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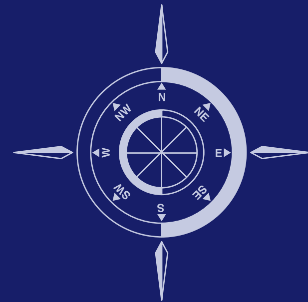
NFB FINANCIAL UPDATE



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FROM THE CEO's DESK

Wow! It seems just the other day that I exclaimed similarly as 2009 drew to an end. The year has blasted past and not without a number of extraordinary events.

We've had Malema sabre rattling, Gill dropping rates, 'Godzilla' (Helen Zille) and her Provincial team showing the ANC central government up in almost every aspect of governance and delivery, exchange controls now GONE and the equity market, in my opinion, performing way beyond reason together with the rand, which continues to surprise on the strong side. NFB also turned twenty five!

Combined, the South African market has outgunned all of the traditional places and South Africans have gone in search of safety from being total Rand Barons. For interest sake, if one had fully invested in our market over the last decade compared to the London FTSE, or the New York Dow, you would have, in dollars, returned 318%, -2.43% and 1.3% respectively. And so, what does one do with cash either already invested or available for investment? We have always and continue to advise diversity. We also, particularly at present, advocate a cost averaging approach to local equity. These shares might well continue to appreciate, but man, they have had a run, particularly as foreign cash has flooded into overseas emergent market bourses. Our market is demanding a price earnings multiple of between 17 and 18. This is high and will not take kindly to earnings disappointments. Accordingly, we think those who cannot tolerate serious volatility in their portfolio values would be advised to take some profit. Also ensure the CGT implications are factored into your thinking.

Property remains attractive and we continue using different property-based solutions to provide clients with cash beating returns, complemented with inflation beating capital growth over the medium to long term.

For those interested in shorter term investment we have partnered with Investec to provide excellent call rates. Should you, your trust or your company or CC be exposed to tax, like I am, please talk to us about a liquid, tax efficient and safe product we have put together with Sanlam. It currently offers a significantly better after-tax return compared to cash and money market funds, and which generates genuine dividends and a smaller element of interest, unlike some of the products out there which use complex structures and which have attracted the attention of SARS and Treasury.

It would seem appropriate to comment on the impending changes with regard to Exchange Controls. The Minister of Finance announced sweeping relaxations to current excon regulations and restrictions recently. These will, for most South Africans, mean the end of Exchange Controls and allow us to expatriate R4 million per annum to any foreign destination. This is extraordinary and requires careful thought and execution if seen to be appropriate. The relaxation is seen as a pawn in the rand-weakening strategy of government, but interestingly has been met with further strengthening as the dollar, sterling, euro and other currencies jockey to weaken their currencies to lessen the economic woes in their domestic economies. I mean, the Aussie dollar even strengthened for the first time to sell at a premium to the US unit!

Just a quick reminder, stay away from funny property based investments like the syndications on offer. The press is going to be riddled with tales of woe as these schemes come to a predictable end. Much has been said about Sharemax. We don't know the inside story, but what one reads from credible sources is scary enough.

We expect a further interest rate cut, and I, personally, don't believe this will be the last. It remains for me to thank all of our clients, institutions and networkers as well as staff for your support and effort during this extraordinary year.

We, at NFB, wish you well over the festive season and for the year ahead - wait for it - 2011.

Mike Estment, CFP® BA
CEO, NFB Financial Services Group

IN THIS ISSUE

From The CEO's Desk
The Resilient Rand
The Risk-Reward Relationship In Equities

THE RESILIENT RAND

The rand dollar has been the topic of many a dinner table and braai in recent months and its continued strength has investors asking: "Why?" In this article we will recap what impacts on currency valuations and what is happening in the global market and what is keeping the rand at its current strong levels. Written by Jeremy Diviani, Private Wealth Manager - NFB Gauteng

Firstly, I would like to recap some basic economics and see what the main drivers of a currency's strength or weakness are.

The Current Account is the difference between a country's exports and imports and a deficit (which is what South Africa currently has) is when that country imports more than it exports. This is generally a bad thing for a country and in order to pay for the imports one has to buy dollars, sterling, euros etc. and sell rands. If we are therefore net sellers (i.e. net importers) of rands there will be an oversupply of rands and so the value of the currency will depreciate. The concern with a current account deficit is that if it keeps on increasing the local economy will remain dependant on foreign imports; thereby keeping the local currency weak.

Another contributor to currency strength or weakness is the country's total debt relative to its GDP. This ratio is similar to a company's debt to asset ratio. If this ratio gets out of hand it is a concern for investors and may lead to the selling of the share. For South Africa, debt to GDP is roughly 40%; whereas the US is roughly 90% and rapidly moving towards 120%, the UK roughly 90% and Japan 200%. This gives a strong backing to the argument that maybe the rand is not strong, but rather that there is dollar, sterling and yen weakness driving our strong currency.

Another factor that impacts the value of the rand is currency flows. If there is a constant amount of rands in the market place and demand for rands increases, Economics 101 states that the rand must strengthen. Currently the rand is in demand and the South African government is not buying bonds to increase the amount of rands in circulation and so the rand is strengthening.

Property rights also impacts on the demand for a currency. If the government takes away the right to own what is yours it impacts foreign investors and may lead to a selling of rands. Zimbabwe is a clear case in point and investors will be hesitant to enter Zimbabwe while the government has a policy of the state taking ownership of companies and land.

We can see that the decisions that governments make don't necessarily impact the currency directly, but definitely have knock on effects. There has recently been commentary that the central

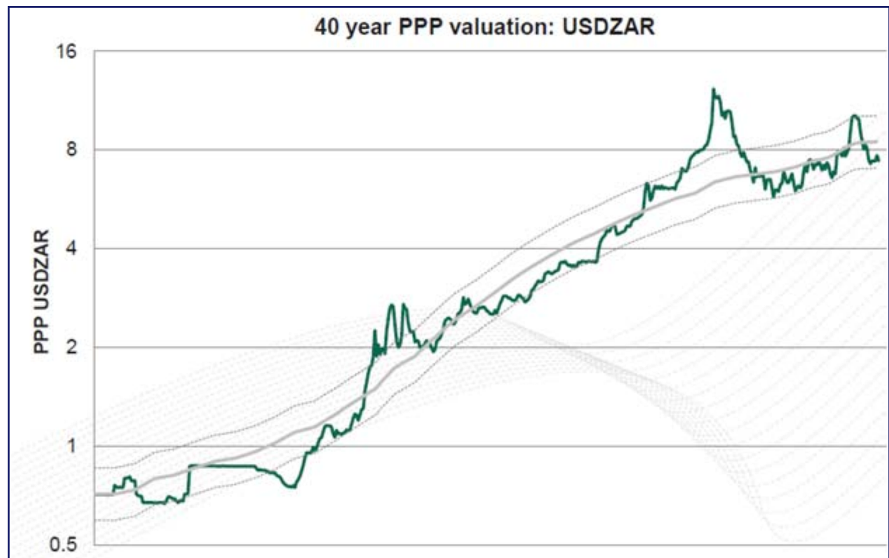
bank must step in and weaken the currency to help our predominately export driven market and help certain industries against strong imports from China. The problem with this argument is that in order for the central bank to weaken the currency it would have to buy back its bonds with foreign reserves and unfortunately our reserves are not at a level that will make an impact. This means that the currency is controlled by the world commercial banking sector and foreign investors and if they decided to sell off the rand, they could impact its value, as was shown in 2008 when the developed world moved out of emerging economies and the rand ran to its worst levels in 10 years.

With this in mind let's look at some of the factors that are keeping the rand at the current strong levels. The rand strength is as a result of the global investor searching for yield. The developed world is currently offering next to nothing for cash and bond yields are low. South Africa, alternatively, has attractive cash yields of around 5%-6% and government bonds yielding around 8%. This global search for yield has also filtered into our listed property market and year to date this is one of the top performing asset classes. The yield search is complemented by the carry trade where foreign investors can borrow at next to nothing and invest in SA for an attractive net yield.

To put this into perspective roughly R100 billion has flowed into South African bond and equity markets. Roughly 75% has flowed into the bond market and the balance into the JSE. During the whole of 2009 R100 billion was received into SA. This illustrates the increase in flows from foreign investors. This is also not a phenomenon restricted to South Africa as we can observe other developing, resource driven economies have also received flows. The concern with this currently accelerated increase of flows into SA means that the strength could unwind if interest rates in SA are cut significantly and, dependant on the offshore investors' appetite for currency risk, we may see funds leaving our shores. This mass selling of rands will depreciate it.

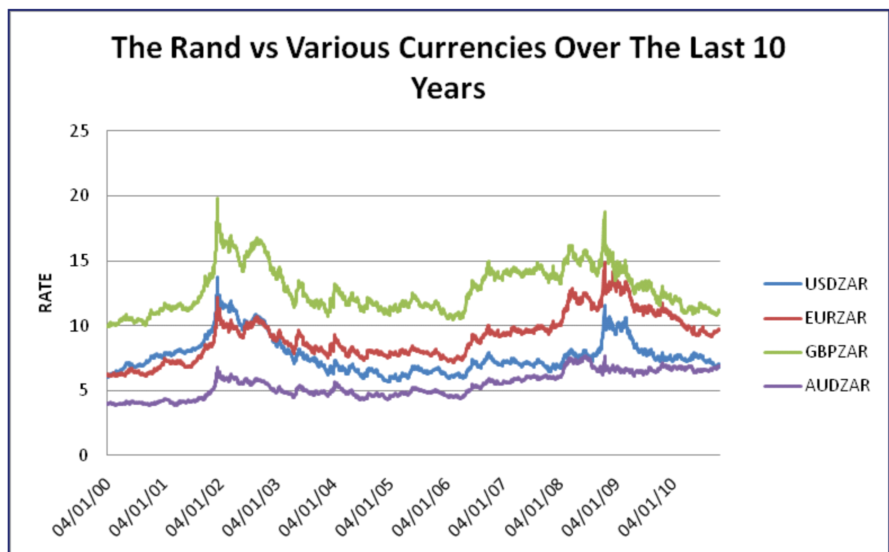
When assessing whether the rand is over or undervalued one can look at the Purchasing Power Parity of the two currencies being valued. Simply put, assume the same widget was produced in South Africa and the US and that in year 1 they both had the same purchase price. In South Africa we have an inflation rate of around 3.2%; this means that the price of our widget will increase at a minimum in year two by 3.2%. However, in the US, they have a 0% inflation rate currently and so the same widget will not increase in price in year two. The exchange rate is the balancing mechanism and so the rand should depreciate against the dollar. Therefore, our rand should depreciate at 3.2% per annum against the dollar for the current year. The rand, however, has done the opposite and has strengthened about 9% this year.

Investors often ask if the rand can get stronger from here; in such circumstances it is always good to remind ourselves of previous highs and lows – the rand reached R2.21 to the US dollar in 1986 and one of its worst levels was in 2002 when it was at R12.31. This purchasing power parity is graphed below and it also shows that using historical trends the rand is currently overvalued.



Source Nedgroup Investments

This leads us to see that there is an opportunity in the offshore space and while the rand is strong one can diversify ones portfolio into new geographical regions and currencies. This investment is not to be traded back into rands, but is rather an opportunity to get a greater number of dollars or shares or units for your allotted R4 million offshore allowance. If you wish to discuss this further we recommend you talk to your NFB Wealth Manager.



THE RISK-REWARD RELATIONSHIP IN EQUITIES

With investing directly in equities becoming increasingly accessible, it has become increasingly important for investors to understand the dynamics of the market they are invested in. Written by Chris Lemmon, Director/Portfolio Manager - NVest Securities

With the implementation of screen based trading and the abolition of the open outcry system on Diagonal Street, the Johannesburg Stock Exchange has become increasingly accessible to investors looking to take direct equity exposure in their investment portfolios. With more and more retail investors entering the market, it has become increasingly important for them to understand the dynamics of the market they are invested in, as well as having an understanding of the relationship between risk and return.

Modern portfolio theory posits that every investor attempts to maximise their return for a given level of risk. Intuitively this makes sense as one would expect to make greater returns by investing in direct equities, where one puts capital at risk to participate in the profits of a business, than one would expect from money market yields, or in fact government retail bonds with their underlying guarantee. Where this gets a little more intricate in portfolio construction is that not all equities carry the same inherent risk.

While there are a number of ways in which an investor can protect themselves against unnecessary risk, we will look at two specific factors. **The first is to commit only long-term money to the construction of your portfolio.** A carefully constructed equity portfolio is a powerful investment vehicle, providing an investor with real growth over the long-term. However, the risk of negative equity returns increases significantly as one's investment horizon compresses. This risk is magnified where investors take positions in the equity market on already committed money. It is specifically in this instance that traders are forced out of the market in loss-making positions to cover other financial commitments falling due. We subscribe to the idea that the market will track earnings growth over time, but routinely goes through periods of euphoria and pessimism. While a fundamental review of a company's financials gives one insight into their ability to grow earnings, underpinning share price appreciation, market sentiment is far more difficult to predict. Although relatively short in nature, it is a powerful force that can drive returns for a number of years. The JSE today is a good example of this phenomenon, as the market tries to price a recovery from the depths of the financial crisis we're currently trading on a trailing PE of 17.62, a premium of approximately 20% over its long-term average.

The second way to manage your risk is to understand the company and industry you are investing in. Different industries carry different risk profiles, with cyclical businesses such as mining companies, Anglo American as an example, far more vulnerable to an economic slowdown than a pharmaceutical company such as Aspen. This is further illustrated by a share's beta coefficient. With the market at a beta of one you would expect a company with a beta of more than one to be more risky than the market i.e. its share price variation relative to its historic average is greater than the variation on the return on the market relative to its long term average. This is clearly evident when looking at Anglo's and Aspen. Anglo American carries a beta coefficient of 1.32 (remember a cyclical business and more volatile), while Aspen carries a beta of 0.32, a defensive pharma business.

Besides industry specific factors, each company carries its own unique elements of risk. From capital structure to cash flows, earnings profile to capex expenditure, small growth businesses to mature industry stalwarts, each brings with it a unique relationship between risk and reward. As an investment house we tend to look for protection (or lower risk) by buying companies we believe trade in value territory. Broad value metrics include low price to book and price to cash flow multiples, low PE ratios and higher dividend yields. In an uncertain environment a focus on key fundamentals allows you to make conviction calls on businesses you understand and that offer reasonable downside protection. **Remember modern portfolio theory: you need to understand the risk you have taken on in your investment portfolio to assess its performance correctly.** ⊕

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