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FROM THE CEO's DESK

A few editorials ago, I offered comment on Comrade JuJu and noted that, although his woodworking skills were sadly lacking, he was endowed with other skills with far more sinister potential. Not a year has passed and our academically wanting Youth leader has seen himself re-elected and is ranting about the nationalization of assets, pillaging Sandton properties on their way to Pretoria to claim the mines and other things which he and his cohorts regard as rightfully theirs. Now, under normal circumstances, we could chuckle at this impetuous nonsense, but I note the reaction he has gotten from the more mature, if no less radical, heads of Organised Labour and the Communist Party.

Add to this the somewhat surprising gains in the recent local elections celebrated by many of us as a victory for the DA who have, it seems, done a good job of delivery in the Western Cape and elsewhere where they are in charge, and you have an inflammatory situation where less than level headed politicians might lose the plot and make pre-election promises they, and we, might live to regret!

The risk to the ANC, as well as the individuals in office in the forthcoming Election (who only have to look back to Polokwane to realize that if Thabo could meet an embarrassing and ignominious end, so could they), is a voters' stay away or a landslide, either to a new political body, or even the DA. The easy way to avoid this is tacit support and rapid adoption (or even ownership) of this much vaunted and much feared strategy. In my opinion, it has never been more real than now.

Whilst this broadside has been launched we are also in the horrible season of wage "negotiations". This process in South Africa is never likely to be reasonable and is typically characterized with violent action taking place, where property, individuals and the economy at large are negatively affected. It takes a calm mind and loads of belief to manage one's way through these events and I am reminded of some close friends and family loading up on candles and bottled water 17 years back on the eve of our first democratic general election. We, as South African patriots, have developed rather thick skin and must remain aware and watchful, as our erstwhile State President FW de Klerk recently noted in addressing an eminent ladies group in Cape Town. He recognised our development as a democracy, but quickly warned the audience of the risks of not upholding the Constitution and its manic manipulation by the ruling party. He raises the Judiciary's inability to deal with renegade members, the prosecution authority's inability to pursue obvious miscreants and the effective attempt by government to compromise and gag the media by having the right to ban the publishing of details pertaining to misdeeds by the government. This stretches to the sublime level where almost 2000 subsections of government can individually decide what documents and which processes they are engaged with fall inside this "no go" area.

These developments, and the ANC's absolute failure to deal with elements within their senior ranks that are either under suspension or worse might be facing criminal charges, leads to a high level of mistrust and anxiety. Add to this the ridiculous legislation proposed around labour and the ever increasing difficulty and complexity of hiring (because you can't then fire!) whilst the president has set grandiose employment targets and one ends up more confused than ever! The question I'd ask is "Don't these guys ever talk to each other?"

All of this and more leads me to a conclusion. Not in the last few years have I felt more inclined to diversify exposure across geographies and currencies. Notwithstanding the fact that the alternatives to good old SA rand returns, either from markets or cash are dismally low and unexciting, I think that the local currency has remained surprisingly strong for an awfully long time. Overseas markets, selectively, offer lower and less demanding prices than our bourse. It is true, as many commentators remind us, that the developed countries are constructively weakening their currencies to probably make themselves more competitive in export markets, but everything goes in cycles and the rand's turn will arrive where it reverts to its long term weaker trend line.

Choosing to remain local is also OKAY. However, having a toe in the water would then be advised. By this I mean, where possible and affordable, ensure part of one's portfolio be exposed to growth assets as opposed to pure cash. The latter is OKAY at times, but long term, net of tax and after drawings and inflation, seldom delivers inflation matching net returns.

I am not proposing cautious investors run out and switch all their cash into equity. I am simply of the opinion that equity moves and rolls with the blows. If inflation ramps up, earnings will be positively affected and will eventually reflect in share prices, helping to maintain the real value of one's investment. Good shares also typically have a habit of distributing increasing dividends. These are both tax efficient and don't ebb and flow like interest rates tend to.

This editorial is intended to get you talking to your advisor and not as an outright recommendation. Each of us has unique needs, risk, return tolerances and cash flows. The point is we live in a stretched world. Governments, including ours, make promises. Most, if not all, are struggling to deliver on these. Our unique circumstance down on the southernmost tip of Africa is probably not so unique after all. What we need to do is grin, think, engage in healthy debate and then act, remembering that if all is good and well, not doing anything also represents an action!

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IN THIS ISSUE

From the CEO's desk

EFT's - Should you have any?

The Rand carries on trading

NFB
financial services group

ETF's should you have any?

Exchange Traded Funds (ETF's) have taken the investment world by storm.
Article written by **Brendan de Jongh**, NFB Gauteng, Private Wealth Manager

Exchange Traded Funds (ETF's) have taken the investment world by storm and have attracted just under $1.5 trillion of assets under management worldwide thus far (Blackrock Inc). Considering that the ETF industry was a little shy of $1bn of assets under management in 1993, this is significant growth. The ETF market is dominated by America with more than half of the market share, but South Africa is making a small footprint having introduced ETF's in 2000. ETF's are basically unit trusts that can be transacted through stock exchanges. They are therefore bought and sold like shares on the JSE, making this investment vehicle very popular with investors. The portfolio of securities in an ETF typically comprises the constituent securities of an equity or bond market index. In plain language you can "buy" an index (e.g. JSE Top 40, All Bond Index etc.) through one unit / share of an ETF. The asset classes covered by ETF's in South Africa include equities, bonds (including inflation linked bonds), property, fundamental indices, commodities and offshore equities. This is only the tip of the iceberg and if our ETF market were to follow the innovations in the global ETF industry we can expect to see many more offerings in time to come.

Asset allocation and diversification form a great deal of the decision making in portfolio management. Effective diversification involves mixing certain assets in such a way that the overall risk of a portfolio is minimised without sacrificing (or trying not to sacrifice) potential returns of the portfolio. This is achieved by blending assets or asset classes that have a low correlation to one another in an attempt to ensure smoother, more predictable returns. Quite simply it is the old adage of "don't put all your eggs in one basket". ETF's offer investors a means of gaining exposure to certain asset classes (through indexes) cheaply and quickly (efficiently).

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Because ETF's are passive investments (i.e. there is not an asset manager actively trying to outperform a benchmark of sorts) that merely try to track the performance of a broad index, the costs involved in managing the ETF are lower than that of actively managed unit trusts. You can therefore gain exposure to a particular asset class at a fraction of the cost. This could be the strongest reason for the products' growing popularity in the retail and institutional space in South Africa. The passive versus active management styles have been debated for ages and one of the strongest arguments in favour of the passive management style is cost. Essentially you pay extra to an active manager in order for

them to hire top talent and pay for research that will enable them to make investment decisions that may result in outperformance of an index or benchmark. Active managers can therefore purposefully deviate from weightings of an index they are trying to outperform and can be under/overweight an industry (industrials vs resources) or a particular stock (Billiton vs Anglo's). When it comes to active management you pay extra for the manager's prowess and superior investment knowledge. If you purchase an ETF you will never outperform the market, if anything you will slightly underperform because of some of the frictional costs. There is therefore a risk of structural underperformance in the ETF space.

The decision between active and passive management lies with whether the market you are dealing in is efficient or not (or whether you believe the market is efficient or not). What we mean by efficient is that, in most part, investors are rational, risk averse and prices reflect all past and present information correctly. If this is the case, there is no additional information that you can act on that will set you apart from the market because the market has exactly the same information and will act in exactly the same way because investors are rational. Efficient also means that all investors analyze investment decisions in the same manner and therefore come to the same conclusions and act on those conclusions forcing market prices to reflect all known information. Efficient means that active management will not result in consistent, long-term outperformance, and therefore a passive investment strategy is better suited. NFB Asset Management believes that investors are not rational and are not risk averse (they are loss averse).

In the present day and age more and more emphasis is being placed on liquidity, tradability, flexibility, accessibility, transparency and so on. ETF's are the closest to offering all of these things. In order to buy into an ETF all you need is a brokerage account. As previously mentioned, ETF's are traded like shares on the JSE and can therefore be bought and sold anytime during the trading hours of the JSE. This differs to normal unit trusts that are priced only at the end of the day. Market makers stand ready to sell units to you should you want to buy and they will buy back the units from you should you want to sell. Because of this, ETF's tend to trade close to net asset value though there are times when the net asset value deviates from the listed price. Like any share on the JSE, prices are updated throughout the trading day and the ETF issuer discloses the underlying portfolio of shares on a daily basis. This makes the product extremely transparent.

One of the most important features of an ETF is that **it is a great means of diversification**. When you buy an ETF you are buying all the securities that make up a particular index. The ongoing rebalancing of the underlying securities is handled by the ETF provider and this is why you pay them a small fee. Diversification is good, but over diversification means you diversify away from your opportunity of outperforming the market.

When considering including an ETF in your portfolio you need to ask yourself what purpose the ETF is going to serve in the overall objective of the portfolio. Like anything there are pros and cons that need to be weighed up. If you sell all of your existing investments and buy ETF's what you are saying is that no one can outperform the market and therefore the market is the highest return you will receive over the long term (any outperformance is based on luck). Although ETF's are well diversified, they still carry the same underlying risk attributes of the particular asset class the ETF is tracking. An ETF that tracks an equity index will therefore behave similarly to any other equity investment. Understanding the securities that make up the ETF is very important. For example, the Satrix 40 portfolio tracks the ALSI/JSE Top 40 index which is dominated by two resource stocks - Anglo's and Billiton - that make up 28% of the index.

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Investing according to your risk profile is still the name of the game. That involves appropriate asset allocation which many believe is more important than individual security selection or market timing. ETF's are a cheap and effective way of asset allocating, but you still require the necessary portfolio management skills to do just that. The development of the ETF industry in South Africa will be an interesting affair. In the overseas market there are already ETF's that are managed in such a way that asset allocation is done for you by a professional manager. The market for ETF's will continue to grow and will form a greater part of investment decisions. ETF's are an effective portfolio management tool, but active management still forms a big part of our investment strategy. That is because of our belief that humans are not always rational and markets are not always priced correctly. Because of this fact we will continue to seek out those asset managers whom we believe have the capabilities and necessary skills to outperform. ⊕

The Rand Carries on Trading

How and why the Rand has stubbornly hung around R6.70 to the Dollar is a necessary fundamental to understand, and a very significant contributor is that of the "Carry Trade". Written by **Philip Bartlett**, NFB East London, Private Wealth Manager

With the value proposition favouring offshore assets, it seems every fund manager, where allowed, has maximised their foreign allocation. The Rand, however, seems otherwise intent on diluting any offshore gains with a show of strength. How and why the Rand has stubbornly hung around R6.70 to the Dollar is a necessary fundamental to understand, and although there are a number of factors to consider, a very significant contributor is that of the "Carry Trade".

Ultimately, this strategy involves an investor selling a certain currency with a relatively low interest rate (the Dollar), and using the funds to purchase a different currency yielding a higher interest rate (the Rand). A trader using this strategy attempts to capture the difference between the rates, which can often be substantial, depending on the amount of leverage used. The risk lies in the uncertainty of exchange rates compounded by the scale of leverage. A small movement in exchange rates can result in huge losses unless the position is effectively hedged.

It thus stands to reason that a significant demand for the Rand is instigated by the differential between US and South African interest rates. Demand will thus weaken when the differential for gain is squeezed. With inflation edging northwards in South Africa, it is highly unlikely that the Reserve Bank will see the need to cut interest rates locally and as a result all eyes are on Central Banks abroad.

A US rate hike would reduce the incentive to implement the carry trade strategy and hence the demand for developing market currencies, like the Rand. For US interest rates to be hiked, there needs to be inflation, a consequence of consumer spending. Simply put, we need the US consumer to spend in order to initiate the required chain of events. Employment is a prerequisite to being able to spend and explains the preoccupation with US employment figures.

But then again if you were the US, with huge debts in Dollars, there might be some self- gain in keeping interest rates flat, fuelling inflation and ultimately eroding ones debt away by weakening ones currency!!

The upside of a weaker Rand is the cheaper, more marketable South Africa, luring long term investment in the way of infrastructure, employment and sustainable foreign interest. The downside, however, could be the unmasking of SA's "real" inflation. The recent strength of our currency has anaesthetised the pain associated with global increases in food and oil prices and has allowed us to punch above our weight when it comes to the importing game.

The global socio, political and economic influences are too varied and dynamic to be able to call the Rand. What we do know, though, is that the carry trade strategy has resulted in foreign buyers flooding our equity and bond market. These assets are liquid…. and the cash can leave as quickly as it arrived!

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