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Introduction
Graydon Morris

As we near that time of year when many of us take the opportunity to step off the treadmill for a short while, we should reflect on another fantastic year of investment performance for most investors, both in terms of local market conditions, and international positions, with a double whammy when one factors in the currency effects, if measured in ZAR. We continue to caution and to highlight to clients the need to expect, and embrace, volatility as part of a long term strategy of protecting and growing real capital. Statistically, we should soon be due for a negative SA equity market performance over a calendar year. Is 2014 that calendar year or not? The walk, however, as they say, is random. This is why diversity and exposure in many areas is so critical. Whole scale market timing and speculation has no place in a sensible long term strategy. We address this issue partially in a piece in this Sterling Times by our team around "Overconfidence", the enemy of many an investor.

Our small JV, boutique asset management operation, Counterpoint, continues to thrive. The funds under management have grown to over R 1.15 billion and each fund is steadily developing an enviable track record in its respective sector. This development remains work in progress, and the Team is growing strongly. The intellectual strength and breadth this team provides us is invaluable, and we believe that this strategic initiative is crucial in the long term. Notwithstanding this strategy, Sterling Private Wealth remains an open architecture wealth management business. In aggregate, our investor's exposure to Counterpoint managed solutions reflects less than 10% of all assets under advice at present.

A new intern, Sarah Golding, joins the Counterpoint team in Cape Town in January and we wish her well.

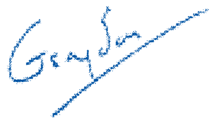
The relationship with Hugo Capital in the Cape continues and grows. The branding between our two businesses will be standardised from January 2014. Janet Hugo has a wealth of experience and enthusiasm, adding tremendous depth and insight into our team. Her strong ties and involvement in the FPI (Financial Planning Institute), too, keep us at the forefront of the developments in our field.

Nicolene Spies joined our administrative team in Sandton from AON recently. She has injected much life and renewed energy into our office. We welcome her again and wish her a wonderfully fulfilling career with Sterling. I am sure many of you would already have engaged with Nicolene and experienced, first hand, her bright and cheery nature, and friendly disposition.

We potentially stand on the edge of monumental changes in the retail financial services industry. It is anticipated that further regulation and development, particularly in the formal retirement funding space, will be forthcoming in the next 24 months. This may entail more standardisation, default options and compulsory preservation, amongst other changes.

We have included a few diverse pieces in this final edition of the Sterling Times for 2013. The piece mentioned earlier dealing with Overconfidence is provided, alongside a view on the current state of investment markets by Cadiz, a view on the process of selecting fund managers, and a short note by Russell Gibson, particularly relevant to our grandparent clients, dealing with planning when one has minor children.

We take this opportunity to wish all our clients a wonderful festive season. We trust that you will enjoy the time with family and friends, and for those travelling, that you all return home safely into 2014. We look forward to seeing you all next year.



Graydon Morris
Founding Director

Should an investor still be looking for that pot of gold at the end of the rainbow? Even as professionals (in fact, perhaps more so), we are at risk of overestimating our ability to predict the future, because as humans we have a tendency to overestimate our competence, knowledge, and experience and our ability to control outcomes. We tend to overestimate the information we have (which creates a knowledge illusion) and the accuracy of our estimates and our abilities (which create control and experience illusions).

I know how tempting it is to look for “the answer” to miserable markets, when they inevitably present themselves......it is, however, very dangerous to ignore the behavioural risk of overconfidence as you compete against the thousand other Tiger Woods’s in the global investment markets.

In 1938, John Durand wrote Timing: “When to Buy and Sell in Today’s Markets”, one of the early classics in active investment management. He also wrote “How To Secure Continuous Security Profits in Modern Markets”, in which he opined: “As this is written, one of the greatest bull markets in history is in progress. People have been saying for several years that prices and brokers’ loans are too high; yet they go on increasing. … People who deplore the high at which gilt edged common stocks are now selling apparently fail to grasp the fundamental distinction between investments yielding a fixed income and investments in the equities of growing companies. Nothing short of an industrial depression … can prevent common stock equities in well-managed and favourable circumstanced companies from increasing in value, and hence in market price.” This advice was penned September 1928.

In March 1998, Brad Barber and Terrance Odean, two respected behavioural finance academics, published a paper often referred to as “the cost of a good idea.” Based on the trading records of 66,465 households with accounts from 1991 to 1996, the researchers compared the performance of the stocks investors sold to the performance of the stocks they bought with the proceeds of the sale. They found that those that traded most (i.e., those investors with the most “good ideas”) earned an annual return of 11.4%, while the market returned 17.9%. The average household earned an annual return of 16.4%. The conclusion? “Overconfidence can explain high trading levels and the resulting poor performance of individual investors. Our central message is that trading is hazardous to your wealth.”

Robert Markman, was a prominent portfolio manager in the USA in the 1990’s.

In March 1999, he wrote, “The asset allocation zealots are mindlessly over-diversifying based on past performance. Ironically, it is the asset allocation zealots, in their rush to mindlessly diversify, who are projecting dangerously from past performance.” In April he wrote “Bubble? What bubble? An all-time high often means the market is going higher. A lot of people talk about this all-time high as if it’s a market top. This market high is a reflection of a strong economy. We often get hung up on these numbers and lose sight of the real direction of the market. The economy is strong. The economy is broad. The economy is deep. All the data coming in is positive. This is no bubble. This market is different from the market top of the ‘60s. This market is different from the market of the early ‘70s. This market is certainly different from Japan. A lot of people are pulling out the old Japanese bubble stuff, saying it’ll happen here. Let’s keep in mind in the late ‘80s, when the Japanese market was truly a bubble, the ground of the Imperial Palace in Tokyo had a greater market value than all the real estate in the state of California. That’s a bubble! This is the future—changing right in front of us. What we have are some pretty high P/Es that are based on expectations of future growth. Those who can’t understand this market don’t understand the role of technology in our economy and how it’s changing right before our eyes.” [over the next few years the market fell about 35%]

We know you’ve all seen the charts: “If you missed the x best days,” your return would have only been x%. That obviously begs the question: Why would someone miss those few best days? The answer is, the market moves up just as quickly as it moves down. According to one recent study, 70% of the best days in the market occurred within two weeks of a worst day (14 out of 20 days) and 100% of the best days occurred within six months of a worst day (20 out of 20 days).

Remember that in predicting the future, the key is not simply getting a single prediction correct; it’s getting all of the interacting consequences correct. Ask yourself, just six years ago, would you have confidently predicted that Americans would elect their first African-American president in 2008? Would you have imagined that Citigroup would trade for a time under $1 or that General Electric would trade for a time under $6 or that Bear Stearns and Lehman Brothers would virtually vanish? That Chrysler and GM would file bankruptcy?

Would you have guessed that we would have a fall of more than 50% in the broad stock indices or that oil would triple in price and then fall by more than $100 a barrel? Some gurus might have seen parts of this pattern, but all of it? Again, life is far too complex to be predicted with any consistency.

The moral? Sterling Private Wealth’s investment philosophy, although not static, is founded on decades of financial research and practical experience. We believe that profitable long term investing is based on buy and-manage with a consistent exposure to the market, allocations based on forward looking expectations, formalized and continual rebalancing, careful attention to the management of expenses and taxes, all based on the unique circumstances of each client.

Where should one invest or how should one structure one's investments to achieve an acceptable outcome?

Paraphrased and Sterling Private Wealth Edited Guest Article by Cadiz Asset Management

With markets reaching new ground on the upside of late, many investors are questioning future strategy. With this in mind, we are sharing the following views penned by Cadiz.

The investment outlook that we currently convey to our institutional investors can be summarised as follows:

1. The world economy is in a mild upswing, led by the US and supported by the rest of the developed world. Not only has Japan recently joined the expansion trail but even Europe has managed to work itself out of recession, which is likely to persist into 2014. Growth in the developed world is largely driven by the services sectors, whilst manufacturing production and capital investment spending are two growth vectors that are yet to kick in.

2. Emerging market growth continues to deteriorate, although Chinese growth has stabilised. A major risk for emerging markets is the anticipated tapering of liquidity injections by the US Fed, which may pose funding risks for those countries with large current account deficits; like South Africa. Global liquidity will, in all likelihood, remain accommodative as central banks err on the side of caution; being more concerned about economic growth than about inflation for the time being.

3. The SA economy will likely see its sub-par growth continue for a while. Expectations are for interest rates to remain low for longer. The Reuters consensus only sees rates moving higher during 2015. Inflation most likely peaked during August at 6.4% and is expected to move to within the target band by the 4th quarter of 2013. The current account deficit, at 6.5% of GDP, remains a concern. Even more so is the funding thereof in an environment of capital flowing back to the developed world on the back of higher interest rates there? The outlook for the Rand therefore remains uncertain, despite potentially being undervalued on many measures.

Having briefly described the investment environment, the question remains; 'Where should one invest or how should one structure one's investments to achieve an acceptable outcome?'

We know that interest rates, as far as policy rates are concerned, will remain extremely low for longer than what most of us had expected. However, interest rates in the bond market and at some stage even in the money market are likely to move higher. For bond investors higher rates in themselves pose the risk of capital loss which, in turn, will dilute your total return. But the main point about interest rates remaining low for longer is that it is good news for both equity valuations and economic (earnings) growth. This is therefore good news for global and domestic equities, bar perhaps a short-term period of consolidation. Valuations are by no means cheap, but the fact remains that equities are cheap relative to other asset classes like bonds, cash and even property. With global liquidity remaining supportive, equity markets are more likely to grind higher than experience a renewed bear market. International surveys also point out that fund managers are still underweight equities and by implication overweight bonds. The fat lady may yet sing for equities.

With inflation at around 6%, money market rates are unable to beat inflation, even before tax. One has little choice but to remain underweight cash except for purposes of maintaining liquid assets in the event of a crisis. Bond funds will not necessarily solve your problem as they have to contend with rising interest rates and the risk of negative capital returns. As Jonathan Myerson points out in his review of tapering's effect on local bonds, the smart money will retain a healthy exposure to extra income funds, which hold little exposure to fixed rate bonds and offer yields of 2% in excess of money market funds.

Property has been a very popular asset class for many investors. Not only has it performed exceptionally over a long period of time, but people feel comfortable about property as they feel they understand the asset class and it is tangible. Yes property is tangible and yes, property has done well, but there is a good reason to be more cautious on this asset class. Global interest rates have been on a downward trend since 1981. Lower interest rates benefit the valuation of financial assets, especially those with a long duration like property, hence the reason for their stellar performance. Take note, however, that property will be negatively affected by higher interest rates and returns in future will be below the average of the past 20 years. It may still be worth your while to hold property, especially as an income generating asset, but caution is warranted.

Foreign exposure remains an attractive option, especially foreign developed market equity exposure. Both Europe and Japan look attractive and within that there is potential upside to the financial and technology sectors. The arguments put forward for the other domestic asset classes all hold for foreign investments, making the diversification argument so compelling for foreign equities. If you are concerned about Rand strength diluting your returns, one must believe that the long term potential upside on the equity investment outweighs the potential for the Rand to strengthen.

Investors with a long term investment horizon

Where should one invest or how should one structure one's investments to achieve an acceptable outcome?

should consider picking a couple of good value funds and staying put – for now at least. If you are in the retirement phase, do an asset-liability matching exercise. Simply put, this means you need to allocate your assets according to your income requirements. Invest the next three to six years' income (the money you will require to live on) into income funds, as we ordinarily advise. The risk that your equity investments will be negative after six years from now is very small, if not zero. Remember that you have set aside many years' worth of income in conservative funds, which you can use to live off. Your biggest risk is that you may outlive your assets and the more conservative you are in aggregate, the higher the probability of this because your cost of living will grow faster than your capital.

By structuring your asset allocation on the basis described, your assets will in all likelihood outgrow inflation whilst retaining flexibility and liquidity throughout. Remember though that you should rebalance your assets regularly to retain this structure.

Planning for Minors

Russell Gibson
Director: Sterling Private Wealth

This piece is particularly relevant in the case of simultaneous death of the parents, and naturally is something that our grandparent clients may ponder.

At the end of last year, a motor vehicle collision tragically claimed the lives of two young parents. They were survived by three minor children. How often do we take this possibility into account when doing estate planning?

Here are some important factors to bear in mind when undertaking estate planning for parents with minors.

Appointment of a guardian

Both parents and wealth managers often overlook this consideration. They possibly think that the surviving parent remains guardian in the event of the death of the other parent, so why worry. Also, it is a tough task deciding who will raise the children when a parent dies. Sometimes it is just difficult because parents are unable to agree on a suitable guardian. It is imperative to assist parents who have minor children with these challenging decisions. There must always be a nominated guardian stipulated in the Will. The roles and responsibilities of guardians are highlighted in the Children's Act, stipulating, for example, a guardian of a child must be able to:

- Administer and safeguard the child's property and property interests;
- Assist or represent the child in administrative, contractual and other legal matters;
- Give or refuse any consent required by law in respect of the alienation or encumbrance of any immovable property of the child.

More than one person may have guardianship of a child; each is competent to exercise independently and without the consent of the other any right or responsibility arising from such guardianship. This can create obvious problems, especially in cases where the consent of all the persons that have guardianship of a child is necessary (for example, in respect of matter like the alienation or encumbrance of any immovable property of the child).

The Children's Act does not require consent of all the guardians in cases where cash and or movable property are disposed off. The tension this can create between guardians is to the detriment of the minors.

There is a distinction between the appointment of a guardian and a person to be vested with the care of the children. A parent who is the sole guardian of a child may appoint a guardian and/or a person to be vested with care of the child in the event of his/her death. Therefore, one person can be the guardian of a child while another is vested with taking care of the child. Such an appointment must be contained in a will made by the parent. A guardian or person vested with the care of children cannot be appointed if the other parent is still alive.

Review beneficiary nominations and beneficiaries

This includes not only beneficiaries in terms of a will but also nominated beneficiaries in terms of life insurance contracts, trust deeds and pension fund benefits. Many parents comment that they have not updated their will, insurance and pension funds to reflect their youngest child or children. It is therefore crucial to review any documents with beneficiary nominations after the birth of each child. It is too late after the parent's death.

Where are the assets ending up when dying simultaneously?

In the absence of provisions in a last Will and Testament, a minor child's cash inheritance is paid over to the Master of the High Court's Guardians Fund for safekeeping. The other assets (movable and immovable) are registered or transferred to the minor, meaning that it will be managed by their guardian. If the guardian is not good with financial matters, consider a testamentary trust. Whether it makes sense to set up a trust depends on the beneficiary's circumstances, the value of the assets and a proper analysis.

Reasons for setting up a testamentary trust include:

- To provide for maintenance obligations;
- To ensure that minors' inheritances are invested until a certain age;
- To administer assets on behalf of minors;

- To avoid payment of cash inheritances to the Guardian's Fund;
- To save taxes. Testamentary trusts established for minor children are treated more favourably by the tax authorities in that they are subject to the ordinary income tax rates that apply to individuals, but without rebates. This can have the effect that a trust correctly created for minors can have a much lower tax rate (as low as 18%) compared to the normal inter vivos trust rate of 40%.

Payment of maintenance

Assets like fixed property, investments (especially where the income on the investment will be too low) and income from pension funds may not necessarily provide sufficient income for a child's day-to-day living expenses, school fees and or tertiary education. The executor and or trustees may therefore be faced with the situation where the children cannot continue attending their school or university because there is not enough money for everybody. When both parents die, both incomes, if applicable, are lost for the surviving children. A proper analysis should be done to establish the after-death maintenance needs of the minor children. When established that the current assets including investments will not sufficiently provide for the minor children's financial needs, appropriate life insurance could be considered.

Businesses interests

Where one or both of the parents have business interests, they should be assisted with business continuance planning, especially in case of simultaneous death. Planning for business continuance will allow for an orderly succession of control in the businesses of the deceased. Business succession planning will also ensure that minor children would not lose future maintenance which would happen if the businesses were sold at low prices. The formation of trust could be used in this instance. The minor children's shares can be bequeathed to a Testamentary or an Inter Vivos trust created specifically for this purpose.

However, in the planning, one should keep in mind to make sure that the appropriate trustees are nominated and they are willing to be trustees for this purpose; they have business experience and that they will be able to take appropriate decisions on behalf of the trust and the beneficiaries (the minors). Because of the trustee's fiduciary duty, it can be very onerous and risky to be a trustee especially in a trust with business interests and minors as beneficiaries.

Appropriate Active Manager Selection

James Guimaraens

One of the principal methods of identifying investors who will encounter little success over time is to observe those who are most obsessed with the appointment of fund managers. The reason for this is that fund managers typically subtract value from, rather than add value to, the investment process. It is not that money managers are incompetent but that their services are, on the whole, overpriced relative to the value they bring to their customers.

In the asset classes that matter most to investors – local and global large cap stocks – many managers (by no means all) will under-perform over time by at least an amount equal to their fees and trading costs. In the more complex and obscure asset classes, where useful information is difficult to come by, talented and hardworking managers may modestly add value net of all costs. The main reason investors spend so much time and emotional energy on working with managers, despite the modest-to-negative return we are likely to receive for our efforts, is that fund managers are actual human beings, while almost all other aspects of the investment process are purely intellectual. It's a lot more fun and a lot more interesting to spend time talking with an intelligent investment manager than it is to run mean variance optimization algorithms or participate in long conference calls with accountants about tax managing our portfolios.

We herein try to address a couple of the principal issues associated with Investment Manager appointments. Specifically:

- We analyze why it is so difficult to identify best-in-class managers in time to profit by investing with them.
- We look at why it is that good past performance can be completely meaningless.
- We identify the (mainly qualitative) characteristics of best-in-class managers.

The Challenge of Identifying Best-in-Class Managers

It is almost impossible to express how difficult it is to identify truly outstanding portfolio managers in time to profit by investing with them. By "truly outstanding," we mean managers whose outperformance relative to the broad markets and to other managers will be so great as to result in significant wealth creation for their and our investors. Consider that in the past few decades several thousand people won large lotteries – lotteries large enough to result in significant wealth for their winners. But since 1970 how many Warren Buffetts have there been? More than one, to be sure, but not thousands. Not hundreds, not even dozens. Statisticians will tell us that playing the lottery is a fool's game, that in the aggregate lottery players lose far, far more money than they win, and that even the remote possibility of gaining great winnings doesn't begin to justify the cost of playing. What would statisticians tell us about the challenge of finding outstanding money managers?

Periodically, we take a look at the percentage of US large cap mutual funds that have outperformed the Vanguard S&P 500 Index Fund (Institutional) over the past ten years (until 31/12/2012). Of the 3,724 US large cap stock managers in the Morningstar database, only 500 had a ten-year track record, only 98 outperformed on a pre-tax basis, only 79 outperformed on a pre-tax, risk-adjusted basis, and only 40 (forty!) outperformed on an after-tax, risk-adjusted basis. Now if you believe that, back in 1991, you could have picked those forty mutual fund needles out of the huge Morningstar haystack, you are a very confident investor!

If identifying great managers weren't difficult enough, timing in the enterprise is everything. People who invested with the legendary hedge fund manager, Julian Robertson, early in the game, had little idea how much money they were about to make.

But people who invested with Robertson late in the game had little idea how much money they were about to lose; same great manager, very different outcomes... for different reasons one could argue similarly for Bernie Madoff.

The same phenomenon is commonly encountered on a mass basis. Consider that between 1984 and 2000, while the S&P 500 was producing an annualized total return of 16.3%, the average mutual fund equity investor in the US realized an annual return of only 5.3%.

Those investors could have achieved an annual return of 5.8% by simply investing in risk-free

Treasury bills. True, equity mutual funds substantially underperformed the market during that period, but the worse culprit was extremely poor market timing by investors – retail investors chased performance, constantly selling out of funds that had underperformed (just as they were about to outperform) and buying funds that had outperformed (just as they were about to underperform).

Finally, outperformance among managers tends to show little persistence over time, at least if we define outperformance to mean "consistently landing in the top quartile of all similar managers."

A while ago a study was undertaken, which looked at persistence even among managers in a sector of the market that is generally considered to be inefficient, and where talented managers should have room to run – namely, US small cap managers.

An analysis was prepared a decade ago using a group of 57 small cap growth managers and compared relative performance over time. Most investors believe that capable managers should be able to add value in inefficient sectors with reasonable consistency over time. Hence, the purpose of the exercise was to determine how often managers remained outstanding performers over time.

Of the top fifteen managers in 1995, only two remained in the top fifteen by 2002. On the other hand, the manager who finished last (57th) in 1995, was the eleventh rated manager by 2002. In other words, investors hiring any of the top performers in 1995 would have been sorely disappointed by 2002.

Adding value is determined by the extent of wealth accumulation. To illustrate this point, If you assumed that each of the 57 small cap growth managers referred to above was given $1 million at the beginning of 1996 and calculated the wealth accumulation through 2002 based on each manager's returns over that period. The best performing manager at the end of 2002 had accumulated $3.3 million. Unfortunately, that manager had been ranked number 48 of the 57 managers in 1995, and hence was highly unlikely to have been hired in 1996. The worst performing manager at the end of 2002 had reduced client wealth to $700,000 over the period. It will not surprise you, we hope, to learn that the worst-performing manager had been ranked number 1 of 57 in 1995. That manager was highly likely to have been hired by investors in 1996.

The non-persistence of manager outperformance wasn't limited to these unhappy examples – non-persistence was characteristic of the entire group. As noted, only two of the top fifteen managers in 1995 appeared in the top fifteen based on accumulated wealth through 2002, and a full two-thirds of the original top performers in 1995 had fallen below the median manager in wealth accumulation by the end of 2002.

The Main Problem: Recent Good Performance Is Almost Irrelevant. The main mistake investors make in engaging managers is hiring a firm that has experienced good recent performance – say, a better-than-average five-year track record.

The reason this is a mistake is that, more often than not, a good five-year track record says virtually nothing about how the manager is likely to perform over the next five years. That track record might indicate that the manager will continue its outperformance, but it is far more likely that the track record indicates one of the following:

The good track record is simply the result of "the law of small numbers". In his endlessly amusing book, A Mathematician Plays the Stock Market, John Allen Paulos points out that we tend to misunderstand the role chance plays in the outcomes of apparently even games. Imagine that two people – we will call them George Soros and George Bizos – flip a fair coin 1,000 times each, competing to see who can come up with the most heads. We tend to imagine that, after that many flips, the outcome would almost always come out very even, with Soros and Bizos each getting about 500 heads and 500 tails. We infer from that conclusion that if one of the players actually ends up well ahead of the other, that outcome must be due either to an unfair coin or to the special skill of one of the players.

In fact, as Paulos points out, there is a far greater probability that after 1,000 fair coin flips, Soros or Bizos would be well ahead of the other, having flipped 525 heads to, say, 475 heads. We might call this "the law of small numbers," that is, 1,000 flips may seem like a lot, but actually it's not enough observations to ensure that Soros and Bizos will come out even. Thus, if 10,000 people all flipped a fair coin 1,000 times, the aggregate results would tend to be that a goodly number would end up with pretty darn good records and an equal number would end up with pretty sorry records. A very few would have spectacular records and a very few would have abysmal records. Far fewer than we might expect would have "even" records.

This outcome looks alarmingly like the outcome of fund manager five-year track records (which are based, after all, on only sixty monthly observations, or in some cases on only twenty quarterly observations): a tiny number have spectacular records, a tiny number have abysmal records, a goodly number have pretty darn good or pretty darn bad records, and only a few have average track records. Investors who engage managers purely on the basis of good five-year track records are likely to fall victim to "the law of small numbers."

The good track record may simply the result of fortunate timing. Imagine a money manager who has been in business for fifteen years and who, for thirteen of those years, has reliably turned in undistinguished performance. But during the past two years, for reasons unknown to us or the manager, performance has been quite good. These two “lucky” years of performance pulled the manager’s five-year record up to the point where it now has a very creditable five-year track record. As a result, many unfortunate investors, impressed with that record, will engage a manager who is clearly undistinguished and who can be relied upon to continue in that vein.

The good track record may simply be the result of style rotation. Let’s consider two managers. We’ll call them Value Capital Investors (VCI) and Capital Value Investors (CVI). Both are deep value managers who do well, naturally enough, when value stocks are in vogue and less well when growth stocks are in vogue. Both have been in business for many years and have built their businesses in the same way. Just after periods of value outperformance, when their track records are strong, VCI and CVI both aggressively market their records, building their asset bases. After periods of value underperformance, when their track records are weak, VCI and CVI both work hard to keep their clients from defecting. The result of all this is a repeating pattern of strong asset growth followed by weak asset growth or even asset contraction, followed by strong asset growth, etc.

But there two things wrong with this picture. The first is that investors are constantly making the wrong decisions about VCI and CVI: engaging them just when they are about to enter a period of weak performance and terminating them just when they are about to enter a period of strong performance. Investors are, in effect, buying high and selling low.
The second problem is that VCI turns out to be a very competent manager, while CVI is well below average: investors should be engaging VCI and should be avoiding CVI. But investors don’t do this because the differences in aggregate performance between the firms are overwhelmed by the sector rotation effect: being a deep value manager had more impact on a manager’s performance than did being a good manager.

The Characteristics of Effective Fund Managers

Nonetheless, the main characteristics of best-in-class managers are simple enough to state. They are as follows:

- *Investment philosophy.* The quality of a portfolio manager’s investment philosophy is perhaps the single most critical element in judging whether the manager is likely to be capable of sustained outperformance. Unfortunately, this issue is also likely to be of little help to individual investors in identifying best-in-class managers. The reason is that there is no such thing as a money manager who can’t articulate an investment philosophy that sounds good. The only way to know whether or not what sounds good actually holds any water is to put the manager through a thorough, multi-level scrutiny, as described above, ending with an intensive on-site grilling of the manager and its senior team by an investment professional who has had vast experience interviewing and working with managers.
- *Discipline.* Even the most solid investment philosophy won’t create wealth unless it is implemented in a disciplined manner. To determine whether the manager is a disciplined investor and is sticking to its philosophy in good times and bad, it is necessary to conduct a detailed review of the manager’s performance during periods when the wind has been at his back and when the wind has been in his face. Attribution analysis and a close examination of investment decisions that turned out badly can shed important light on these questions. In particular, “sell discipline” – strict rules that determine when a security is to be sold – is important. As noted above, sell discipline tended to disappear during the bull market of the 1980s and 1990s. Under more normal market conditions, however, sell discipline is crucial. Otherwise, managers will tend to hold appreciated securities far too long and to believe that they are “smarter than the market,” therefore holding on to under-performing securities that should be sold.
- *Experience.* Any manager can outperform over a short period of time, and investors who hire such managers after that period of outperformance will almost always – almost always – be disappointed. The five-year rule is intended to enable investors to observe a manager’s performance over a full market cycle, that is, a period of time during which the manager’s investment style and philosophy are in vogue as well as a period of time when they are out of fashion. Hence, five years might be too short a period of time or, in a few cases, it might be more time than we need.
- *Asset base.* Some investment philosophies and styles can be carried on at huge scale, but others will be successful only if they remain niche businesses. Bond managers can oversee tens of billions of Rands with relative ease. Indeed, scale matters in bond management because trading costs, can eat up a large fraction of the potential returns. But small cap managers face the opposite problem: the float of most small cap stocks can be very thin, making the management of even a few hundreds of millions of Rands

problematic. Many professionals believe that trading costs are so high with smaller stocks that any return advantage is completely negated. Thus, with small cap stocks smaller really is better all around.

- *Alignment of interests.* Money management is a business, and like any business operator, fund managers will attempt to maximize their profits. If those profits can only be maximized by acting in the interests of clients, the manager-client relationship is likely to be satisfactory to both parties. Unfortunately, there are many ways in which fund managers can increase their profits at the expense of client investment returns. One obvious example is for the manager to emphasize asset gathering over alpha generation. It is far easier for a manager to increase its fee revenue by focusing on proven sales techniques than by focusing on the complex challenges associated with investment outperformance. As a result, most fund management firms are really sales organizations, not money management organizations, and are to be avoided on that ground alone.
- *Organizational stability.* A sound investment philosophy can only be implemented by an investment team that has worked together for years and that has experienced little, ifany, turnover. Even among managers who have produced outstanding long-term track records, organizational instability is an excellent early warning sign that performance is likely to deteriorate. The same is true of asset management firms that have recently been purchased – this is almost always a sure sign of bad things to come.
- *Quality of the client base.* This may seem an odd characteristic to focus on, but in fact the quality of a manager's client base can make an important difference in the manager's ability to function with minimal interference and maximum stability. Typically, managers who have performed competently over the course of many years, but who are never (or rarely) the best-performing managers in any year, will wind up with a stable, sophisticated client base that understands what the manager is doing and that will be patient with periods of underperformance. Managers who have shot the lights out now and then, followed by periods of very poor performance, will tend to wind up with a client base consisting mainly of unsophisticated, "hot money" clients. It is virtually impossible for a manager to operate sensibly if clients are constantly pouring money into the firm and then pulling it out again.
- *Personal integrity.* This should go without saying. While it may seem harsh, any blemishes on a manager's record should disqualify the firm from serious consideration. This includes regulatory problems at the firm level and also personal problems at the individual professional level and even, on occasion, at the individual personal level. It is always interesting to hear a manager talk about its style, but a returns-based style attribution analysis rarely exaggerates. The professionals at a firm may appear to be the very soul of rectitude, but a background check will result in far fewer sleepless nights for investors.

Sterling Private Wealth – Fund Manager Selection

We are delighted as a Wealth Management Team to have access to independent manager research, both Global and International, undertaken diligently and thoroughly, by a dedicated, professional and experienced team at Fundhouse.

Our own practical local example of this decision making is presented below:

As custodians of our clients' financial wellbeing, we are well aware of the numerous debates that rage across the pages of the financial media. One hot topic is soon followed by another, often the debate is 60% fact and 40% inappropriate context. The result is a skewed conclusion using correct facts that have been selectively extracted to prove a point. The interpretation of these facts is presented as fact, when in reality it is opinion.

The current hot topic is the use of indexation or passive investing, being the use of a tracker fund or investment that replicates a specific index. The theory extracted from data presented to the reader provides a valid argument, being that active fund management simply adds a layer of fees that are seldom justified by the eventual outcome. Rather use indexation, reduce cost, and avoid the costly mistakes of consistent underperformance.

We agree entirely with this strategy, assuming the average investor is indeed someone who regularly alters their fund holdings from one fund to another, chasing performance. We have spent considerable time researching and interrogating the data and the arguments, to ensure that the portfolio strategy we utiltise for our clients remains appropriate, efficient and effective.

From our perspective, specific to our clients, the passive investing theory has several flaws:

- Asset allocation – your asset allocation is a far greater determination of long term performance than the specific fund managers in your individual asset classes. Indexation, tracker funds, passive investing, does nothing to avoid the often serious negative consequences of trying to time markets by moving in and out of equity holdings prematurely.

- Taxation – capital gains tax is a potentially onerous cost of trading your funds regularly, particularly if SARS decides to tax your gains as income, not capital gains. The majority of our clients hold substantial portfolios and tax is a serious matter that by implication creates the time necessary to research and carefully consider any changes to the investments. We seldom see rash fund switches made on the spur of the moment;
- Fund manager selection – we pride ourselves on the fact that our "SPW Houseview Portfolio List" of approved fund managers has remained remarkably static over the last ten years. We spend considerable time researching and supporting the managers in our portfolios, remaining loyal and committed through periods of underperformance. Our clients do remain invested through a full fund manager cycle, and are not "the average investor".

MANAGER STYLE

A guiding principle for our fund manager selection has always been the use of "valuation based-investing". This term is easily thrown about, and can be interpreted in numerous different ways when applied to fund managers and the methodology they use in selecting stocks. If we ignore the endless debate of what the term means, for us the most important factor is what the ultimate result is for our clients.

Our objective is to utilise fund managers who:

- Do not chase performance relative to an index, or peers;
- Place a strong focus on limiting unnecessary capital losses when markets suddenly experience a large fall;
- Adhere to their investment philosophy, and stick with their portfolio holdings regardless of significant underperformance.

In conjunction with this, we also are in the privileged position of knowing our clients personally, having close relationships, and being able to professionally assess the most appropriate fund manager and portfolio for the situation. Clients with a high risk tolerance will become frustrated with a fund which is too focussed on capital protection; conservative clients will be uncomfortable with a fund manager who appears to experience high volatility.

STAY INVESTED THROUGH A FULL CYCLE

It is impossible to assess a fund manager over an investment period that does not include the full cycle of the market. Fund managers who outperform over the long term do not achieve this with consistent index-beating returns. The very nature of the performance comes from holdings that differ substantially from the index. They will underperform substantially, and often for extended periods. But when their stock selection finds favour with the market, the outperformance is sudden and dramatic.

From January 2007 to May 2008, at the end of the last bull market, the JSE All-Share index was up 27%. The average of the general equity unit trust sector only produced 16%, and the three equity managers we were using produced an average return of 10%. In fact one of our fund managers produced a slight negative return. This was manna from heaven for the passive indexation fans and growth or momentum driven proponents.

In May 2008 the global markets suffered a meltdown. The JSE fell -42%, the average general equity fund fell -34% and our equity managers fell an average -25%. Staying with January 2007 as the start of your investment, over three years to 2010 the JSE produced a 21% total return, and our fund managers delivered 28%. Our fund managers delivered 2.5% per annum above the index, nett of costs, whilst providing substantially lower capital losses in the market collapse.

To provide a more extreme example, Nedgroup Managed Fund is a flexible asset allocation fund managed by Piet Viljoen and his team at RE:CM Asset Management. The fund tends to hold approximately 60% in equity markets, and has been lagging the peer group for the last couple of years. Looking back to 2008, this fund lost 8% when the market fell 42%; an astounding achievement considering the majority of the fund was invested in equity. He too had lagged peers substantially in 2007 and 2008 prior to the crash. Over the last three months, the returns have been stellar, rapidly eroding any lagging performance. This fund is perfect for the client requiring substantial equity exposure, but who values medium term real capital protection.

We spend considerable time reviewing client portfolios, including both asset allocation and fund manager diversification, but we remain comfortable that the fund managers we apply to our clients' funds remain appropriate and highly effective in delivering the expected returns over the full investment cycle. They are the ones being paid to adapt their holdings to the risks and opportunities we currently face.

Over the last 10 years, our active fund managers have outperformed the JSE by, on average, in excess of 3% per annum. If you stayed invested through the full cycle, we are confident that you would agree that this is money well spent.

Market performance

Investment market performance

period to 31 October 2013	Index	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
South African equity	JSE All Share Index	26.2%	17.9%	20.2%	13.2%	20.00%
South African equity	SWIX	26.3%	19.0%	21.1%	14.2%	21.10%
South African fixed interest	SA All Bond Index	4.1%	8.3%	10.2%	8.8%	9.20%
South African property	SA Listed Property Index	18.5%	18.5%	23.0%	17.9%	23.6
South African cash	STefI (3 month NCD's)*	5.0%	5.3%	6.4%	7.5%	7.50%

Short Term Fixed Interest Index*

Investment market performance

period to 31 October 2013	Index	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
international equity	MSCI World (unhedged)					
	Index (USD)	25.8%	11.9%	13.3%	3.9%	7.4%
international fixed interest	Barclays Capital Global					
	Aggregate (unhedged)	-1.5%	2.0%	6.1%	5.2%	5.1%
	Index (USD)					
international property	UBS Global Investors Index					
	(USD, unhedged, net divs)	10.0%	10.1%	14.4%	0.7%	8.8%
US dollar	LIBID 1 month (USD)	0.2%	0.2%	0.2%	1.4%	1.9%
euro	LIBID 1 month (EUR)	0.0%	0.4%	0.6%	1.6%	1.8%
pound sterling	LIBID 1 month (GBP)	0.5%	0.6%	0.7%	2.0%	2.8%

Breakdown of local share market performance by sector

period to 31 October 2013	% of ALSI	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
Top 40	84.0%	26.8%	18.0%	19.6%	12.7%	19.5%
Mid Cap	14.0%	21.0%	16.7%	23.7%	16.2%	22.8%
Small Cap	3.0%	36.5%	20.8%	22.2%	15.6%	24.0%
oil and gas	5.0%	44.6%	22.6%	16.5%	14.8	n/a
basic materials	24.0%	0.5%	0.5%	9.3%	4.0%	13.1%
industrials	6.0%	28.3%	18.8%	17.5%	12.8%	21.8%
consumer goods	23.0%	50.0%	34.7%	33.0%	24.7%	27.9%
health care	3.0%	52.6%	35.9%	42.7%	24.2%	29.6%
consumer services	12.0%	32.9%	28.6%	33.2%	24.3%	29.7%
telecommunications	7.0%	31.7%	21.7%	17.3%	18.4%	24.8%
financials	19.0%	29.2%	21.8%	22.2%	11.7%	19.7%
technology	0.0%	38.8%	32.8%	40.3%	23.4%	23.5%

The FTSE Group and the Dow Jones Indices have created a new definitive industry classification standard. The Industry Classification Benchmark indices were implemented by the JSE on 1 January 2006.

Market performance

Breakdown of international market performance by country

period to 31 October 2013	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
United States: S&P 500	24.4%	14.1%	12.6%	3.5%	5.3%
Germany: DAX	24.4%	11.0%	12.6%	5.4%	9.5%
United Kingdom: FTSE 100	16.4%	5.9%	9.0%	1.3%	4.6%
France: CAC	25.4%	3.9%	4.3%	-3.1%	2.5%
Japan: Nikkei	60.5%	15.9%	10.8%	-1.9%	3.1%
Hong Kong: Hang Seng	7.2%	0.2%	10.7%	3.4%	6.6%

All returns are calculated in the respective local currencies and are based on index levels.

Currency exchange rates

period to 31 October 2013		1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
ZAR/USD	10.0563	-13.8%	-11.4%	-0.6%	-4.3%	-3.7%
ZAR/EUR	13.6523	-17.7%	-10.7%	-1.8%	-5.2%	-5.2%
ZAR/GBP	16.1269	-13.3%	-11.5%	-0.6%	-1.9%	-3.2%
ZAR/JPY	0.1025	6.0%	-5.3%	-0.5%	-6.7%	-5.0%
USD/EUR	1.3579	-4.5%	0.8%	-1.3%	-0.9%	-1.6%
USD/GBP	1.6044	0.6%	0.0%	0.0%	2.5%	0.6%
USD/JPY	0.0102	23.1%	6.9%	0.0%	-2.4%	-1.1%

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