



THE DANGERS OF INDEX INVESTING

By Magnus Heystek—Investment Strategist

THERE'S an old saying in the investment world that if you are on the wrong bus, you need to get off and find another bus that will take you to where you want to go. Why am I reminded of this old hackneyed saying? And what has this to do with the current state of investment markets?

Let's go back a couple of years ago to the bull market in equities from 2003 to 2008. Stock markets were having a terrific run and anyone could make money by buying virtually any share or equity market fund as it would be higher a year or two later.

It was also a time when the advocates of index-investing, notably the purveyors of the Satrix range of funds, were advising all and sundry to "buy the index" and to forget everything else.

Index-investing became the latest rage in the investment world and billions of rands poured into these funds. The financial media also became cheerleaders for this type of investing with many journalists and financial commentators blindly recommending that investors should simply buy the index.

It was at best sloppy journalism and at worst an uncritical (and perhaps inexperienced) understanding of the nature of investment markets.

At the time we had to warn our clients and potential clients about the dangers of index investing, especially an index as highly volatile and highly correlated to commodities as the Satrix 40, the most popular exchange traded equity index fund in South Africa.

On many radio programmes on RSG and Radio 702, I warned about the dangers of index investing, especially an equity index. In the throes of the equity bull market in 2007 and 2008, in particular, it would seem, all caution was thrown to the wind and large amounts of money was poured into Satrix and other passive type of funds.

This also creates a vicious cycle: the more the equity market goes higher, the more fees equity funds make and the more money is spent on promoting these types of products.

The printed media, in particular, benefit as these investment houses spend huge amounts of money in advertorials, which are seen by the reading public as investment advice. When the markets crash and burn there is no one left to protect the investor: neither a fund manager nor an investment advisor.

Ask yourself this: when last have you seen or heard an advertisement about the Satrix 40 or any other equity-index fund? The reason for this is that over the last one, three and five years, equity index funds have been particularly poor performers against the other major asset classes available to South African investors.



Investment Seminar

PRETORIA INVESTMENT SEMINAR

DATE: TUES 20 SEPTEMBER 2011
TIME: 15:30 FOR 16:00
VENUE: WATERKLOOF GOLF CLUB
 JOHANN RISSIK DRIVE
 WATERKLOOF

LOUIS NIEMAND: INVESTEC
 ➤ FINDING SHELTER IN THE STORM?

MAGNUS HEYSTEK: BRENTHURST
 ➤ CREATING GLOBAL WEALTH

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Global
Markets
AND SA ECONOMY

THE DANGERS OF PASSIVE INVESTING

INSTRUMENT	1 MONTH	6 MONTHS	1 YEAR	3 YEARS	5 YEARS ANNUALISED/ SINCE LAUNCH* ANNUALISED
FTSE/JSE All Share index	-2.7	-5.9	10.6	8.6	8.8
Satrix 40 Portfolio A	4.6	-5.6	11.8	7.6	8.0
STANLIB Property Income A	2.8	12.6	14.1	19.3	18.1
STANLIB Aggressive Income A	1.8	7.3	10.6	13.2	11.3
Investec Opportunity A	3.2	2.5	10.7	8.1	9.9
Coronation Capital Plus A	1.8	1.3	8.5	10.6	10.3
*Since launch annualised performance is stated where 5 years annualised performance does not exist					

This table with the investment returns of a number of alternative asset class funds we use shows how poorly a passive index fund such as the Satrix 40 has performed. Investors who blindly followed the advice have been badly affected as all other available asset classes, including cash-type funds, have beaten the highly touted passive index funds. This is one of the main reasons why we have not been impressed by the marketing hype of passive investments in South Africa.

Simply put, if you are in an equity index fund you are on the wrong bus and no bus conductor to tell you that fact...

My words of warning were drowned out by the seemingly easy way to make money in a bull market: just buy the index and the index will do the rest.

What the advocates of these types of investments did not point out was, when the index falls, your investments fall at the same speed. There is no safety net (that you have with actively managed funds) with these types of products.

Years of experience in the investment world has taught me many things, but one thing is for certain: investors hate (and fear) losses more than they appreciate and get excited by gains in the market.

The argument in favour of index investing was based on a number of claims, all of them highly questionable, especially in light of what has happened over the last five years or so. First, it was claimed that equities (shares in companies listed on the stock exchange) is the best asset class over time. It was furthermore claimed that index funds beat most actively managed funds and that the investing costs were much lower.

ON ALL THREE COUNTS WE HAD A PROBLEM AS A FURTHER AND MORE DETAILED ANALYSIS WOULD SHOW THE FOLLOWING:

⇒ While equities have performed better than most other asset classes over very long periods, there have been very long and painful periods when equities show very little growth and in fact, shown substantial losses.

Equities have also not been the best asset class in South Africa over the last ten years, but listed property.

In Japan equity investors have lost money now for more than 20 years, in the process losing more than 75% of the value of index at January 1990.

⇒ While index funds have given better returns than the average actively managed equity funds, it has been very easy to select funds that have beaten index funds handsomely over most periods of time. Good research and a weeding out of badly performing funds have thrown up many actively managed funds that have beaten index funds by a substantial margin.

⇒ The argument of lower costs also holds very little water. Investment costs in SA are very competitive by global standards and over time the value that a good active fund manager can add in the form of better returns with lower volatility is well worth the money.

Our function as investment advisors is to identify those fund managers and include them in our choice of recommendations.

To further understand the concerns we raised about equity index investing it is important to understand a little better the larger investment business in South Africa.

On the whole the **LISTED EQUITY INVESTMENT** area is dominated by equity-related funds and products. The largest and most profitable investment companies and funds are all equity funds. This is where the big money is made in the investment world; where you will fund the superstars of the investment world. This is also the area where most of the marketing of investments takes place.

ALTERNATIVE ASSET CLASSES, NOTABLY BONDS, FIXED INCOME FUNDS, MONEY MARKET FUNDS and to a lesser extent **LISTED PROPERTY** are considered the step-sisters of the investment industry. Less money is made over time on the marketing and promotion of these types of funds and hence the investing public is less exposed to these other types of asset classes.

The average investor has a good working knowledge of equity investing, but ask the average investor how a bond fund or fixed income fund works and they have no idea.

This unfortunate state of affairs however goes to the heart of the relationship between funds, investors and investment advisors. Do we work for our clients or for the fund houses, which create and market the equity-based investment products?

The answer is very clear in our minds. As fiercely independent investment advisors we work for our clients and our choice of funds or asset classes are totally unrelated to the fees paid to us by our clients. Whether we recommend equities, bonds, cash, money market funds or listed property has no bearing on the investment advisory fees we receive from our clients.

The prospects for **EQUITIES** are also not looking good going forward. Economic growth, globally and in South Africa, is slowing down dramatically, further evidenced by annualized growth of 1,4% in the second quarter of 2011, way below expectations.

Equities have been struggling for months now and so far investors in equities have seen their investments decline. Further mooted increases in the price of many regulated products, especially electricity, is bound to have a depressing impact on consumer expenditure.

In the United States the equity market has been in a bear trend for almost 12 years now and certain analysts are warning that the behaviour of equity markets in developed world are starting to look ominously similar to that of Japan. The Japanese economy has been strangled by a deflationary death spiral for over 20 years now as equities and properties, the two asset classes which normally protect investors against inflation, have made investors poor, very poor.

DEFLATION as an economic phenomenon is far more terrifying than inflation, especially to people over-indebted with assets that are losing money. Nothing destroys an individual or company faster and more ruthlessly than deflation: the asset that you have are losing value but you still have to repay the original debt as well as any finance charges attached to it.

During the great depression that lasted from 1929 to 1934 the two investments that protected your wealth were bonds and gold (and gold shares). It is starting to look like that all over again.

GLOBAL GOLD SHARES have been an astounding investment, beating every other asset class in the world, including SA equities, by a substantial margin.

Local gold shares have lagged badly, an issue that has been covered in a previous newsletter, but for the first time in many years they are starting to look better and are we expecting healthier returns going forward. The local gold mining industry has shrunk considerably since its heydays, when SA was still producing the most gold in the world, and is a shadow of its former self.

Investing in local gold shares has not been a great investment but with a rand price per kilogram now in excess of R430 000 are prospects started to look better.

However, we remain steadfast in our recommendation: if you wish to participate in the continued gold boom, we advise that you take your money offshore and buy into one of the three global gold funds we have identified. The returns have been good over time but gold shares are currently trading a discount to the price of physical gold. We would not be surprised to see global gold shares rectifying the current discount and if the gold price holds at current levels could investors be rewarded with a 50% return in the next year.

OFFSHORE INVESTMENTS

- ⇒ We continue recommending offshore investment based primarily on the arguments of diversification and the fact that the rand remains, in our view, hopelessly over-valued.
- ⇒ The adjustment in the rand value, when it comes, will be both brutal and swift.
- ⇒ The rand is currently supported by the inflow of hot global money in search of higher yields. This money can (and will) flow out very rapidly if the underlying economic variables changes.
- ⇒ As far as fixed foreign investments are concerned, South Africa, faring poorly and with a net inflow of \$1,6 billion in 2010, barely made the top 10 counties in Africa in this regard, slightly behind that economic powerhouse Sudan.
- ⇒ SA is making life difficult for foreigners to invest in bricks and mortar and things that create jobs.
- ⇒ We are increasingly being considered as investor unfriendly and an expensive place to do business.

INVESTING IN MAURITIUS

I have just returned from a well deserved break (of course I will say that) from the tropical island of Mauritius. Some of my long-standing clients will know that it is one of my favourite holiday destinations and I have been going there for more than 20 years.

During that time I have seen this sleepy tropical backward island turn itself into an economic powerhouse. Every time I go back there are new buildings, new highways and one can actually see the money and wealth flowing into the island. Financial services is now a bigger contributor to the economy than tourism, textiles or sugar production, not because the other sectors are lagging, but as a result of the rapid growth of the former.

The South African presence is all over the island: Pick `n Pay, Debonairs, Shoprite, Game, Investec, Pam Golding and Seeff just to name a few of the many companies that have set up shop.

There is virtually no unemployment on the island of 1,2 million people and there is an investor friendly government in power. You can register a company and open a bank account within three days...

The country also was under colonial rule for hundreds of years and became independent in 1968. It is a multi-racial, multi-cultural and multi-religious country with its own problems, but it seems to have the collective will to make the country a success. A tiny minority of French-speaking whites is the wealthiest grouping on the island, but there is no talk of retribution or land reforms.

Personal income tax is very low, there is no exchange control or capital gains tax or inheritance tax while company tax is a maximum of 15%.

Historically, foreigners have been not able to own residential land in Mauritius until the introduction of the Integrated Resort Scheme about 8 years ago. Buying a residential property with a value of \$500 000 or more gives the owner and his/her immediate family residency and after 5 years citizenship.

I have visited and analyzed most of the IRS-schemes on the island, two of which are being developed by South African developers. The one that has impressed me most is the West Island Resort, a marina development on the West Coast at Black river. Anyone who wants more information on this development (and the others) is welcome to contact me at magnus@heystek.co.za for more details.

BUILDING GLOBAL WEALTH: INVESTMENT SEMINAR, 20 SEP 2011

MAKING AN INVESTMENT DECISION IS NOT EASY, ESPECIALLY TODAY! A WORLD OF EXTREMES!
Developed market interest rates at lowest levels since 1940 and Government Bond yields at lowest since 1958. Debt at all-time highs. China growing at 10% into perpetuity? Gold and other commodities at all time highs. Peripheral Europe in crisis with unemployment in Spain more than 20%. Japan's share of global equity markets down from 44% in 1988 to currently only 8%. South African inflation and interest rates at multi-decade lows and still demand is weak.

...These are just some of the conundrums we as investors are facing today.



SEMINAR PRETORIA

DATE: TUES, 20 SEPTEMBER 2011

TIME: 15:30 FOR 16:00

VENUE: WATERKLOOF GOLF CLUB, JOHANN RISSIK DRIVE, WATERKLOOF

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INVESTMENT PRESENTATION

15:30 - 16:00 Registration

16:00 - 17:45 Presentations

17:45 - 19:00 Refreshments

KEY NOTE SPEAKERS INCLUDE:

LOUIS NIEMAND: Equity Product Specialist, **INVESTEC ASSET MANAGEMENT**

➤ **FINDING SHELTER IN THE STORM**

MAGNUS HEYSTEK: Director & Investment Strategist, **BRENTHURST WEALTH MANAGEMENT**

➤ **OFFSHORE INVESTING? WHY OFFSHORE? HOW MUCH OFFSHORE? PORTFOLIO CONSTRUCTION?**

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