



FROM THE CEO'S DESK

I have just turned 50 and returned from a wonderful two-week break in Italy. So, what is so remarkable about either event? Well, I discovered the scary reality of global inflation and had the time to contemplate the somewhat bleak outlook if things don't revert to the mean.

Amongst many notable price changes, measured in euros, we found food prices were significantly up on a year and even six months ago. Petrol, or more correctly Diesel, cost us 1,5 euro or roughly R18 per litre! The demand for goods, emanating from the East, is unrelenting and I am not sure that there is any obvious end in sight.

Back home, we have suffered the embarrassment of the xenophobic attacks and the crime around these events. I am not sure that the Government is willing to accept their own constituent's dissatisfaction with the desperately slow delivery of the promised housing, services and security. The current highly charged and totally ineffective cabinet, still de jure run by Mr. Mbeki, is second-guessing the elected new elite of Comrade Zuma and his shadow cabinet. The Government continues to conduct themselves in a manner which serves only to underpin their detractor's views of incompetence and myopia.

At the same time spare a thought for investors and investment advisors alike. Just seven months ago investment sentiment was at an all time high, forecasts both locally and abroad looked sure to support high double digit returns in growth assets and interest rates looked sure to have peaked and were set to begin a decline back to the lows we had experienced a few years earlier. So what went wrong?

Firstly, Polokwane. It tumbled the current cabinet and sent a strong message that the country was calling for a new leadership, more intent on delivery of more to more.

Secondly, the alarming continuation of the almost vertical trajectory of the price of a barrel of Brent crude oil! From a price of US\$40 per barrel in January 2005, already high by historical standards, it rocketed to US\$90 per barrel in January 2008 and has recently topped US\$130 per barrel!

This represents a form of global taxation and also pressurizes farmers into redirecting grains and maize as well as sugar cane into the production of fuels. This, together with a growing demand for non-staple foodstuffs from the East, particularly China, is causing shortages and consequent inflationary pressure on foodstuffs.

The danger I see developing, far quicker than any of us believed reasonable, is a resurgence of very high inflation. The problem with the current causes of this inflation is that monetary policy will only have a muted effect on the reversal of the trend. The next issue will be significant upward pressure by organized labour on salary increases, particularly for the lower end of the labour market, and this can lead to added inflationary pressures as were last seen a decade ago.

Practically this sets an interesting challenge for investors and their advisors alike. Inflation beating

returns require you to achieve anything above the Consumer Price Index (CPI). In the last few years, this implied returns of between 5% to 6% or maybe 7%. Now, with inflation officially hovering around 10%, one needs to achieve 11% or 12% to be maintaining the buying power of your rands! Clearly, this will not be easily achieved as costs and tax, in its various forms, must first be taken into account, before determining the net return and then there is still the investors need to draw income which must be considered.

Another concern of mine is the rand. Having encouraged our clients to take advantage of what has been a remarkably strong currency, we find ourselves in a position now where the local unit has weakened to approximately R8 to the USD and R12 to the euro. Is this the end of the game and where to next? Probably a good, broadly applied, rule of thumb, applied rather successfully in the past, is to subtract our CPI, from that of the country whose currency you might be keen to invest in.

The net difference should approximate the depreciation your currency will suffer, compared to the other unit where inflation is lower, and vice versa. Putting this in plain English, if we have an inflation rate of 12% and the euro zone an inflation rate of 2%, the rand should lose 10% that year to keep things on an even keel. This rule of thumb does not even begin to factor in other issues such as a change in global sentiment to South Africa or other emerging countries, nor does it factor in political disruption or changes for the better or worse. Of great importance, we need to bear in mind that while we live here and suffer from emotional attachment to our country, international portfolio managers do not! They are devoid of emotion and should they believe that markets or the rand are getting too hot or are vulnerable to domestic or regional developments, they will sell without blinking an eye.

We remain keen on our clients availing themselves of their foreign allowances and have a few interesting solutions for family trusts who cannot invest directly into foreign investments. A further opportunity which NFB has applied itself to, is in the offering of products which allow the investor to gain exposure to the much needed growth offered by equities and other growth assets both locally and abroad, whilst underpinning these with guarantees of capital or even a moderate positive return. These offerings are wrapped in tax efficient structures, which suit individuals and more specifically trusts, where otherwise significant Capital Gains Taxes result.

These products go a long way to providing investors with a hedge against higher inflation, particularly where they enjoy adequate income from existing investments and are seeking strong growth but without full exposure to the volatility and risk, which typifies equity-like investments.

Mike Estment, CEO

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ALL IS NOT AS IT SEEMS



The current reality of the South African market is that all is not as it seems and as the old adage goes "one should never judge a book by it's cover". Written by **Andrew Duvenage & Grant Magid**, Financial Advisors - NFB Johannesburg

There is an old adage that says that 'one should never judge a book by its cover'. Investors would be wise in applying this pearl of wisdom when considering the fortunes of the local market, and trying to understand the performance of their portfolio.

The current reality of the South African market is that all is not as it seems. Many investors track the performance of the market by looking at the level of the All Share Index. Having recently reached all time highs at around 32300 points, an investor would be forgiven for thinking that all is well on the investment front. In reality, the situation is rather different. The South African market is, in a sense, an anomaly in that a few very large companies make up a disproportionately large part of the market. As much as 40% of the market capitalisation can be attributed to 4 companies (namely Anglo, BHP Billiton, Angloplats and Sasol).

What does this mean? If these few large companies' share prices rise, the All Share index will also rise, creating the impression that the entire market is moving forward. However, if one looks deeper, it may well be the case that the majority of shares in the market are under huge pressure, and are in fact losing value, but this is hidden by the disproportionate weighting of the performing shares.

The graph below shows this in practice. If one goes back to September 2002, the JSE All Share Index is up just under 250%. However, if one strips out the performance of the four largest shares on the market, the return would have been far more modest at around 70%.

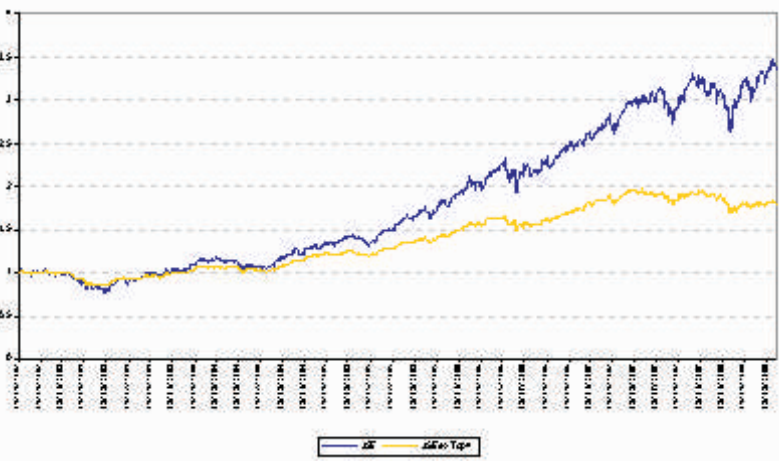
If one looks at the 12-month performance of the JSE (until 1 June 2008), a return of 11% would have been recorded. However, if the performance of the abovementioned shares is stripped out, the index was down 15,33%. In the same time period the Financial Sector was down around 30% and the Industrial Sector was down 8%. The performance of the overall market has been very different to the performance on the All Share Index. This may have resulted in a degree of disappointment for clients who have based their performance expectations on the All Share Index, but have in fact received far lower returns as a result of having more diversified exposure to the whole market.

The question is "How does this relate to an investment portfolio, and how does one use this information?"

In a market like we have seen in recent times, a resources super cycle, the index would have outperformed most actively managed equity funds as it would be an extremely risky strategy for fund managers to invest as heavily as the index in 4 or 5 shares. Investors may query whether they should simply invest in index funds as these are often a cheap option and seem to have performed better than fund managers in recent times.

The answer to the question is that while having exposure to index funds may play a part in a well-balanced portfolio, as a low cost component, it is certainly not a panacea for one's investment needs in

the equity space. The nature of the SA market is that index funds are over-weight resources, and thus if resources do well, so will the index. The issue is: for how long can resources continue to outperform all the other sectors in the South African market? At some point the converse must also apply - when resources under perform other sectors, your index investments will do the same. With resources having enjoyed tremendous growth over the last 5 years, a prudent investor should be considering whether there is value elsewhere in the market, and the most likely answer is yes. Financial stocks, for example, have significantly underperformed as a result of the world's credit crunch, and in reality are more fairly priced



than some resource counters and other shares (see attached graph).



It is at this point that the advantages of using an actively managed solution in a portfolio will come to the fore, as an actively managed fund is not constrained to the weightings enforced on an index fund. Active managers are able to purchase shares based on their estimations of value. Given how skewed the South African market has been over the last while, in terms of drivers of market performance, this has to be an attractive strategy.

In times of volatility, it is interesting to note trends that start to become evident in investor behaviour and in market movements.

Market Trends

The first trend that we would like to note is that of large numbers of investors choosing to sit in cash, with the objective of riding out market volatility and re-entering the fray at the start of another bull run. With interest rates in a money market type of investment currently sitting at around 11%, with the prospect of further increases given Tito Mboweni's stern warnings, investors would be forgiven for indulging themselves with the relative comfort and stability of this strategy. Unfortunately, in practice this strategy is perhaps not as viable as it may seem. This strategy has problems from both a short term and a long-term point of view.

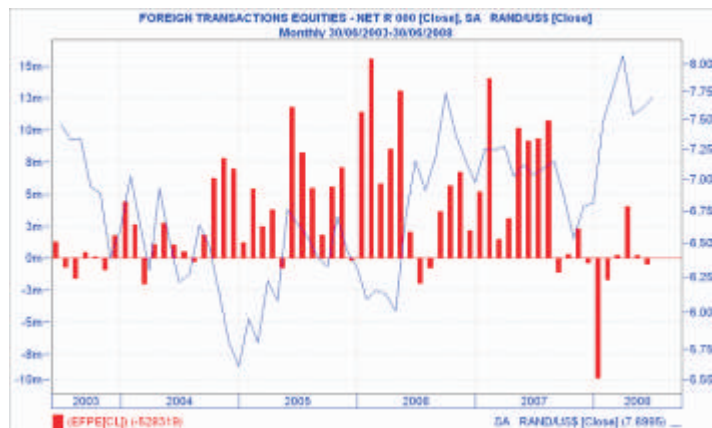
In the short term, it is difficult if not impossible to correctly time the bottoming out of a market. Sitting long of cash and trying to time the market results in a high probability of missing out on market recovery and is a risky strategy to follow. As the saying goes, long-term wealth creation is about "time in" the market as opposed to "timing" the market!

There are also risks associated with staying in cash in the long-term. With interest rates at 11% investors may believe that a good risk free rate of return is being achieved. Investors are forgetting two critical factors that need careful consideration, namely tax and inflation. The interest that is generated by cash is taxable according to the marginal rate of an investor. In the case of a 40% taxpayer, the net return derived from cash is significantly different to the gross return on offer. An investor needs to compare this net return to inflation to determine if, in fact, they are getting real returns.

Currency Volatility

The other issue worth discussing at this point is what we currently perceive to be the current vulnerability of the rand. Classical economics dictates that if an economy runs a current account deficit, the currency associated with that economy will depreciate unless it can manage to attract foreign investments into the economy to finance the deficit. These inflows come into two forms, namely fixed investment (plant and infrastructure), or investment into the stock market (known as "hot flows" of money). If these inflows match the outflow of funds as represented by the current account deficit, theoretically the currency should remain stable.

In the South African context this school of economic theory is particularly interesting. The Eskom power issue has resulted in a significant slow down of foreign direct fixed investment as a result of both perceived and actual capacity constraints. This has resulted in South Africa being almost exclusively reliant on flows into the JSE and the bond exchange to protect our currency. The problem with this is that should foreign investment money leave, our currency will come under immense pressure. When one considers that foreign investors account for more than 50% of the JSE's market capitalisation, it is easy to see the potential problem.



This exact scenario played out in February and March of this year. As one can see in the attached graph, February 2008 saw significant outflows of money from the JSE (around R10 billion), and almost immediately the rand nose-dived from below R7 to the dollar to over R8 to the dollar. The rand subsequently strengthened on the back of inflows into the JSE in April. The point though is the alarming relationship between the fortunes of our currency and flows of money into or out of our market. Should a huge change of sentiment occur towards emerging markets, or more specifically towards South Africa (at this point words like xenophobia, political vacuums, and corruption raise their heads), the rand may be in for a torrid time.

In Summary

In the words of one of NFB's senior advisors "so what?" What does all of this mean and how do we integrate this into investment strategy? A few conclusions can be drawn from our observations and are summarised as follows:

- 1 Diversification in an investment portfolio is critical. The level and type of diversification, whether by asset class, currency, sector or manager will be determined by things like risk preferences and personal circumstances, but none the less remains the single most important principle in investing.
 - 2 In the equity space, index management has looked particularly attractive given low costs and recent performance. In a South African context though, it is not a panacea, and whilst it can play a part in an equity portfolio, a degree of active management is still important.
 - 3 Cash has a role to play in a balanced portfolio but when factors like inflation and tax are taken into account, it is not a viable long-term strategy. In the short term, cash may seem like a sensible place to protect wealth, but the timing risk when getting back into the market is something that one needs to be cognisant of.
 - 4 International diversification is mission critical. The potential weakness of our currency, the very real political and economic problems that we face, and the principle of international diversification necessitates the use of international assets in a well-balanced portfolio.
- Do not succumb to knee jerk reactions. It is tempting to make drastic changes in turbulent conditions - especially when losses have occurred. Very often though this can be compared to changing sail in a storm. A well thought out, predetermined investment approach is more likely to have favourable outcomes in the long term than an emotionally charged approach. ○

Featuring : Berkshire Hathaway

NFB prides itself on aligning its investment philosophies and the products it structures for clients on the best that the world has to offer. Recently NFB structured an investment based on Berkshire Hathaway's shares and the investing talents of its founder, Warren Buffett. Here then is a synopsis on the man himself and the company he manages. Article by Gavin Ramsay, Director - NFB East London

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."
~Warren Buffett

Warren Buffet - the entrepreneur

If there is any investor who you could look up to and use as a "role model," Warren Buffett would be your man. He takes a simplified and long-term approach to investing and he has put Wall Street day-traders to shame. He is without a doubt one of the greatest investors of all time, but when you hear him speak he is likely to resemble your grandfather with his sincerity, down-to-earth nature and wisdom from years of living. Often called the "Sage of Omaha" or the "Oracle of Omaha", Buffett has amassed an enormous fortune from investments managed through the holding company Berkshire Hathaway, of which he is the largest shareholder and CEO. With an estimated current net worth of around US\$62 billion, his wealth has surpassed that of Bill Gates for the first time to become the wealthiest person in the world.

Since taking over Berkshire Hathaway, Buffett has weighed every decision against its impact on the balance sheet. As of 2005, he had succeeded in building Berkshire into one of the nine companies that are still rated by S&P as AAA, the highest credit rating achievable and, thus, with the lowest cost of debt. Buffett takes comfort in his belief that, for the near future, his company will not be one of those shaken by economic or natural catastrophes.

Berkshire Hathaway - the company

Berkshire Hathaway is a conglomerate holding company headquartered in

Omaha, Nebraska, United States, that oversees and manages a number of subsidiary companies. Berkshire Hathaway's core business is insurance, including property and casualty insurance, reinsurance and specialty nonstandard insurance.

The Company has averaged a 25%+ annual return to its shareholders for the last 25 years and 21.1% for the last 43 years while employing large amounts of capital and minimal debt. \$1,000 invested in Berkshire Hathaway shares 43 years ago would currently be worth \$3,628,000, with 2001 being the only calendar year in which the share price has gone down. The S&P 500 Index returned only 10.3% per annum (including dividends) over this period, losing money in 10 of the last 43 years.

The company owns a diverse range of businesses including those in candy production, retail, home furnishings, encyclopaedias, vacuum cleaners, jewelry sales, newspaper publishing, manufacturing and distribution of uniforms and manufacturing, importing and distribution of footwear.

The share price of Berkshire's Class A shares is around \$130,000, making them the highest-priced shares on the New York Stock Exchange. Berkshire Hathaway is notable in that it has never split its shares, which not only contributed to their high per-share price, but also significantly reduced the liquidity of the stock. This refusal to split the stock reflects the management's desire to attract long-term investors as opposed to short-term speculators. The result is also that the Berkshire Hathaway share price trades at a discount of around 25% to underlying assets reinforcing the share as a true value proposition.

Although by no means a complete list of all the holdings and subsidiaries of Berkshire Hathaway, the list below includes some of the companies where Berkshire Hathaway have a material stake:

- The Washington Post Company (18.2%)
- Anheuser - Busch Companies (4.8%)
- Kraft Foods (8.1%)
- American Express (13.1%)
- The Coca-Cola Company (8.6%) - the profits of every 12th Coke sold accrue to Berkshire Hathaway.
- Wells Fargo (9.2%)
- Johnson & Johnson (2.2%)

Warren Buffet has proven himself as the best value investor of all time. Current market turmoil is the perfect environment for unlocking value, and no one is better suited for the job. ○

Contact us: