmarking as capital for anything in particular? The answer is no, we want to wait to see where this thing ends up and I reckon we are only going to be definitively able to assess that towards the end of this year, beginning of next year, but clearly there are opportunities that we have been looking at for some time which we will continue to pursue. So I think we are in the fortunate position of being able to continue with the stated kind of overall strategy and when those opportunities are ready, provided we are happy with price and lots of things we will pursue them, but we do not intend spending R1 billion.
<b>David Danilowitz</b>	Okay. And then maybe just looking forward and trying to ignore market volatility which as Stuart says has been impossible, what type of target RAE would you be targeting for your business?
<b>Bruce Hemphill</b>	Ja, I think that we have not given a target range before. What we have said specifically is that we have been on record to say probably the 2006/2007 average earnings between the two, it is probably a good long term base. That could give you a sense of what sustainable RAE is and I think the one side clearly is the earnings and the other side is the [unclear] and I think you have raised an interesting point and that is really the journey that we run

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	<p>in terms of risk capital, is to understand our risk a little bit better and where possible utilise the capital a little bit smarter. So RAE for us going forward will be a key focus. I think what we have shown is on a normalised RAE. At the end it is 2008 which run in at about 22% and I think on a true cycle basis probably slightly lower than that right now. It is probably where we are but on a true cycle basis we think that that should be sustainable.</p>
<b>David Danilowitz</b>	<p>Thanks.</p>
<b>Operator</b>	<p>We have no further questions. Would you like to make some closing comments?</p>
<b>Bruce Hemphill</b>	<p>Nothing except to say that we appreciate the interest that you have all taken in the call and we really appreciate the line of questioning, particularly from our Finnish friend, Mr Risto Ketola. Thank you.</p>
<b>Operator</b>	<p>On behalf of Liberty Holdings, that this afternoon's conference. Thank you for joining us. You may now disconnect your lines.</p>

END OF TRANSCRIPT