

INVESTMENT REPORT



SPREADING RISK IN AN INCREASINGLY RISKY WORLD

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AS the global financial turmoil tightens its icy grip on the world's financial markets, investors are increasingly starting to question the safety of their investments with local banks.

The situation was not helped by the news earlier this week that ratings agency Moody's has downgraded SA's largest bank Absa from neutral to negative. The uncertain mood was further undermined by Absa's own admission that it has taken a massive loss, the extent which is currently not yet known, on failed single stock future contracts in four JSE-listed companies.

Absa's exposure to these four companies—Pinnacle Point, Convergenet, Blue Financial Services and Sekunjalo Investments—is about R1,4 billion, but at this stage it is unclear what the actual losses, if any, could be.

Coming on the back of previous banking downgrades (FNB and Nedbank) by Moody's last year, investors are understandably skittish about the safety of their own bank.

Given the dire global financial environment, which now totally dominates tv news channels and newspapers, it is no surprise to see punch-drunk investors moving into the safety of money market funds with one or more of SA's large banks.

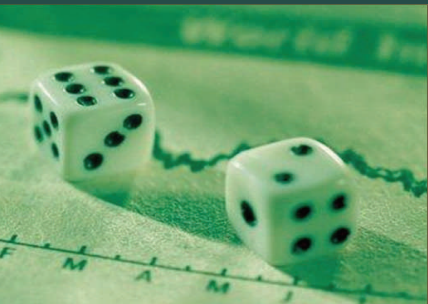
If investors were worried about the risk of one or more banks going under, they should rather be considering a unit-trust money market investment as opposed to a money market investment with their personal bank.

Most banks offer money market investment accounts but investors need to understand that a direct money market investment with a bank offers no protection should that particular bank find itself in trouble.

While no SA bank appears to be in trouble to the extent of US and UK banks would it be prudent to consider a unit trust money market, particularly for large amounts of money.

The world's financial system is in such dire straits that no one can, with any degree of certainty, guarantee that one or even more of our banks cannot find themselves in financial trouble.

A far better option would be to consider a unit-trust based money market account which offers far greater security than a money market account with a specific bank.



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Unit-trust money markets, on the other hand offer investors a spread of several (up to ten and more in certain instances) wholesale money market accounts, rather than just one particular fund linked to the bank of choice. This makes it a far safer investment than money in the particular money market account of a specific bank.

It is also worth remembering that SA offers no deposit guarantee unlike most other western countries which offers varying degrees of deposit guarantees. Britain, for instance offers a guarantee on the first £50 000 in case of a bank failure. Australia offers an unlimited guarantee even though investors with more than AUS\$1 million must take out insurance. Ireland offers a 100% guarantee.

A better understanding of the working of a unit-trust based money market fund would enable investors to make a more informed choice.

Money market fund managers specialize in placing client's money on the best possible terms with institutions wishing to borrow money for short periods of time. Because of this access to wholesale money unit trust money market funds usually offer a higher rate of return than offered by retail banks.

In accordance with the requirements of the Collective Investment Schemes Act (Cisma) money market funds are restricted to investing in interest-bearing investments with a maximum average maturity of three months. This ensures liquidity and that capital is retained.

In addition no single investment can have a term to maturity exceeding one year which reduces price fluctuations and interest-rate risk.

To further protect unit holders (investors) against risky underlying holdings the act furthermore prescribes the specific instruments that may be used by money managers.

Depending on the investment policies of a particular fund, the portfolio manager may invest in either short-term debt instruments of government or short-term loans to companies and negotiable certificates of deposits of banks. Other acceptable money market instruments include debentures, treasury bills and call accounts.

Money market unit trusts aim to provide a high degree of capital stability with a minimal risk of loss.

To ensure an investor's capital is protected against default by a financial institution, Cisca requires all investments by money market fund managers to be of the highest credit quality. These investments are rated by ratings agency CA Ratings on a continuous basis and only money market instruments with the highest ratings (za AAAM) can be used by fund managers.

Money market funds are also compliant with Regulation 28 of the Pension Funds Act and are suitable for retirement funds. Neither interest distributions nor capital growth is taxable within retirement funds under current legislation, thereby making it suitable as an underlying investment in retirement annuities, preservation funds and living annuities.

Under existing tax legislation all interest distributions greater than R19 000 (for persons under 65) or R27 000 for investors older than 65 are taxable.

At average money market rates this means that you will only start paying tax on amounts in excess of R173 000 (under 65 years) and R250 000 for investors older than 65. For married couples these amounts are doubled.

CONCLUSION:

Money-market unit trusts offered a far better diversification of risk, and hence of loss, than money market accounts offered by individual banks. Furthermore, investors are likely to achieve higher rates of interest than the rates offered by commercial banks.

Speak to either one of our four registered financial planners for more information about the range of unit-trust based unit trusts on offer. Not only are you likely to get a higher interest rate, but will you also be protected in the event of a systemic banking collapse in South Africa.

BUDGET 2009/2010: AN AUSTERE OCCASION

André Roux, head of fixed income at Investec Asset Management, looks ahead to what we can expect from Finance Minister Trevor Manuel when he unveils the national budget on 11 February.

This is likely to be Finance Minister Trevor Manuel's toughest budget by a long shot. Back in September last year, when the Medium Term Budget Policy proposals were drawn up, the world was a different place and it seemed as if South Africa would maintain reasonable growth in the New Year. But that is all history now.

We now know that the economy is likely to struggle and we'll be lucky if we end the year with positive growth. The deterioration in the economy is already evident in the monthly revenue and expenditure data issued by Treasury. Vat receipts in December, for example, were down to what they had been a year before and far lower than what had been budgeted in February last year. The same applies to company tax, which has also run into negative territory.

We expect a superhuman effort from SARS in the dying weeks of the fiscal year. Revenue for the current financial year is likely to fall short by about R12 billion from the revised figures introduced in September. The deficit will probably rise from the revised R9 billion to an amount in the region of R20bn.

We have become used to Treasury exceeding their revenue targets year in and year out, so the shortfall is likely to be a new experience for them. In itself, it is not a problem and Treasury has already been stepping up its issuance programme steadily in recent months. The real problem is that the base for calculating next year's revenue is now a lot lower.

EXPENDITURE:

The medium-term expenditure programmes announced in September last year provided for various plans unveiled in the ANC's manifesto. Non-interest expenditure growth for the next fiscal year was projected to increase by 18% above this year, which by any reckoning reflects fairly substantial real growth and appears to provide more than enough money for the first stages of the somewhat more expansionary programme of the new ANC leadership.

We don't expect Manuel to be under any pressure to increase this level of spending. Likewise, against the backdrop of a global growth slowdown, we doubt that he would want to reduce the level of spending either. We believe he will do his level best to maintain his commitments to all the infrastructure and poverty relief programmes and will probably try to stick to the expenditure numbers he set out in September.

REVENUE & DEFICIT:

As far as the revenue for the next financial year is concerned, there is no way Manuel is going to achieve the targets set out in September. Indeed, he will be lucky if he maintains growth in company tax at some positive level, while the performance of VAT in the 5-6% range will probably be no better than this year. Personal income tax, however, is likely to remain reasonably buoyant, largely because remuneration levels would have risen based on the higher wage settlements we have seen over the course of last year.

We shouldn't expect Manuel to be as generous to taxpayers as in previous years, although he may try to deal with the fiscal drag on personal income tax to provide relief against inflation erosion. We expect some R5 billion to be given back to the taxpayer.

Revenue for next year will be lower by some R18 billion compared to the September figures, while next year's deficit will be revised upwards from around R52 billion to R70 billion, equivalent to about 2.6% of GDP. It is a much bigger deficit than we have become used to in recent years and harks back to the years when Manuel took over as Finance Minister. However, given the deficits we are seeing globally, it is still relatively conservative. In the US, for example, the deficit for the year is expected to exceed 10% of GDP.

It may well cross Manuel's mind whether he is not being too conservative, but in our view he wouldn't want to revive the consumer boom or widen the deficit further by cutting taxes substantially. He will probably be too worried about a worsening current account deficit, which is always a possible source of instability.

FUNDING:

The deficit will put more pressure on funding. There are significant foreign redemptions in the next fiscal year so the net domestic bond funding requirement will probably be in the region of R70 billion. While current bond auctions are in the order of R1.2 billion a week; these will rise to R1.8 billion a week as the fiscal year progresses.

The bond market is likely to suffer from bouts of indigestion and we will see some upward pressure on the long end of the curve; indeed, the market is already starting to price this in.

CONCLUSION:

This is not going to be a fun budget, so be prepared for an austere occasion. Manuel would have just returned from Davos, where the dialogue is likely to have been gloomy - we expect he will use the occasion to warn the nation to tighten their belts and prepare for a tough year!

The world's lowest growth, highest inflation and shortest life expectancy. Democratic elections were held; the people spoke, and yet for some reason the struggle continues. Fix Zimbabwe and the rest of Sub-Saharan Africa looks great as an investment destination.

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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