# THE STERLING TIMES 12

MARCH 2015

STERLING
PRIVATE WEALTH

# Inside this issue

# 2015: Introduction to the Year

Graydon Morris

We welcome all our clients to the New Tax Year, after a frenetic first two months of 2015, following on from a trying 2014 on many fronts, both economically and politically.

In 2014, equity markets produced real (after inflation) returns of around 5.5% and 4% for local and global markets respectively. Some investors may perceive these outcomes as anaemic, especially when framed against the heady performance of 2012 and 2013, when real returns of approximately 20% were the norm.

However, the 2014 achievements are actually very close to the 4.5% average real return achieved over the past 114 years by the 23 equity markets tracked in the annual Dimson, Marsh and Staunton survey.

Importantly, it is also more in line with the average returns we expect for the next several years than the high rates achieved in the post-financial crisis recovery period. We continue to caution investors to ensure that return expectations used in planning their wealth management affairs remain prudent. A good starting point for a pre-retirement savings programme is a real rate of return of around 4% – 5% p.a., while new retirees who are starting to draw an income should ideally aim for an initial income rate of no more than 4% – 5% of their portfolio value.

We expect volatility to continue. We pledge to continue working with our investors to see the wood from the trees, adopt long term mindsets, and remain focussed.

A few interesting pieces have been included in this latest edition of our Sterling Times.

Importantly the recent Budget had, in our opinion, two critical outcomes. Firstly, there was no significant increase in taxes, and the relaxation of Exchange Control further, will be widely embraced.

We welcomed Kim Crowie to out Cape Town office on 1 March. Kim joins us from PSG Asset Management and will be of great help to our clients in the Cape and elsewhere over time, of that we are sure. We hope you enjoy a wonderful career at Sterling, Kim.

Graydon Morris
Founding Director

# How Wealth Advisors Add Value


Russell Gibson
Director, Sterling Private Wealth


After the 2007-2008 Financial Crisis, client satisfaction with wealth advisors has declined significantly, leading many to consider changing existing advisory relationships. Some client dissatisfaction was perhaps due to nothing more than poor communication and/or mismatched expectations, but much of it was undoubtedly well-placed. We seek to address some of the key qualitative and quantitative sources of value added that can be provided by wealth advisors. We also seek to enumerate several key factors that any family should consider before hiring a new advisor or initiating a change to an existing relationship.

Before we attempt to describe the value of advice, it might be helpful to define what we mean by "wealth advisor." Simply put, a wealth advisor helps structure, implement, monitor and maintain a client's overall investment portfolio. This is distinct from a money manager who typically buys and sells securities seeking to generate attractive returns within a narrowly defined mandate (e.g., large cap stocks or high yield bonds). Since we're talking primarily (though not exclusively) about investment value-add, we're excluding advisors who are primarily offering non-investment services such as tax, accounting, estate planning, bill paying, etc.

We believe that the single most important type of advice a family can receive from any financial advisor – so important that it outweighs advice of any other kind – is working with the family to design an overall investment strategy that is right for the family and its specific needs. Advisory firms that offer one chief strategy are doing most families a serious disservice.

How important is this? It's difficult to be definitive since every family's experience is different, but the anecdotal evidence is bloodcurdling. Failing to design the right portfolio is an extreme example of failing to stick to a long-term investment plan during periods of market stress (Bulls or Bears). Let's go back to the late 1990s.

At that time the stock market was incredibly strong – it was the era of "irrational exuberance" – and tech stocks internationally were even stronger. Families who were being advised by large financial institutions woke up to find themselves in a peculiarly dangerous vortex caused by the intersection of greed and conflicts of interest. Financial institutions were competing with each other to manage every tech IPO that came along, and families were jockeying to get an allocation to those IPOs. The result was not only that families allowed their equity allocations to rise dangerously high – those allocations were also heavily tech-centric.

In other words, these portfolios were far more risky than was appropriate for the families but their advisors weren't pointing this out. When the Tech Bubble burst, these families were hit very hard. The result was that independent wealth advisors saw their businesses grow rapidly as families fled the big institutions. Unfortunately, the families left with only about 60% of their previous capital.

No doubt some of the family's lost money because they panicked and sold at the bottom, but if so they were alarmed mainly because their portfolios had become way too risky, far beyond their own tolerance for market fluctuations. Where were their supposed advisors while this was going on? They were too conflicted to speak up.

But many families simply had no choice but to bail out of the markets at the worst time.

## Transitioning the Portfolio

A key factor to consider is how the wealth advisor will get you from here to there in terms of your goals. There are a wide range of issues presented by the challenge of transitioning a portfolio from its current posture to the new, hopefully improved strategy. However, the two key issues are:

- Transitioning the portfolio in a way that minimizes costs, especially taxes; and
- Transitioning the portfolio in a way that minimizes market timing risk.

When we say costs, we are mainly referring to taxes. In most portfolios there are appreciated positions and also positions with unrealized losses. Managing those gains and losses in an efficient way is important. In addition, many families own concentrated equity positions, and if those are going to be fully or partly diversified decisions will have to be made about the many strategies available.

Market timing risk refers to the danger of moving out of one asset class and into another just before the abandoned asset class appreciates and the new asset class declines. When the declines are especially severe, a family can lose confidence in its advisor before the relationship has really started.

A further important consideration to keep in mind is that if you have just sold your family company or share options, or property for a terrific price, the great likelihood is that the equity markets are near a top.

For example, imagine a family that had sold its business and was sitting in primarily cash and engaged a wealth advisor in mid-2007. If the advisor had quickly transitioned the family into an equity-centric portfolio designed for success over the long term, that portfolio would have been clobbered during the 2008 market crisis. It's true that if the family had a very long investment time horizon, the 2008 losses shouldn't have mattered. But *psychologically* it would have been a very difficult eighteen months and the family might have abandoned its new strategy and terminated its new advisor prematurely.

Since families tend to hate losses more than they love gains, it might make sense to manage these transitions more gradually. Understanding these nuances within the family and transitioning the portfolio accordingly is an important value-add by a wealth advisor.

## The Ongoing Activities of a Good Wealth Advisor

The focus of a good wealth advisor, quarter-by-quarter, year-by-year, is to add value to the family's portfolio above and beyond what could be expected from a fully indexed, static position. The following activities are additional ways that a wealth advisor can add value, including:

- Designing an appropriate strategic allocation
- Helping to avoid behaviourally-driven investing mistakes
- Tactically adjusting the portfolio to avoid over-priced market sectors
- Recommending opportunistic investments
- Selecting from among best-in-class investment managers
- Properly locating investments to optimize the value of trust & estate planning vehicles
- Intelligently managing taxes
- Regularly rebalancing the portfolio
- Maintaining discipline in the face of market turbulence
- Reporting timely and accurate results

Each of these activities could easily justify an entire essay paper. We provide just a quick overview:

### *Designing an appropriate strategic allocation*

We mentioned this earlier: it's essential that the strategy recommended by a wealth advisor be right for your family. In a worst-case situation (as described above), the results can be multi-generationally disastrous. But even in a more normal situation, a family that is pursuing an inappropriate strategy will find itself in a constant state of agitation.

### *Selecting investment managers*

Full details of our views on how best to identify good active managers are beyond the scope of this piece. Two critical sources of value that can be added by advisors are manager selection and manager sizing. To calculate whether a manager chosen by your advisor has outperformed is reasonably simple at the individual manager level but becomes somewhat more complex at the total portfolio level. This is because at the individual manager level, one needs only compare the manager's performance to the most relevant benchmark or peer universe and calculate the return differential. At the portfolio level, however, the value of sizing decisions (e.g., allocating 5% versus 10% to a certain manager) needs to be isolated from the value added by the managers versus their respective benchmarks. Advisors decide not only which manager to use, but also about how much capital to allocate to each manager.

At the *individual manager level*, value added is the return difference between the manager's results and its relevant benchmark. At the *asset class level*, average manager selection value can be measured as the difference in return between an equally-weighted benchmark of managers and the appropriate asset class benchmark. (In other words, we are trying to account for the influence of manager-sizing decisions.)

### *Advising on Asset Allocation.*

Many large and complex private client portfolios are comprised of a series of interdependent trusts, retirement funds and estate planning vehicles each of which may have different risk tolerances, liquidity requirements, regulatory restrictions and tax treatments. Locating the appropriate managers and strategies within the right entities can be critical to the overall success or failure of the estate planning strategy. Managing fixed interest tax efficiently is crucial.

### *Managing Taxes*

Taxes generally represent the single largest drag on the long term growth of capital. Unfortunately, taxes are very difficult to avoid (legally) and are an inevitable by-product of a successful long-term investment strategy. Competent wealth advisors believe that tax consequences should be understood and optimized, rather than simply minimized. Optimizing taxes means:

- Designing portfolios from the ground up to be tax-efficient;
- Selecting fund managers (non collective investments) who by default (i.e., low turnover) or design (i.e., explicit tax management) optimize tax realisation;
- Harvesting tax losses in one account to offset gains elsewhere;
- Working closely with non-investment advisors like accountants and attorneys to fully understand each client entity's marginal tax rate.

Some aspects of astute tax management can be measured but it is difficult and time consuming to do so. Efforts have been made to standardize the reporting of after-tax returns across the investment industry but such efforts have failed to gain traction because of their complexity and the cost of implementation.

## *Rebalancing the Portfolio*

For all investors, the importance of portfolio rebalancing lies in its role in controlling risk. As noted earlier, a portfolio that is allowed to drift with the vagaries of the market will tend very quickly to take itself well outside the family's desired risk parameters. Typically, portfolios that are not rebalanced become more risky over time, because on average higher risk assets tend to appreciate faster than lower risk assets.

## *Avoiding emotional investing*

We've already alluded to the importance of sticking to your long-term strategy despite many temptations (fear and greed) encouraging you to deviate from it. Beyond simple rebalancing, advisors can be helpful in dealing with typical, frequently-encountered behavioural issues that can harm your returns. We mention a few examples here.

## *Investing in managers at the right times and for the right reasons*

It is a well-documented phenomenon that investors earn much lower returns (internal rate of return, or IRR) than the managers or funds they have invested in (time-weighted return, or TWR). This sad outcome occurs because investors tend to chase "hot" managers investing in them *after*, rather than *before*, the outperformance has been achieved. On the flip side, investors are often impatient and too quick to terminate existing managers experiencing bouts of short-term underperformance thereby failing to benefit when these managers rebound.

## *Avoiding lousy products*

While it does not show up in the investor's quarterly performance report, the ability of a wealth advisor to steer clients away from inappropriate investments has a significant influence on long-term results. This could be anything from an advisor acting as a buffer for close friends who have the latest "can't miss" ideas to providing an objective opinion about the JSE's "Pick of the Day".

## *Admitting when we're wrong*

No advisor is right all the time. That said, nothing positive is added to a relationship when an advisor is overly defensive about advice that fails to work out. It harms everything from your trust in the advisor's judgment to the effectiveness of future communications. There is, however, much to be gained from addressing what occurred in a straightforward manner and discussing what the appropriate next steps should be.

# A Word on Fees

Investment fees, whether paid to wealth advisors, money managers, custodians or others, are extremely important. We believe that fees should be optimized, not minimized – in other words, you want to be sure you are getting value for what you're paying. Consider just some of the many ways it's possible to go wrong on fees.

There will always be advisory firms that can't compete on quality but that can compete on price. If you are in the market for an advisor and one or two of the firms are offering fees significantly lower than the others, this is a red flag. Chances are that the firm offering such a discount is either not able to deliver the services you need or is going to make it up elsewhere (see the following bullet point).

Many firms use advisory fees as loss leaders. For example, if a firm offers wealth advice and also manages money, it might charge very little for the advice and make it up on the asset management side. This is almost universally true of banks, investment banks, brokerage houses, and large asset management firms. Over time, saving a bit on wealth advisory fees and having your money managed in potentially expensive, uncompetitive products is a very poor bargain. Moreover, a firm that charges little for wealth advice is probably never going to be very good at it. In reality, the "wealth advisors" at such firms are likely to be functioning mainly as salespeople for the asset management business.

# Other Important Considerations

For some families – and some family members – the qualitative issues can be more important than quantitative success. Here are some additional "qualitative" value-adds to look for in a wealth advisor:

## *Expertise*

Does your advisor come to the table with a point of view that is articulated and well-supported? Or is the advisor consistently wishy-washy: "on the one hand this, on the other hand that." Does your advisor have confidence in each recommended manager and a first-hand understanding of each manager's investment strategy? Or does he or she offer several managers and insist that you make the choice?

## *Communication*

When you talk, is your advisor actually listening? When your advisor talks, is he or she speaking plainly or using industry jargon?

## *Authenticity*

Is your advisor candid with you? No advisor, no matter how good or how experienced, can know the answer to every question a family might pose. When your advisor doesn't know the answer, he or she should admit it and go find the answer promptly.

## *Trust*

Do you have complete trust in your advisor? Most families don't expect to become close friends with their advisors, but if you feel awkward or uncomfortable with the person on the other side of the table, a change needs to be made.

## *Partnership*

Note that there are different "levels" to client relationships. A good advisor will help other family advisors – attorneys, accountants, trustees – become even better at their jobs, which will of course ultimately redound to the individual family beneficiary.

## *Education*

In the course of working with your advisor, do you feel that you are becoming a smarter investor? Most clients will never become professional investors, nor do they wish to do so. But if your advisor is willing to take the time to explain what is happening in the portfolio and in the capital markets, to answer your questions and discuss issues at whatever length and depth you need, over time you will become a better, wiser, more sophisticated steward of your family's capital.

# The Importance of the SA Financial System

## Guest Article by Mike Schussler: Economist

The financial wealth of South Africans is huge and is one of the country's major strengths. In 2012 South Africa had over R2.7 trillion in pension fund savings. Pension savings in South Africa equalled 87.6% of GDP, the sixth highest in the world according to data kept by the OECD!

Only very rich countries such as the Netherlands; Switzerland and the United Kingdom had more in Pension fund assets as a percentage of GDP. Two of the most unequal countries in the world had pension assets that put them into the top eight countries in the world of pension assets to GDP.

But this amazing fact is also quite astounding in that the actual value of South African Pension fund assets is easily in the largest ten countries in the world today when valued in dollars. The pension fund assets of South Africans are bigger than those of France; Spain or Germany.

The relationship between the overall success of South African companies and these private pension funds assets cannot be discarded and probably also the reason why our asset managers and insurers are able to become global players. Investec, Old Mutual and Sanlam all have operations in many other countries using their South African base as a good launching pad.

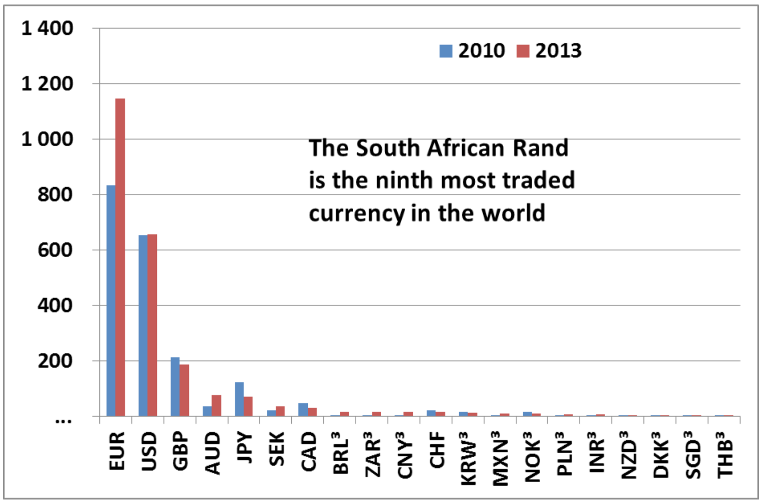
However other parts of the South African financial market are as important and very nearly as big in terms of rankings in the world. Our insurance and unit trust markets are not quite in the top ten markets but are still in the top 20 biggest markets in their respective categories as far as Myciti data from 2012 show.

This is probably one of the reasons that South Africa has such a liquid foreign exchange market which in itself has allowed South Africa to live beyond its means as foreign money rapidly came into a stock exchange which is very liquid.

These pension funds (along with unit trusts) own at least 40% of the JSE and many other smaller private companies (venture capital) without which South Africa would not have seen so many successful companies growing up such as MTN or even state owned companies that are able to tap liquid debt markets.

Our banking system is ranked fairly high as well and while its size is likely to be in the top 20 countries here too when looking at private sector debt to GDP; this part of the financial sector has very good links to our foreign trade and into Africa where it is becoming part of the success of the continent.

**Graph1: Foreign exchange turnover in US Dollar per day by currency.**




*Source: Bank of International Settlements.*

South Africa built up these huge assets over the last 60 or so years for millions of South African households. While certainly not enough savings in most of these accounts if one takes into account that life expectancy is over 20 years for most who reach retirement age of around 60, the funds are nevertheless substantial by any measure.

The big asset base has allowed South Africa and its companies to punch above their weight in the global arena. South Africa is now an economy that makes up 0.5% of the World Economy and less than 0.5% of the global trade.

South Africa is the world's 28th largest economy and is 55th in the world competitiveness report of IMD and 53rd in the World Economic Forums competitiveness report. Nothing to write home about as for the size of our economy - our abilities are clearly lacking in many areas.

But a very big factor in keeping the South African economy from sinking away completely is the size and soundness of our financial markets. All ranking publications over the years and major research organisations have been very complementary about our financial institutions from the banks to our financial exchanges.

In fact, in the competitiveness reports the banks and the South African Financial Exchanges have ranked consistently in the top five places and often right on top. Our currency is the ninth most traded in the world and the JSE is the 18th biggest stock exchange in the world! Our bond market turnover in 2008 was the 13th highest in the world making it liquid and one of the most important in the emerging world.

## OK so South African financial markets are big so what does that mean?

Our ability to trade shares, bonds and foreign exchange has attracted positive attention of major pension funds from afar and they have again allowed our companies access to cheaper funding and helped many of them gain funding and listings on international exchanges. Notice too that our financial markets out preform the actual economy which is not seeing the same ranking or growth that our financial markets are. Often our market is an indicator of overall emerging markets while our economy tracks developed economies performance closer.

This positive aspect can probably at least partly be traced back to the Asset Management institutions in South Africa and they are themselves seen as offering good services and being competitive and most major ones have now established good foot holds in major financial centres of the world such as London and New York.

They are actually one of South Africa's best service exports. Our financial institutions have always been strong in the SACU countries but have now broadened their base to include most of Africa where they offer financial services from banking to investment and insurance products. They are clearly also helping to identify African companies that they think are good bets for the future while at the same time helping these companies improve their transactional openness to lower the cost of their funding.

I believe that they are doing in Africa what they did in South Africa from about the seventies onwards and that is to fund expansion and make African companies world players by slowly increasing funds available and also advising the companies from venture capital aspects to corporate governance.

Without the huge asset base in pension funds South African companies such as SABMiller; Anglo American; BHP Billington; Richemont; MTN and a host of others would not be in the top companies in the world. Today 70% of the revenue of the top 60 companies on the JSE comes from outside our borders but the majority of the shares are still owned by South Africans, although foreign shareholders have increased and are nearly at 50%!

Remember that even the State pension fund manages assets for individuals and this has provided a very powerful capital base for these South African firms to become international firms. This has benefitted everyone in South Africa in the last few years as South Africans have lived beyond their means without the currency sinking like a stone.

The reason is simply that foreigners like our liquidity and still give our companies cheaper capital in which they increase revenue in other countries and bring some of it back in the form of profits and some dividends again flow out to other countries.

This of course further increases the liquidity of the Foreign Exchange Market making it one of the most complex in the World as the reasons for in and outflows are becoming more financial in nature than real economic activity would allow.

This huge pension asset base has also allowed South Africa easy access to funds for major government projects as South Africa has one of the most liquid bond markets in the World too. This has allowed major State owned Companies much easier and cheaper local access to funding.

If Eskom was for example in Angola it would probably not have had access to the funds that it requires. The hundreds of Billions of Rands it requires would have been a far greater struggle and reliance on multinational organisations (Like the World Bank) would have been much bigger with them getting a say in government budgets and the like.

So the fact that power stations, roads, dams and harbours all have access to the ease of local funding also provides an easy way to get international funding as international players get access to price discovery information. They can look up SANRAL and ESKOM bonds from our exchange on their computer screens with access to documentation and outside opinions available too. So rating agencies both local and foreign as well as market research is available giving players plenty of information to trade on in South African debt.

This has also allowed South Africa to start to develop a private sector debt market and gives banks an ability to take over some of the risk when a local small firm buys or rents planes from overseas or the ability to fix car prices for a year or so.

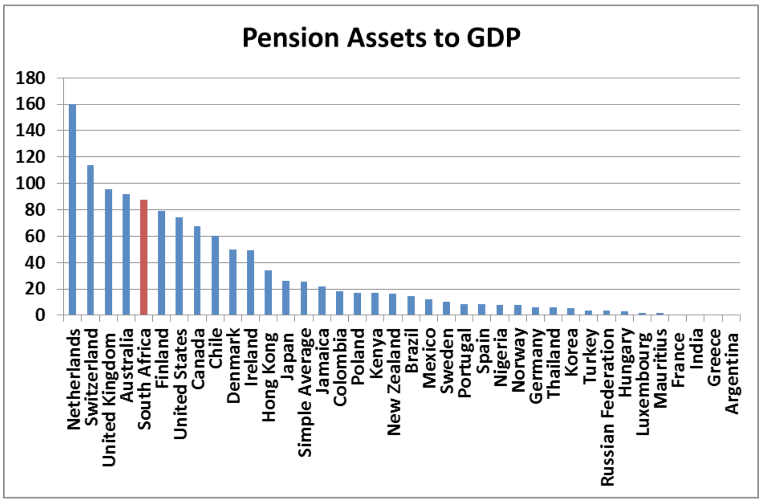
Locally there are also smaller players such as stock brokers and treasury management firms which cater to local company needs and give them more insight and the ability to manage risks much more effectively. They consolidate many of the funds trading on their own and provide service to multi-national operations for all but the biggest banks and corporates.

Insurance and Pension Funds employ nearly 100 000 people today, an increase of 20% over the last five years while banks employ about 175 000 people, an increase of 6% over the same period. Combined with other financial services the industry employs a combined 333 000 people!

It is one of the few private sector areas that have increased employment in the last five years outside of security, retail, wholesale and telecommunications. This fact is very often overlooked but the people in this sector are well paid and highly skilled.

They are also very often some of the best exports that South Africa has as many end up working for financial institutions outside the country. Here they are often able to help the firms in either the debt or equity arena to get international funding as they are often the ones making the actual decisions.

**Graph 2: Pension fund assets to GDP**




*Source: OECD and economists.co.za*

We under value our financial resources and often do not fully understand the value of the firms that operate in this sector.

Without the big liquid sector many infrastructure projects would cost much more and South African firms would not have had the capital to invest in other countries on their way to becoming world beaters.

South Africa would have fallen far further off the international radar and many South Africans would not have been able to afford things like cars, mobile phones and flat screen televisions as the prices have remained low because our firms have been able to expand beyond our borders with the liquidity of the financial markets.

Taking a quick look at the competitiveness reports it is clear that were it not for the excellent financial markets and regulation of these markets along with the massive asset base South Africa would not have been in the top 70 countries in the WEF report and probably at 58 in the IMD report (which only has 60 countries)!

The country would have had hardly any access to savings from the rest of the world and many of our companies may not have had the resources to expand into other countries.

Now the trick will be to attract more foreign firms here and I believe that keeping an ear out for what the big financial firms are stating about where our companies should invest might just teach us a lot in attracting investment.

# Global Macro Economic Developments

## By Dr Alex Pestana

Strategist at Counterpoint Asset Management

*As Counterpoint nears its 3rd birthday, we reflect on the hugely positive impact the Professional Investment Team at our Asset Management associate has had on our Wealth Team, and ultimately our clients.*

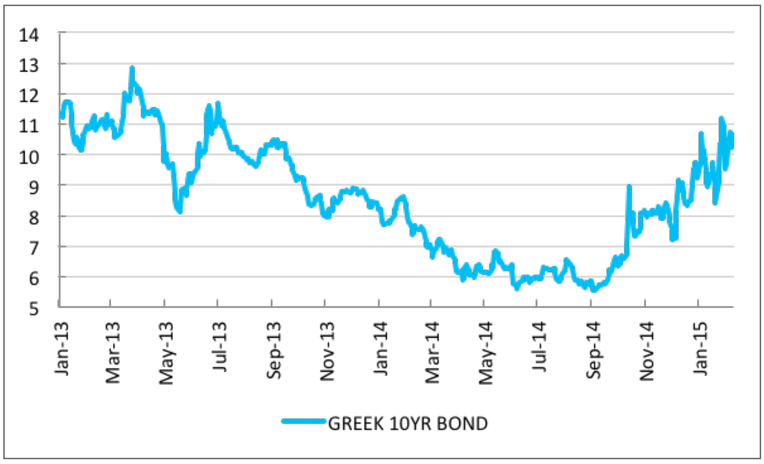
*Alex's global insight is invaluable and we remain proud of our association with both him and his colleagues.*

After an initial bout of volatility in markets, the year got off to a strong start, especially once the European Central Bank (ECB) announced the full extent of its quantitative easing (QE) programme. The stimulus package, worth 1.1 trillion euros, is to be dispensed in installments of 60m euros per month up to September 2016, or until the ECB sees a sustained adjustment in the path of inflation to their target of 2%. In effect, the ECB is to be taking over the mantle of the US Fed in providing liquidity to the global economy. This, together with continued massive stimulus from the Bank of Japan, a required reserve cut in China, and the cutting of rates in several countries including India and Australia, boosted the courage of investors to extend the bull run in equities. The JSE All Share index returned 3.08% in January, led mostly by consumer services (+11.8%), the health care (+6.6%) and the financial sectors (+4.5%). Property also performed well, the SA property unit trust index rising 10.5% and SA listed property rising 7.4% over the month. A lot of the performance on the local bourse was driven by the fall in the oil price and the moderation of interest rate hike expectations resulting therefrom. South Africa performed well in the international context too, the MSCI South Africa Index returning 4.6% in USD over the month, versus the MSCI Free Index return of -1.8% and the MSCI Emerging Market index return of 0.6%. SA bond yields also reacted strongly to the lower oil price as well as the ECB's announcement, resulting in an excellent performance from the JSE All Bond index of 6.5% over the month.

Playing second fiddle in terms of its impact on markets to the ECB's QE programme, but which nonetheless remains a grindingly worrying factor, was the election of a left-wing government in Greece. The new government has pledged an end to its austerity programme and is seeking to restructure the debt it owes in a series of negotiations with a Eurozone rapidly saturating by their demands. An exit of Greece from the Eurozone would put the skids under the Euro and possibly sow the seeds of the beginning of the end of the monetary union. An outright default by Greece on its debt, while not as serious as was the case three years ago owing the European banking system having reduced its exposure to Greece, would nonetheless hurt especially European markets, and shatter a confidence that remains fragile. It would furthermore exacerbate deflationary fears in the Eurozone, the headline inflation of which is negative and is proving the bane of Mr Draghi and his committee at the ECB. Greek markets have reeled on the Greek news, and tend to fluctuate with the fortunes of a possible compromise on their debt.

**Chart 1: Getting the economy wrong…The Greek vs the German Stock Markets**

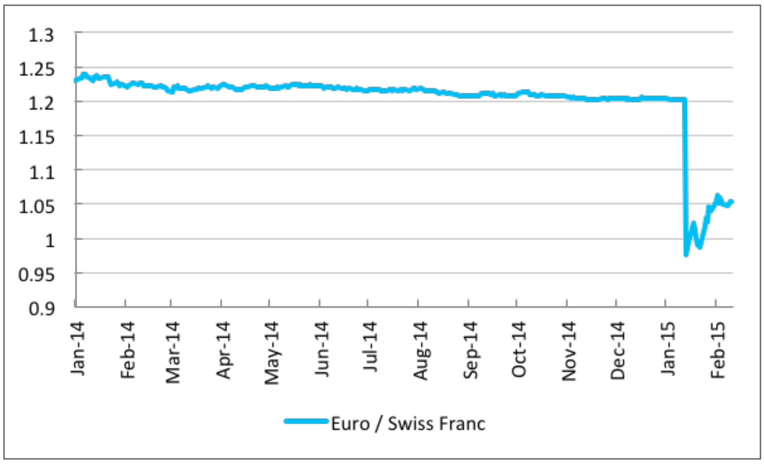
**Chart 2: Greek debt being penalized… Greek Government 10y bond yield**




## Negative Deposit Rates

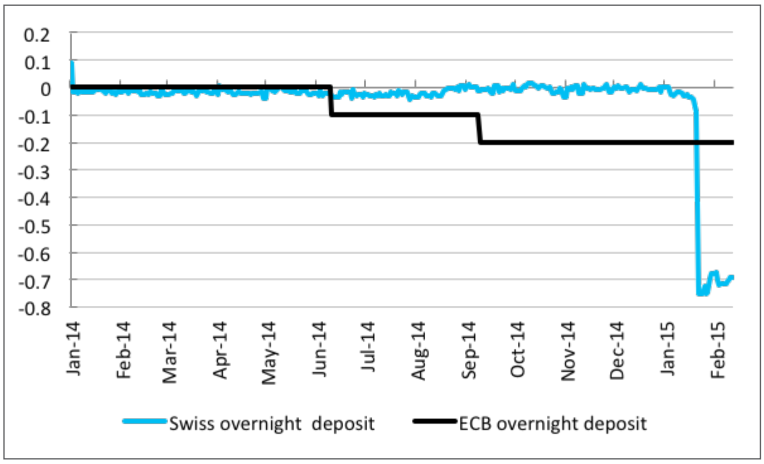
The Swiss National Bank (SNB) caused a major stir in the market when it relaxed the peg of the Swiss Franc against the Euro. To counter all the pressures of 'refugee capital' seeking the safe haven of Swiss banks, the SNB loosened the peg it had committed to keeping in place only three days before.

**Chart 3: The Swiss Franc – Euro exchange rate – ceiling suddenly falls**




This caused a big fall in the Swiss equity market, and resulted in huge trading losses for some banks and a few casualties in the hedge fund universe. But then the SNB went further and cut its interest rates on excess deposits from an already negative -25 b.p. to a new negative interest rate of -75 b.p. In response to this, the Swiss banks of UBS and Credit Suisse have in turn started charging their clients for Swiss franc deposits. The ECB also cut its deposit facility rate to -20b.p. in January. So, the bizarre world of negative interest rates is here! Hardly having become accustomed to negative yielding nominal bonds, the investing public is now faced with negative return on their cash in some parts of the world.

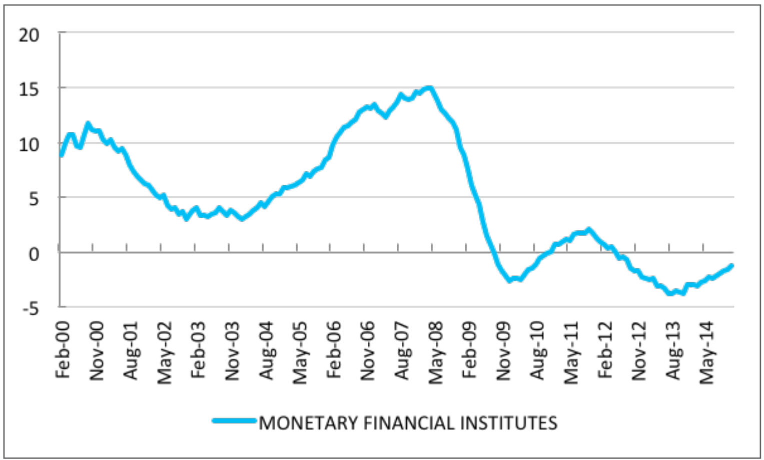
**Chart 4: Interest rates on excess overnight deposits at both the ECB and in Switzerland go negative**



Of course, households can avoid paying a negative interest rate on a bank deposit by buying a good safe and keeping their money in it. The problem is that one is then exposed to burglary, and of course, bank notes are flammable. It is not feasible for large corporations and financial institutions to safeguard money the way that households might. A huge security and storage infrastructure is required for this. The lower bound for interest rates is therefore not zero, but some lower number that incorporates the alternative costs of safekeeping.

The problem with quantitative easing is that despite flooding the banking system with liquidity, it is not clear that banks will want to lend out this money, or that borrowers will want the money at even low interest rates. Lending by European monetary institutions has in fact been running at negative levels for the past three years (see Chart 5). What can be done to induce the banks to lend is to penalise them for holding money at the central bank, which is achieved by slapping a negative interest rate on it. A recent study by the ECB estimated the private cost of cash payments to be 1.1% of GDP on average in the participating countries. The unit social cost was estimated at 2.3 cents per euro of transaction (the utility of not holding cash). It therefore appears that interest rates have room to fall to even more negative levels than they already have.

**Chart 5: Aggregate lending growth at Eurozone lending insitutions has been negative for the past three years. Hence the need for negative interest rates on deposits.**

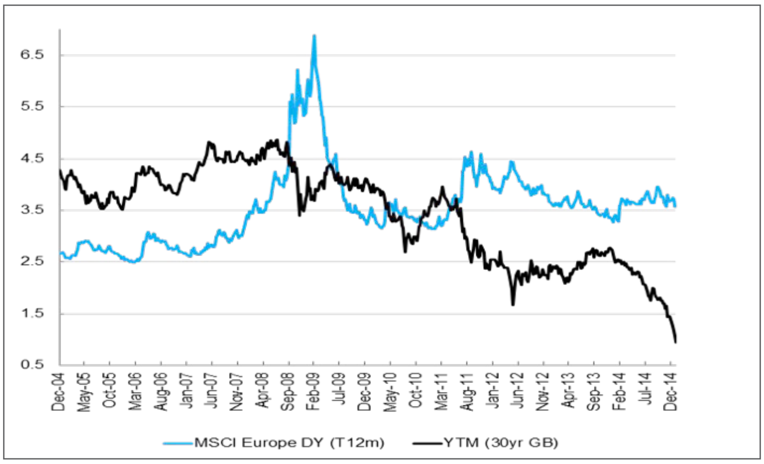



## Implications of Negative Deposit Rates

What are the implications of negative interest rates? The first is that traditional fixed income savers get penalised. They start treating savings like a depletion account. Real rates of return above inflation become difficult to achieve, even with low negative inflation. Traditional fixed income investors start looking at low-risk, stable dividend paying shares. An opportunity exists on European solid dividend paying stocks, which are trading at cheap levels against European bond yields (see Chart 6).

The opportunity cost of holding a non-return bearing asset like gold drops, giving a boost for the investment side of gold as opposed to jewelry demand.. Asset-liability books get strained if not properly matched, and pension shortfalls could build up. The major currencies which yield a higher interest rate will benefit, which in today's configuration means the US dollar and the British pound. Investors continue to look for return where they can get it and become prepared to take on the currency risk to do so. South African equity and bond inflows should be underpinned as global investors continue to take on currency risk in search of yield, which could be rand supportive in the short term.

**Chart 6. MSCI Europe Dividend yield – much higher than the European 10y Bond yield**




But in the longer run, the risks in the system continue to grow. Rising bond yields or defaults could eventually strain the global financial system which would have been bid up to expensive levels. Even worse, given the high indebtedness of many countries, a sovereign bond default could put strain on the whole global financial system in this age of instantaneous connectivity. For the moment though, the liquidity taps runs and equity markets respond positively to ever-lower discount rates.

# Budget Highights

## 2015 Budget Speech Update

The Minister of Finance announced amendments to tax and other legislation that may affect investors. These changes, which came into effect on 1 March 2015, are discussed in more detail below.

### Income tax

Individuals and special trusts

The tax brackets have been adjusted for inflation and income tax rates have been raised by 1% for all taxpayers earning more than R181 900 a year. The highest marginal tax rate for individual taxpayers has increased from 40% to 41%. The personal income tax rates for the 2015/2016 tax year are listed below.

| Taxable income | Tax rate |
|---|---|
| R0 – R181 900 | 18% of taxable income |
| R181 901 – R284 100 | R32 742 + 26% of taxable income above R181 900 |
| R284 101 – R393 200 | R59 314 + 31% of taxable income above R284 100 |
| R393 201 – R550 100 | R93 135 + 36% of taxable income above R393 200 |
| R550 101 – R701 300 | R149 619 + 39% of taxable income above R550 100 |
| R701 301 and above | R208 587 + 41% of taxable income above R701 300 |

### Companies and Trusts

The income tax rate for companies remains unchanged at 28% and the rate for trusts (other than special trusts) has increased from 40 to 41%.

### Tax Thresholds

Tax thresholds have been amended to:

R73 650 for taxpayers younger than 65
R114 800 for taxpayers aged 65 to below 75
R128 500 for taxpayers aged 75 and older

### Rebates

Rebates deductible from tax payable have been amended to:

R13 257 per year for all individuals (primary rebate)
R 7 407 for taxpayers aged 65 and older (secondary rebate)
R 2 466 for taxpayers aged 75 and older (tertiary rebate)

### Interest Exemptions

Interest exemptions remain unchanged:

The exemption on interest earned for individuals younger than 65 years remains R23 800 per annum.

The exemption for individuals older than 65 years remains R34 500 per annum.

### Medical tax credits

Monthly tax credits for medical scheme contributions will increase as follows:

From R257 to R270 per month per beneficiary for the first two beneficiaries
From R172 to R181 per month for each additional beneficiary

### Dividends Tax

Dividends tax remains 15% on dividends paid by resident companies and by non-resident companies for shares listed on the JSE.

Most foreign dividends received by individuals from foreign companies (shareholding of less than 10% in the foreign company) are taxable at a maximum effective rate of 15%.

Interest withholding tax

A final tax at a rate of 15% is imposed on interest from a South African source payable to non-residents with effect from 1 March 2015. Interest is exempt if payable by any sphere of the South African government, a bank or if the debt is listed on a recognised exchange.

## Retirement lump sum taxation

At retirement

The first R500 000 of a retirement lump sum withdrawal remains tax free. The table below illustrates how lump sums will be taxed:

| Taxable lump sum (R) | Rate of tax (R) |
|---|---|
| R0 - R500 000 | 0% of taxable income |
| R500 001 – R700 000 | 18% of taxable income above R500 000 |
| R700 001 – R1050 000 | R36 000+ 27% of taxable income above R700 000 |
| R1050 001 and above | R130 500 + 36% of taxable income above R1050 000 |

## Pre-retirement

The first R25 000 of a pre-retirement lump sum withdrawal remains tax-free. The table below illustrates how lump sum withdrawals will be taxed:

| Taxable lump sum (R) | Rate of tax (R) |
|---|---|
| R0 – R25 000 | 0% of taxable income |
| R25 001 – R660 000 | 18% of taxable income above R25 000 |
| R660 001 – R990 000 | R114 300+ 27% of taxable income above R660 000 |
| R990 001 and above | R203 400 + 36% of taxable income above R990 000 |

## Capital gains tax (CGT)

CGT inclusion rates remain unchanged but the maximum effective rate has increased slightly for individuals and special trusts, as well as for other trusts. The effective rate remains unchanged for companies.

| Investor | Maximum effective tax rate |
|---|---|
| Individuals and special trusts | 0% - 13.65% |
| Companies | 18.65% |
| Other trusts | 27.31% |

## Specific exclusions worth mentioning are:

Annual exclusion of R30 000 for capital gain or loss granted to individuals and special trusts

R300 000 granted to individuals in the year of their death

## Changes proposed for the future

Interest withholding Tax

The term "interest" is to be defined for withholding tax purposes. Provisions will be introduced to ensure that the withholding tax will only apply to interest that would be taxable in South Africa.

## Retirement Funding Reform

The alignment of pension, provident and retirement funds is scheduled for 1 March 2016. Lump sums paid by all funds will be subject to compulsory annuitisation and the tax deduction of contributions to these funds will be 27.5% of the greater of an individual's taxable income or remuneration.

## Exchange Control

From 1 April 2015, South African residents' foreign capital allowance will increase from R4 million to R10 million per calendar year, or upon emigration, or R20 million per family unit.

Sterling Private Wealth (Pty) Ltd
Ground Floor, Block B, 19 Impala Road, Chislehurston
Private Bag X9978, Sandton 2146
t. 2711 883 8828  f. + 2711 783 0091
www.sterlingwealth.co.za



Sterling Private Wealth (Pty) Ltd, Reg. No. 2007/004491/07 FSB Licence No. 32319