

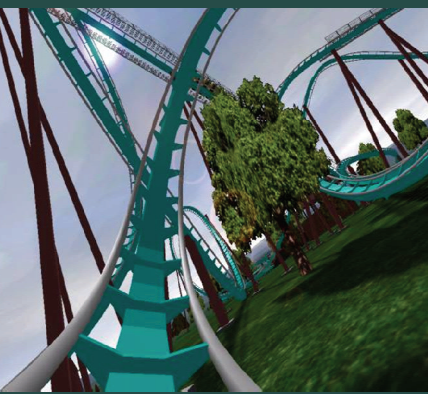
INVESTMENT REPORT



SIX MONTHS THAT CHANGED THE WORLD

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By Magnus Heystek—Investment Strategist

IT is inconceivable that investors will ever again have to undergo the financially traumatic events of the last six months.

The bankruptcy of giant American investment bank Lehman Bros. on 19th September 2008 was the trigger event that unleashed the cataclysmic shock-waves that have so far destroyed an estimated \$40 trillion in global personal wealth.

Up to that point it seemed as if the problems emanating from the US sub-prime mortgage market could be contained within the US banking system without it spilling over into the rest of the global economy. But it was not to be.

The International Labour Organisation (ILO) has warned that more than 50 million people could lose their jobs by the time the global economy starts recovering while the International Monetary Fund (IMF) has forecast that the global economy would contract by about 1%, the first global economic contraction since the Second World War. Earlier this week the finance chiefs of the world's largest developed and emerging countries met outside of London to discuss the crisis. Key to any revival is the global banking system, the G20-countries said ahead of the meeting.

Identifying and dealing with the “toxic” assets on banking balance sheets remains the key to unblocking the global financial system. Without dealing with this issue the hope of invigorating the world economy remains slim. It is now accepted that the decision to allow Lehman Bros. to fold was a big mistake. Until that time it was accepted that the bank was “too large to fail”.

And fail it did which caused the global banking system to come to a grinding halt in the days thereafter. Nobody was safe from overnight closure with the result that no bank wanted to deal with any other bank. A world without the flow of money was like a patient of life support whose oxygen was cut-off, leading to a quick demise.

As it is, the global economy still runs a major deflationary risk, something identified by US Federal Reserve Bank governor Ben Bernanke and other western leaders. Bernanke, coincidentally is considered an expert on the Great Depression of the 1930's, having done his doctorate in economics on the causes and possible remedies for such a situation.

Bernanke and other finance leaders have also witnessed the deflationary spiral endured by the world's second largest economy, Japan.

THE LAND OF THE SETTING SUN

In 1989 the Japanese stock market capitalization was approaching that of Wall Street, after a bull market of more than 20 years. At the time Japanese companies were moving into the US in a very large scale, buying up majority stakes in US companies and prime US -properties. A front page article of Fortune Magazine in 1989 forecast how Japan would dominate the global economic scene for decades to come.

Since then, nought came of that prediction. In fact, Japan tumbled into a recession/depression and despite several short-lived recoveries, the Japanese stock market has lost 70% and more of its value from the peak.

Japan, still the second largest economy in the world (barely just, as China is set to overtake it very soon) has been one of the biggest victims of the current global economic crisis. Japanese exports have fallen 54% (!) in the last six months, it's almost perennial trade surplus has plunged into a deficit of \$9 billion dollars and the mainstay of its economy- the export of motor vehicles—has plunged 63% in just four months. Talk about falling off a cliff.

It also did not help much that its currency, the yen, was very strong during this period of time, further undermining its export competitiveness.

Japan also has other problems. The population is now literally shrinking as they have the largest proportion of elderly people and the lowest proportion of children. By 2050, it has been estimated, 70% of their labour force will have disappeared. Japan could become the largest old-age home in the world.

THE DANGERS OF PROTECTIONISM

One of the major reasons why the world plunged into an almost decade-long deflationary depression after the 1929 Stock Market Crash was the instinctive move towards self-preservation by nations. Many commentators warn that another such move by nations could cause a repeat of the mistakes made 80-odd years or so ago.

Trevor Manuel, SA's minister of finance, underlined this threat just before he left for the G20-meeting of industrial leaders in London last weekend. He understands perhaps better than anyone the threat that any restrictions on global trade would hurt the economic fortunes of developing countries, especially African ones.

Yet it remains strange that Trevor Manuel keeps on insisting that the SA economy will not experience a recession, still sticking to his prediction that the economic growth rate will be 1,8% year-on-year.

Our standby- president Kgalema Motlanthe even went further recently when, on his return from the Davos-meeting in Switzerland at end-January, still insisted that SA will achieve 4% growth this year.

He obviously did not know at the time that his finance minister was interviewed on the same radio station (Radio 702) the night before, saying the economy would grow at only 1,8%.

These pronouncements by politicians on the economy are worthless and are meant for the unthinking editors and unthinking voters.

Equally unthinking was the call by the National Union of Metalworkers (Numsa) who, according to The Weekender of 14 March 2009, called on Government to "save all failed companies".

This is the kind of protectionist response, which if repeated on a global scale, could plunge the global economy into a very deep and protracted depression.

Yet the reality has hit the SA economy very hard, and matters could get much worse in the months to come.

Manufacturing output, one of the major sectors of the economy, dropped by 11% on an annualised basis in January this year, after a drop of 7% (year-on-year) in December 2008.

Virtually every other indicator of economic activity indicates that the economy is already in a recession—not a "technical recession" as some journalists have started describing the current situation --but a real, hard-hitting, jobs-destroying and confidence sapping recession.

The residential property slump, for instance, is now far worse than the 1985 property crash and global banking group HSBC forecast earlier this week that SA's banks could possibly write off residential debt in excess of R57 billion over the next couple of years. More than 100 000 homeowners stand to lose their homes over the next three years.

In addition, SA's banks have virtually stopped lending money for residential property purchases, with more than 60% of loan applications now turned down, according to bond originator ooba.

Any revival of the residential property market therefore is remote at this stage. Even a drastic lowering of interest rates will not help those who have lost their means of income.

OUTLOOK FOR INVESTMENT MARKETS

Against this background investors are naturally apprehensive about the outlook for the stock markets. However, it bears repeating that economic data is backward-looking while INVESTMENT MARKETS ARE FORWARD-LOOKING.

With comparisons between the Great Depression and the Great Recession growing ever louder, a simple worst-case scenario is to look at how investments fared during the Great Depression.

FTSE/JSE AFRICA ALL SHARE

Daily 2005/05/17-2009/03/16



According to the National Bureau of Economic Research the US is now 14 months into the current recession with the Dow Jones down by 52% Fourteen months into the Great Depression, investors were down "only" 46%.

Economic conditions in 1931 were far worse as unemployment and economic output plunged at a far greater rate than currently.

The good news is that if history is about to repeat itself, it could be an excellent time to re-entering the stock market. Conventional wisdom holds that the Depression was a bad time to be an investor in the stock market. The media loves to focus on the sharp drop in the market in 1929, followed by scenes of long queues at soup kitchens as unemployment rocketed to 25% of the US population.

Excitable commentators also like to cite the statistic that it took until 1954 -25 years—for the market to reach its 1929 peak.

That figure is misleading as it assumes that investors put all their money into the stock market the day before the market peaked, stopped buying shares and never received any dividends during that time.

The Motley Fool-website has an interesting study in its latest newsletter which compares investment returns made at the same time in the cycle (fourteen months) in the Great Depression and what returns were made in subsequent years.

A typical investor would have waited five years to break even on a lump-sum investment and someone doing monthly investments would have waited less than two years to break even and thereafter made excellent profits as the market recovered.

To which one can add an interesting titbit for South African investors: only twice did the SA stock market double in one year. The one was in 1979 when the gold price rocketed and the other one was 1933—in the middle of the Great Depression.

Over a 21- year period since the bottom of the market in 1931 to October 1954 (when the Dow Jones-index reached its pre-1929 peak), shares rose by a total of 678% excluding dividends. By contrast, US Treasury Bills rose by a total of only 18% over the same period of time.

The S& P 500 index (the broadest measure of the US stock market) has only three times in the past 100 years declined by more than 50%. The first was in 1929-31 (down 82%), in 1972-74 (down 54%) and the current decline of 62%.

A different calculation done by local economist Mike Schussler from Econmists.co.za shows that the S&P 500 rose by 350% (dividends included) in the five years from its lows in 1931 and 48% after the lows in 1974.

Schussler also shows that the JSE is now very cheap when measured against gold as well residential property.

These statistics should serve as a warning to investors wanting to capitulate in the current climate and head for the perceived safety of US government bonds. A year ago US 30-year treasury bills were trading at 3,84%. At the time this asset class was considered to be at risk from inflation as food, oil and other commodities were soaring.

As it turned out, panicked global investors sold down their shares and headed for the short-term safety of US bonds, now trading at around 2,2%, the lowest on record.

WHAT ARE THE LESSONS INVESTORS CAN LEARN FROM THIS?

A year ago in our investment newsletter to clients (May 2008) we warned of a pending slowdown in investment markets. We particularly warned against high-flying commodities and we also urged our clients to take protection against an expected drop in the value of the rand. Our recommended portfolios, by and large, reflected this view.

What we did not foresee was the total collapse of virtually the global economic system and the sharp sell-off in equities. This was a once-in-a-generation event with very little warning. The speed at which investment markets unravelled from September to mid-November last year was as breathtaking as it was gut-wrenching.

Our biggest function now is to guide our clients through these difficult times. An added responsibility is to ensure that our clients are in the appropriate portfolio in relation to their long-term investment objectives.

And lastly, only if the risk profile or tolerance to risk has changed dramatically (such as a loss of employment, divorce, death of spouse, retrenchment etc.) do we recommend any changes to our chosen portfolios in general.

So while the worst of the market's decline might be behind us, does it not mean all plain sailing from now on. It would be worthwhile to remember the following:

1. IT'S VERY DIFFICULT TO TIME THE MARKET BOTTOM.

Just because stocks have fallen and valuations are low does it not mean they cannot fall further. So if you are going to need the money in the next five years, then there are safer places for your money than stocks (See below for a recommended portfolio if this applies to you).

2. MARKET TIMING ISN'T NECESSARY TO ACHIEVE GREAT RETURNS

The Great Depression was a terrible time to be a speculator but long-term investors who continued buying stocks did fine.

3. STICK TO A PROVEN INVESTMENT STRATEGY.

Now is not the time to be falling for radical investment strategies which promise to restore your portfolio back to health in a short space of time. Trust your investment strategy and stick to the plan.

Even though legendary investor Warren Buffett has taken a terrible pounding in the current crisis, with his Berkshire Hathaway Fund down 37% last year, has he not changed his investment style. Some of his best long-term investments were made after very sharp falls in markets, allowing him to pick up great companies at knock-down prices.

**GREAT LONG-TERM INVESTMENTS ARE NOT MADE AT THE TOP OF MARKETS
BUT AT TIMES LIKE THESE.**

DECLINING INTEREST RATES OFFER OPPORTUNITIES: HOW WOULD YOU LIKE AN EXTRA 2,78% PER ANNUM?

Globally, interest rates have fallen to record levels. Japanese investors have been receiving no interest on their savings for years. They have now been joined by investors all over the world, including the UK where interest rates are the lowest on record, the US and countries in the euro-zone.

South African investors have been protected from these sharp drops in interest rates as interest rates remained high. The SA Reserve Bank has dropped rates by 150 basis points but it now seems certain that interest rates will fall sharply over the remainder of the year. Some estimate that the repo-rate (the rate at which the SARB sells money to the commercial banks) could drop by another 300 to 400 basis points.

Many have questioned the reluctance on the part of the SARB to cut interest rates more aggressively sooner. The Bank now runs the risk to be behind the curve in terms of using monetary policy to stimulate the economy. Most countries in the world have cut rates in response to sharply weaker economic conditions.

The SA economy is hurting badly, unemployment is soaring and exports are dropping sharply, yet the Bank seems to be fighting last year's battle: inflation.

This is bound to change very quickly and rates are set to tumble as SA starts to feel the full impact of the global recession. For people with large bonds on houses and cars this is good news as it could save thousands per month in repayments. However, for savers and investors this is bad news.

Risk-averse investors can expect to see rates on money market investments fall to about 6%, perhaps even lower, by the end of the year.

It's during such times that desperate and sometimes uninformed investors start chasing risky investments in an attempt to gain an extra percentage point or two.

Current conditions have often in the past been the seedbed for investment scams, the Masterbonds, the Supreme Bonds and others which have ended up costing the investing public billions.

Anticipating this potential problem Brenthurst Wealth have constructed a low risk investment portfolio which offers a suitable and attractive alternative to money market funds in a declining interest rate environment.

It also offers investors the added security of having funds placed with three of the largest and safest investment companies in SA which offers investors more protection than having money with only one company.

In a systemic banking crisis—which we do not foresee, it must be added—a spread of investment risk adds another layer of protection to investors.

The portfolio consists of a finely blended portfolio of cash, bonds, preference shares, bonds, property funds as well as some blue-chip equities, which offers investors an opportunity of beating cash-returns by between 2 and 3 percentage points.

It is not very well known that certain assets—bonds, for instance—can produce excellent returns as well as some added capital gains in an environment of declining interest rates.

The portfolio has been back-tested going back five years and it shows that investment returns on this portfolio has beaten money market rates by an average of 2,78% per annum.

The fund is 100% liquid and is split up amongst three of the top investment houses-Investec, Allan Gray and Nedgroup. It is also available on all three the open architecture investment platforms used by Brenthurst Wealth, namely Stanlib, Momentum and Investec.

Both the initial and ongoing fees are very competitive and changes can be made to the portfolios at no additional cost. Speak to any of our registered investment planners about more details on this portfolio.

PRINCIPLES FOR INVESTMENT SUCCESS

➤ “EVERYTHING CHANGES”

Bear markets have always been temporary. And so have bull markets. Share prices usually turn upward from one to twelve months before the bottom of the business cycle and vice versa. If a particular industry or type of security becomes popular with investors, that popularity will always prove temporary, and when lost, may not return for many years.

➤ “BUY DURING TIMES OF PESSIMISM”

Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.

➤ “SEARCH WORLDWIDE”

To avoid having all your eggs in the wrong basket at the wrong time, every investor should diversify. If you search worldwide, you will find more bargains and better bargains than by studying only one nation. You also gain the safety of diversification.

➤ “KEEP AN OPEN MIND”

Never adopt permanently any type of asset or any selection method. Try to stay flexible, open minded and sceptical. Long term top results are achieved only by changing from popular to unpopular the types of securities you favour and your methods of selection.

- source:Franklin Templeton Investments, all data as @ 31.01.06

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