



# INVESTING IN AN UPSIDE-DOWN WORLD

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EVER since the end of the Second World War investors have been taught one thing: inflation is the enemy and all investment objectives must be focused on beating the relentless rise in the cost of living.

During this period of time—roughly 65 years—most countries in the modern world experienced varying degrees of inflation. At times inflation exceeded 15%, as in the early 1980's, but on average global inflation was stuck at around 4 to 8% per annum on average during this time.

The dominant school of thought over most of this time was that excess inflation was a monetary phenomenon and that any increase above a desirable inflation rate — as expressed by the inflation targets used by many countries—was to be dealt with by an increase in interest rates.

South Africa was no different and this is still the primary tool used by the authorities to contain inflation.

The primary exception over the last 20 years has been the experience of investors in Japan, the second largest economy in the world.

Here inflation was not the enemy, but a lesser known phenomenon known as deflation. Instead of having to deal with rising prices, Japanese investors, businesses and consumers have been battling with declining prices in goods and services and also shrinking asset values.

The Japanese stock market has since 1990 lost more than 75% of its value while property prices have declined by about 80% over the same time. Any investor who did not adjust his/her investment strategy would have been financially crippled by this structural shift in the financial landscape.

Over-indebted investors who bargained on leverage to increase their wealth, a desirable practice in an inflationary environment, found themselves slowly squeezed into personal bankruptcy as the leveraged assets, mainly property, declined in value over time, in the process destroying balance sheets and credit ratings.

To a certain degree this has been happening in many parts of the world as a result of the Global Credit Crunch which erupted in September 2008. The waves of defaults by home-owners in the United States, Ireland, Spain, Portugal and many other parts of the world, is in essence highly deflationary.

South Africa too has not escaped this trend. The auctioneering industry has mushroomed into a multi-billion rand industry as distressed owners and banks offload surplus properties in an attempt to escape the deflationary death squeeze: declining asset-values, reduced cash flow and crushed balance sheets.

Many over-extended homeowners and property developers have already been ruined by this giant crushing, squeezing financial anaconda.



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Global  
Markets  
AND SA ECONOMY

A personal example will illustrate this better: Brenthurst Wealth recently bought a small office for its operations in Cape Town . We paid R920 000 for an office which had a bond of R1,7 million. The owner has gone bankrupt, which means that the bank has lost R800 000, not including all the other costs, on this one property alone.

Multiply this by the thousands of other properties sold every week by SA's auctioneering firms. These include residential properties, vacant land, small office blocks, hotels, guest houses and even industrial complexes crippled by the sudden slowdown in economic activity.

The best investment classes over this period of time were government and semi-government bonds, cash and offshore investments in instruments which offered some kind of protection from the deflationary death grip.

While most central bankers all over the world have some idea of the causes and remedies to counter against excessive inflation, they remain petrified by the prospect of a protracted period of deflation.

They have seen what has happened in Japan. Interest rates have been at zero percent for many years now but this has done very little to stimulate demand and re-energize an economy that at one stage was threatening to overtake that of the United States.

## ***INVESTING IN A DEFLATIONARY ENVIRONMENT***

Should the world and indeed South Africa move (certain experts say that this has already happened; only it is not clearly evident yet) into a protracted period of deflation would this require a total change of investment mind-set.

The investment strategies that have in the past offered protection against inflation could in future be dangerous to your financial health and work against you.

It's hard to conceive an economic environment where the prices of goods and services are actually declining year after year, albeit only marginally. But that is actually precisely what deflation is.

In such an environment it becomes very difficult for companies and businesses to increase prices in order to grow profits.

The reaction of the average consumer in such an environment is also very predictable: it will rather wait until next year when prices are bound to be lower.

The South African investment world has a substantial bias towards equities. It has been, it must be said, one of the primary instruments to protect wealth against future price increases. Pension funds, asset managers and personal investors have a very large exposure to equity-investments. According to a study done by the Organisation of Economic Cooperation and Development (OECD), SA has one of the highest exposures to equities as a percentage of GDP, namely 76%.

By contrast its exposure to bonds as an asset class is one of the lowest in the world. But in a prolonged deflationary environment equities would not be the best option for most investors. Rather it would be bonds, cash and semi-cash instruments and to a lesser extent income producing properties. And some physical gold, but not gold shares.

The average South African investor has very little understanding of bond type investments and how they can generate income as well as profits.

The South African investment industry, also, has a very substantial bias towards equities. This is where the big money is made and this is where all the research, marketing and promotion are focused.

In many respects this is a normal business decision. Why would you (as a fund manager) spend money and time marketing an investment product where the profit margins are substantially lower than the fees that can be charged on equity-type investments?

*Ask yourself: how often have you see an advert for the bond fund of one of the top asset managers? I would suggest not many.*

The media too has an almost unhealthy obsession with equities and the minute-to-minute gyrations of share prices, the rand and the gold price. Almost every newspaper, radio and television station now has an investment section that focuses on investments. Here too the focus is on equities—shares up, share down and in the studio we have two experts to discuss the outlook for the markets....

**Bonds and the workings of bonds are far more complex than equities. Very few investors understand the inverse relationship of interest rates and the underlying value of bonds. Yet, bond investments have been the best asset class over the past 10 years in the United States, with an average increase of more than 100% since 2000, while equities have shown no increase at all.**

**In SA, equities have now been in a bear-market for more than 3 years, beaten by bonds and property investments, which benefit from declining bond yields.**

While it might be argued that three years is not long enough a period to be crying wolf, the possibility of this trend extending into a five and perhaps ten year bear market cannot be excluded.

Some of SA's largest fund managers are openly negative about equities for the considerable future. Allan Gray's Liddle is openly cautioning about the prospects for SA equities over the next couple of years.

In its 3 September 2010 issue the Financial Times website carried an article on this issue.

*"Much has been written about the Great Moderation and the Great Depression over recent years, but much less attention has been paid to the Great-De-rating. That could be about to change. An increasing number of market professionals are asking themselves if the brutal de-rating suffered by equities during the past decade means the cult of equities is dying."*

Many other highly respected analysts have also mentioned this sea-change in the investment scenario. One is Robert Buckland from Citigroup who feels there is something profoundly happening: a reassessment of the merits of equities and bonds as asset classes, which he believes, will not be easily reversed.

Mr. Buckland is quoted as saying there are several factors that explain why investors are no longer attracted to equities to the same degree. Most obviously, are the dreadful returns in the west and the stomach-churning volatility since 1999.

This trend will be further reinforced if the fears of deflation take hold over the psyche of investors and fund managers, he says.

Other, far more outspoken commentators such as Dr. Nouriel Roubini, the US economist who "predicted" the Great Crash, and fund manager Jim Rogers are more direct: deflation is now the enemy and the old ways of investing no longer apply.

***How then should investors protect themselves if this all comes to pass?***

Before I attempt to answer this question, just some comments again that needs repeating: ever since the introduction of the Financial Advisory and Intermediary Services Act (Fais) in 2004, fund managers, investment companies, journalists and commentators can only offer their opinion and comment. In order to give advice advisors have to be registered with the Financial Services Board. Investment advisors are also liable for the quality of the advice that they render.

It is also important for investors to differentiate between marketing and investment advice. Quite often investors fail to see the difference.

As investment advisors we have to take responsibility for the quality of our advice. And the one thing we know, things will change.

**One of the prerequisites for investment success is to adapt to the changing investment environment.**

For example: over the past couple of years the promoters of passive investment instruments such as the Satrix 40 have tried to convince investors of the merits of their products. It was promoted as an easy and cheaper alternative to active fund managers.

The only problem with such a product is that it's a one-directional bet on a certain asset class, namely equities.

In a protracted multi-year equity-bear market investors in such type investments will be severely impacted, for the reasons as outlined above. It's a bet that equities will be the superior asset class indefinitely and that no further decision needs to be made.

Tell that to the Japanese.

## ***NOW TO THE CRUX OF THIS NEWSLETTER: HOW TO DEAL WITH DEFLATION?***

### **1. Debt of any kind would be a wealth destroyer of note.**

In an inflationary environment the correct debt can be a major source of wealth-creation.  
In a deflationary environment debt will pull you under very quickly.

### **2. Greater exposure to bonds.**

By investing in a bond instrument or fund you are actually buying the debt of someone else, in this case a government, para-statal or municipality, which make regular income payments.  
If inflation turns lower and eventually turns into deflation, the value of such an income stream becomes much more valuable.

### 3. Diversification.

This cannot be over-estimated. There is a feeling amongst investors, sometime perpetuated by the media, that the Great Moderation as John Mauldin describes it will be over very soon and that all will be well and back to normal.

It will take more than 5 years, if not longer, before the global economy and especially that of the developed world shows any signs of normalcy. An extended period of very low growth is forecast by most.

### 4. Flexibility.

It sometimes astounds us how often people base their investment decisions on very long- term views. Forecasting at best of times is very difficult and dangerous and any investment strategy needs to be flexible enough to reflect changing circumstances.

Change of mindset. Admittedly, it's going to be very difficult to change an investment mind-set that has been inculcated over a period of 65 years. But should deflation replace inflation as the greater threat to your wealth would it be financial suicide not to adjust your investment strategy.

## SUMMARY:

AS HOLISTIC ADVISORS ON WEALTH CREATION AND PRESERVATION DO WE NOT HAVE A BIAS TOWARDS ANY PARTICULAR ASSET CLASS, NOR IS THERE ANY FINANCIAL INCENTIVE INTO PROMOTING ANY ASSET CLASS IN FAVOUR OF ANOTHER.

WE WILL MAKE USE OF ANY OF THE PERMITTED ASSET CLASSES AND INVESTMENT INSTRUMENTS AVAILABLE IN ORDER TO ACHIEVE OUR INVESTMENT OBJECTIVES.

WE ARE RECOMMENDING A GREAT EXPOSURE TO BONDS AND BOND-TYPE FUNDS WE ARE BUSY WITH A FOLLOW UP NEWSLETTER IN THIS REGARD BUT WE INVITE ALL OUR CLIENTS TO CONTACT THEIR PERSONAL FINANCIAL RELATIONSHIP MANAGER TO DISCUSS THIS ISSUE.

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