



FROM THE CEO'S DESK

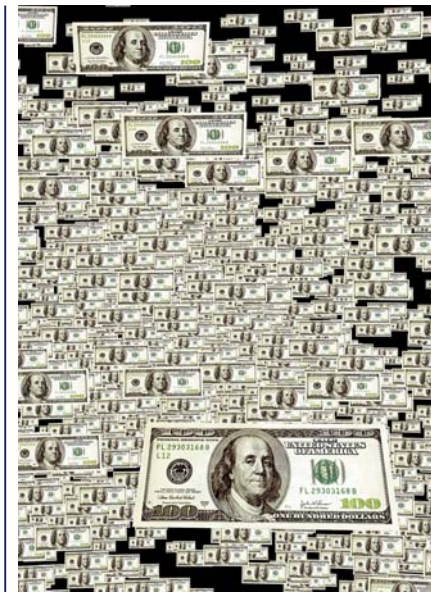
After every uphill there comes a downhill, and vice-versa also holds true. Having just returned from a three week sabbatical during which I, and a bunch of strangers under the watchful eye of Sean Wisedale - author, renowned South African high altitude climber and guide - trekked to Everest Base Camp. I found this truism appropriate and highly relevant during the waking hours of every day. Most notably it applied in the first half of the hike where we were all acclimatizing; disguising how lousy we were feeling, for fear of being sent down the mountain, and not reaching the dreamlike destination of "Base Camp Everest". After all was said and done, 18 of the 19 people who set off from Lukla made it, and all the worry and early trepidation proved a waste of nervous energy! Probably the craziest and riskiest part of the journey was the flight into and, most importantly, the landing at Lukla which has the reputation of having the shortest commercial runway in the world. The Nepalis have countered this risk in a most innovative way: they have built the runway on a crazy uphill where its length, less than 300 metres, is offset by the 15 degree uphill it's built on. This stops the plane before hitting the mountainside that abruptly announces the end of the runway and assists departing flights by offering a crazy acceleration down the hill. I must admit that the lousy food in general makes for lighter passengers departing, which also helps.

So, one might ask: "what does this have to do with our investments"? There are a few parallels between the above brief description of an intriguing trek and the task of negotiating the morass of financial markets as experienced over the last period. Firstly, while being far from convinced that the bear market is all behind us, there is no doubting that we have been severely hammered of late and we are now fast approaching that point where our markets will begin to find traction. There are pundits, economists and money managers who argue that the bear has left town. I am less convinced,

although, as mentioned on CNBC the other day and like many of us, I will be trying to get a sense of the bottom and begin, as a professional advisor and individual investor, to reinvest into the trough. My sense of things is that the baby has been let out with the bathwater and already certain equities and other investments have been the beneficiaries of a marked positive correction. When the entire market follows suit, which is less logical, we soon hear about the turn around. Bear markets, born out of economic crises, such as the one we are living in, last longer than the mean. This fact alone makes me concerned that those predicting a major turnaround in the fortune of the market are either short-sighted, perhaps have a big bet on their view or simply aren't aware of the persistent news indicating massive slowdowns in production, sales, job creation and bank lending, all of which would need to reverse materially to allow us to become supremely positive in our short- and medium-term prognosis.

Having said the above, I would expect rapid correction when it does finally come to stay. We are fast reaching the point where investors will be getting gross (pre-tax) returns of 7% on call. They will be seeking out alternate, more rewarding returns, which would typically come from property investments or equity-based investments, where the capital risk is greater, but the probability of better net results when adding income, dividends and capital gain is higher. Notably, the big pension fund investors with long term strategies, will also be starting to feel the pinch. They will be among the first to be willing to apply some of the vast cash flows and incomes they have been hoarding on call into riskier longer term growth assets. The NFB team are watching things develop and will do everything in our power to ensure the growth-oriented portion of your portfolio is aboard the plane when the market finally finishes its ups and downs and is ready for a takeoff from Lukla.

Mike Estment, CEO



IN THIS ISSUE

From the CEO's desk

Is it in your best
interest?

Inflation



financial services group

Is it in your best interest?



When last did you hear the old adage: “Markets work in cycles”? Interest rates, inflation rates & equity markets all move in cycles. Over the last 10 years the prime lending rate in South Africa has fluctuated between a high of 19% (May '99) and a low of 10.5% (June '06). What are the knock-on effects of fluctuations in interest rates in South Africa? By Alistair Holmes & Grant Magid, Financial Advisors - NFB Gauteng

The impact of interest rate movements is more intricate and vast than one initially thinks, but what needs to be considered is that interest rates are effectively the only tool the Monetary Policy Committee (MPC) has at its disposal to influence a multitude of economic facets. These include combating high inflation; managing the exchange rate and, through various economic linkages, either accelerating or decelerating the GDP growth rate.

In light of the recent global financial crisis and the resulting slowdown in global economic growth the MPC has, and are likely to continue to, cut interest rates in order to stimulate economic growth. These cuts have been met with jubilation and desperation. Those who have over leveraged themselves are on the opposite side of the spectrum compared to those who rely on cash investments to provide their monthly income. We have seen interest rates drop a total of 350 basis points in the last 6 months. We have all been talking about it, even predicted it, but what are the implications?

Initially, many of us will feel relief as we experience an increase in our monthly disposable income, as debt repayment obligations reduce. This could lead to a propensity for those luxuries we could not have 12 months ago. This false sense of security could very well lead to even more people falling foul of spending more than they earn. Keeping your monthly bond repayments at the previous high will enable you to pay off your bond more quickly, thereby saving you thousands of rands. In the example below, we look at a simple R1,000,000 loan over a twenty year period, comparing the recent peak lending rate against current leading rates from the perspective of repayments and term:

Loan Amount	R1,000,000
Interest Rate	15.5%
Term	20 Years
Monthly Payment	R13,366

Loan Amount	R1,000,000
Interest Rate	12.0%
Term	20 Years
Monthly Payment	R10,902

Loan Amount	R1,000,000
Interest Rate	12.0%
Term	11.5 Years
Monthly Payment	R13,366

On a loan of R1,000,000 over a twenty year term, there has been a monthly saving of R 2,464 due to the decline in interest rates. Should this saving be used to accelerate your debt repayment, you will pay off your obligation in nearly half the time.

This is only one end of the spectrum, however, there are many people who are debt free and rely on conservative interest rate linked investments to provide their monthly income. These individuals are feeling the pinch now. Twelve months ago, money market instruments were yielding a gross return of approximately 12%. Due to interest rate cuts this level of income has been reduced by roughly 30%. This is significant in anyone's book. The effect of income tax also needs to be considered.

Current Interest Rate	8.00%
After Tax (assume tax at 30% and a depleted interest income exemption)	5.60%
Inflation Rate	8.55%
Net Real Return	- 2.95%

At present the after tax return of money market type instruments will not enable you to avoid the erosive power of inflation. There is now a very real need to find consistent, stable, inflation beating returns to ensure that your purchasing power isn't eroded through your retirement years. Fortunately, interest bearing investments aren't the only investment options available; there are other options which need to be considered. These include:

1. Structured Investment Products

By the end of 2008, the countries that account for 43% of the global economy were in recession, and the recession has spread this year, touching almost every corner of the world. The local equity market fell 26% in 2008 with global markets losing around 42%. Due to this unprecedented volatility, structured products are being engineered to give investors certainty over a predetermined period of time, hence limiting the risk of investing in equities. Fundamentally structured products can offer you the following:

- A capital guarantee by a top rated institution
- A minimum investment return
- Exposure to equity investments (both locally and abroad) and
- Tax efficiency.

The question to ask yourself is: can your equity manager guarantee you a dividend yield in the region of 4%, guarantee your capital and give you exposure to an equity investment? Structured products can!

2. Property Based Investments

Bricks and mortar are visible, tradable and inhabitable and because of this most investors spend significant amounts of money continually modernizing their homes and having somewhere to run a business from. Residential property is but one of the options when investing in property. Commercial or industrial rental property, Property Unit Trusts (PUT) and Property Loan Stocks (PLS) are other types of property investments clients can purchase to gain exposure to this asset class.

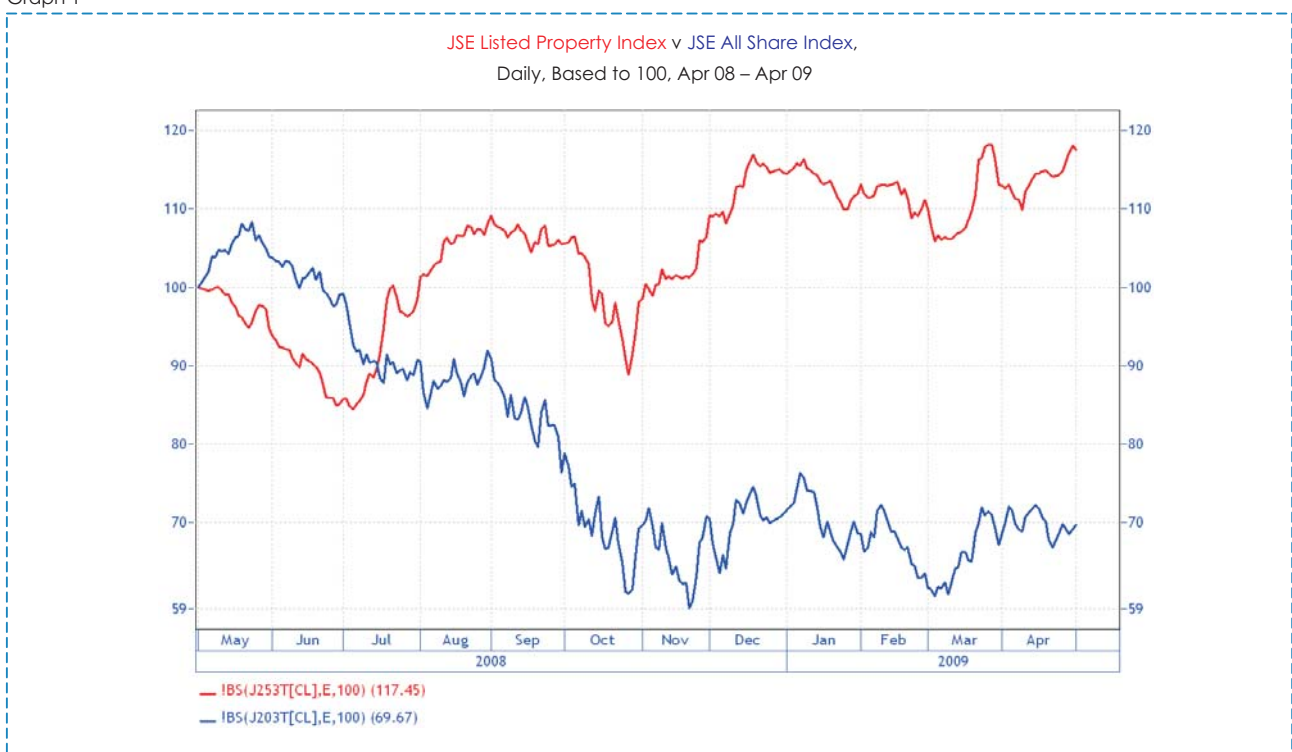
Over the last year Property Unit Trusts (PUT) and Property Loan Stocks (PLS) have outperformed local equity markets by giving clients a return of 17% over the last year (see chart below). Property has the ability to add value to an investment portfolio due to its low correlation to other asset classes. Because of the effects of the recent global meltdown and the slowing of the South African economy, finding portfolios with prime rental properties will come at a premium. With earning yields still around the 7% p.a range they make property an attractive and viable alternative at this point in time. The graph below indicates the upward movement of property vs equity over the last 12 months. (See graph 1 below)

3. Dividend Income Fund & Preference Share Investments

Fundamentally, these two types of investments are similar in that they are both equity based and their returns are in the form of dividends. The benefit being that currently, dividends are tax-free, whilst cash investment returns are subject to your marginal tax rate on any amounts in excess of your annual tax exemption (R21,000 for individuals under age 65 and R30,000 for individuals over 65 years old). The difference between these two options is that preference shares pay a dividend based on a percentage of the central bank lending rate, otherwise known as the repo rate; this percentage is generally between 65% and 85%, whereas dividend income funds derive their divided yield from the dividend profile of the shares they hold; the average dividend yield on the JSE has roughly been 2.8% over the last 30 years. There is an opportunity for capital growth of the underlying shares in both cases.

The essential question is: if the return on these dividend paying investments is greater than the after tax return of cash, is the additional risk incurred worth the additional return?

Graph 1



While there are risks associated with equity based investments, the recent past has all too adequately shown that cash is not without risks such as:

- Default Risk;
- Interest Rate Risk;
- Re-investment Risk and
- Liquidity Risk.

It must be noted that cumulatively though, the following risks inherent in equity based investments, are greater than those of cash:

- Market Risk
- Liquidity Risk
- Retention Ratio Risk

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 an investment strategy? A few conclusions can be drawn from our observations and are summarized as follows:

- Interest rates should continue to fall for the rest of this year, and the ability for cash to give you an after-tax inflation beating return is diminishing.
- Diversification in an investment portfolio is vital because of the inability of cash to generate the level of returns needed. 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.
- Structured Products are able to give more conservative investors the ability to retain their capital and still participate in an aggressive equity investment.
- Property still offers good value and using the appropriate property managers should enable you to achieve stable returns with low correlation to market volatility.
- Dividend Income Funds and Preference Shares offer good value in volatile economic conditions, but companies' earnings and interest rates are under pressure.
- **It is in your best interest, and ours, to carefully evaluate where you are, but also to adapt your game plan for what we believe is going to be an interesting journey.** ⊕



INFLATION SET TO ATTACK THE GLUT OF GREENBACKS

Just as the decadent indulgences of intangible credit has led to recessionary ailments, so the artificial stimulus of “money printing” carries with it some serious side effects. Written by Philip Bartlett, Financial Advisor - NFB East London

Acting more like a paternal surgeon upholding the oath of Hippocrates, as opposed to the bastion of capitalism, the fed has refused to allow the natural course of corporate deaths to balance the playing fields.

With interest rates being slashed, almost touching zero, and the Fed printing more money in the last twelve months than the previous 19 years combined, there's little doubt that inflationary cramps will follow the masking of the pain that ought to have been.

Positioning oneself against the eroding impact of inflation is essential to real growth and although benefitting from an induced deflationary environment in the short term, inflation in the US is going to have a significant global impact.

Ultimately, the recent demand for cash and more specifically Dollars, will be replaced with a demand for “things”. Not just things that hedge against dollar weakness i.e. gold, but things that offer inflation hedging with productivity-linked growth e.g. Platinum, Steel and Oil.

It makes sense that with cash devaluing and monetary policy eventually forcing interest rates up, holding cash and bonds just won't do the trick.

Priced in dollars, commodities will cheapen, especially for those holding Euros and Sterling, stimulating trade in the resource rich, emerging economies and stimulating production. That should be

good news for SA, especially considering mining desks dictate our market direction.

Property will once more enjoy its cyclical journey into favour as the stability of bricks and mortar begins to stack up against holding money in the bank. And so the ebb and flow of the market place will return. And while this all sounds so simple and logical, it's the timing that's not!!

Investors will have to overcome the once bitten twice-shy mantra and seek yields amongst the sweat and dust of very turbulent equities, commodities and fixed asset markets - the very same assets that have recently disappointed.

The tragedy is that the cancer of inflation will be well entrenched, before Mr Legitimately Weary realises he is farming backwards, and now wants, or more likely needs, a piece of the action. At this time markets will have re-rated and so the buy high-sell low cycle will rob the wary, cynical and /or naive.

It's hard to step away from the carnage of a recession, and look forward, especially when the immediate pain has immobilised many into apathy. But, with a strong possibility of dollar weakness and the need to move out of cash there is no doubt that its only a matter of time, before investors will have to leave the cover of their trenches and actively engage with the old enemy – once more into the breach dear friends, once more. ☺

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