



## CREATING WEALTH ACROSS BORDERS

By Magnus Heystek—Investment Strategist

THIS will be the last newsletter from Brenthurst Wealth for the year 2012 and in it we will be discussing the economic outlook for the year ahead with specific reference to the expected behaviour of the rand exchange rate.

But first some background: early in 2011 we formulated a high-conviction strategy that our clients and potential clients should increase their foreign investment exposure. At the time we held the view that most of our clients were over-exposed to local assets which could over time be a risky investment strategy.

This view was also conveyed to our clients at a series of investment seminars held countrywide in Pretoria, Johannesburg and Cape Town. It is pleasing to report that many of our clients heeded our advice and increased their respective offshore exposure over the past 18 months or so.

Not only can they today report handsome profits, depending on the timing and choice of foreign assets, but have they far more globally balanced investment portfolios than before. More about this later in the newsletter.

We might add that our recommendations were met with a fair degree of scepticism from certain of our clients, not entirely convinced about the merits of offshore investing. After all—seemed to be the argument—local investments were doing so well. No need for offshore diversification, it was said.

*FOR THE SAKE OF REFERENCE HEREWITH A BRIEF SUMMARY OF THE REASONS WHY WE HAVE BEEN RECOMMENDING AN INCREASED FOREIGN INVESTMENT EXPOSURE:*

### 1) STRENGTH OF THE RAND

At the time we were of view that the rand was trading at levels not reflecting the economic and socio-political reality of the global economy in general, and the mounting political uncertainty with respects to vital economic issues within SA, in particular. The issue of the nationalisation of the mines, for instance, was becoming a burning issue within the ruling tripartite alliance.

The rand, at the time, was trading between R6:50 and R6:80 against the US dollar for most of the first half of 2011.

The rand at the time was also the beneficiary of the so-called carry trade where foreign inflows of money into SA from countries with very low or zero interest rates were seeking higher returns in SA where bond yields of around 6-8% at the time were on offer.



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## **2) POLITICAL OPPOSITION AGAINST THE STRONG RAND**

Several leading politicians, including the finance minister Pravin Gordhan, labour leaders and top businessmen expressed the desire for a weaker currency to protect local businesses and jobs. This reflected a major policy shift in government thinking and it clearly signalled that a weaker rand would not be considered undesirable nor would foreign exchange reserves be used to protect the rand against the US dollar.

## **3) PERIOD OF RE-RATING OF SA COMING TO AN END**

International credit ratings agencies like Moody's, Standard & Poor's and Fitch, to name only a few, play a very important part in the economic life of nations. Very few large investment institutions will invest in the equity or bond market of a sovereign country without a reference to the credit rating affixed to a country by at least one of the large credit agencies. For more than a decade and a half since the advent of the new SA in 1994 did the country receive improved credit ratings from junk status in 1994 to investment grade ratings over the ensuing years. An improved rating over this period led to substantial foreign inflows into SA's bond and equity market, boosting the international demand for rands and hence its price. From a low point of R13,85 to the US\$ in 2002 the rand improved to levels around R6-R6:50 at the beginning of 2011.

Both Moody's and Standard & Poor's have recently downgraded SA's credit outlook and the country remains on advance warning of further downgrades in the months ahead. Downgrades to a certain level could lead to a massive outflow of capital from the bond market in particular. This is most probably the biggest financial risk facing SA in the near future.

## **4) INVESTMENT DIVERSIFICATION**

Most South African investors still have a very large exposure to local investments. This was due to the historical exclusion of local investors from offshore markets as a result of foreign exchange controls. The very strict restrictions on offshore investing were gradually released from 1997 onwards. This was a move into the unknown for most and the appeal of offshore investing subsequent to the rapid strengthening from 2002 to 2007, when the rand rose from R13:85 to R6,50, further did not endure local investors to offshore investments. This coincided with a weak period for equity markets from 2000 onwards while emerging markets continued to power ahead. It was our calculated view that this period of relative performance was coming to an end.

In addition, there are certain global asset classes not normally locally available to South African investors, such as energy, oil, technology and biotechnology. A move into one or more of such asset classes over the past 18 months or so has been hugely beneficial to local investors.

## **5) OFFSHORE ASSETS OFFERING BETTER LONG-TERM VALUE**

In addition, valuations of developed equity markets, were offering very attractive prospects. After the major declines in global equity markets during 2008/2009, equity markets in the US in particular, were trading at very low valuations. Emerging markets on the other hand, including South Africa, were trading at lofty PE's (price earnings valuations) reflecting a somewhat misplaced optimism that the commodity boom was set to continue indefinitely.

# **OUTLOOK FOR THE NEW YEAR**

So much has happened over the past few months, from the Marikana shooting in August, widespread labour unrest on gold and platinum mines to the outbreak of unprecedented labour unrest in the Western Cape.

The Marikana shooting in particular has had a massive impact on the national psyche.

At the same time it has also led to widespread international condemnation of SA in the form of the front page article of The Economist in October (*Cry The Beloved Country*) and more recently Time magazine. Clearly, the honeymoon period for SA is over as far as the international investment community is concerned.

But that is something for the future. More pressing is the massive and growing deficit on SA's trade account with the world. Last week's trade figures, reflecting a trade deficit of R21,2 billion for October and a cumulative deficit of R104,6 billion for year, is nothing but a shocker. It clearly is a reflection of a country living well beyond its means. A year ago the country still had a surplus on its trade account with the rest of the world.

The trade deficit, according to some economists, is heading towards a dangerous 7,5% of gross domestic product, a level which must be setting off the alarm bells ringing in financial centres all around the world.

Once a country reaches these levels it is forced to borrow money in order to pay its debts, which is not considered prudent in these uncertain times.

This deficit is still being funded by inflows into our bond and equity market. This is where the possible downgrades by one or more of the credit ratings agencies become so vital: any further downgrade could lead to a vicious cycle of downgrades, followed by capital outflows, followed by rand weakness, higher inflation and possibly more social unrest.

Admittedly, this is the worst-case scenario but one that cannot be completely eliminated or discarded. In any case, the latest trade figures puts to bed any further cuts in local interest rates and could lead to an increase in interest rates much sooner than anticipated.

It is hard to see how the trade deficit can suddenly reverse, considering weak demand for commodity products and SA's need to import capital equipment for electricity generation, infrastructure spend and other capital projects.

The slowdown in economic growth in the Eurozone is a further cause for concern. About a quarter of SA's exports go to Europe and the slump in exports to this region is already reflected in the trade deficit.

SA now has to sell about R17 billion worth of bonds and equities *every* month to balance our overall balance of payments.

In its decision to downgrade SA's credit rating earlier this year Moody's diplomatically referred to the country's "fiscal restraints" as one of the reasons for the downgrade.

In simple terms it means that SA's tax revenues are under pressure and that any further increase in social spending, to alleviate poverty in a country with an average unemployment rate above 25%, will have to be funded by increases in taxes.

An increase in company, personal and possibly Value-Added Tax is looking more likely as we move towards the 2013 Budget. Capital gains taxes were increased in this year's Budget and are set to move higher again, we feel. Taxes on dividends could also head north as Gordhan looks for ways to collect more revenue from an economy under considerable pressure.

At the beginning of the year most economists were forecasting growth of between 3,4 and 3,8% for 2012. Growth so far this has been much slower and the third quarter's output has been badly affected by the mining strikes. The Reserve Bank now expects growth be in the region of 2,5% this year. The outlook for growth next year is also much dependant on global economic conditions which remain very unsettled and difficult to predict.

Any longer term forecast on SA's growth rate cannot be done without taking into consideration the effect of rapidly rising electricity costs on business and on individuals.

Last month the Energy Intensive User Group (EIUG) released the results issued a statement on behalf its members. The EIUG consists of 38 of the largest energy consumers, covering 40% of SA's electricity usage.

"South African business is at a tipping point. Energy pricing is pricing capacity out of business. There is no doubt in my mind that further price hikes will push companies out of business". This was the stark warning of Mike Rossouw, chairman of EIUG.

## **COMPREHENSIVE REPORT REVEALED THE FOLLOWING:**

- ⇒ Ten years ago the cost of energy was 50% of the cost of maintaining a hospital. Today the costs are the same—Mediclinic.
- ⇒ A decade ago electricity accounted for 0,8% of sales. It now accounts for 2% and is expected to rise to 4% if the proposed increases by Eskom are implemented—Shoprite.
- ⇒ At African Rainbow Minerals and 18% increase in sales generated a 2% rise in headline earnings because wages and electricity costs swallowed the profits.
- ⇒ Astral Chickens has suspended wages negotiations during its most difficult period in 30 years, mainly as a result of rising electricity costs.
- ⇒ Billions of rands of new foreign investments are on hold as possible entrants consider other countries like Canada and Australia where there is greater certainty with regard to mining rights and future electricity price increases.

Many clients of **Brenthurst Wealth** are businessmen, both large and small, as well as farmers, exporters, factory owners and of course homeowners. Each and every one tells the same story: soaring electricity costs as well as steep wage demands are putting immense pressure on their businesses and livelihoods.

One example of a once proud and dominant industry and now falling rapidly into obscurity is the local gold mining industry. Up to 1980 South Africa was the largest producer of gold in the world.

## **OFFSHORE INVESTING**

**THERE ARE SEVERAL WAYS FOR INDIVIDUAL INVESTORS TO OBTAIN FOREIGN INVESTMENT EXPOSURE. A DISTINCTION ALSO HAS BE DRAWN BETWEEN THE VARIOUS TYPES OF INVESTMENTS AVAILABLE TO LOCAL INVESTORS**

### **DISCRETIONARY INVESTMENTS:**

Investors with tax clearances can invest up to R5 million per year of their discretionary capital. This is made up of the R4 million investment allowance (for which SARS and SARB clearance is required) plus another R1million in terms of the all-encompassing travel, maintenance and offshore expenses allowance. This does not require SARS or SARB permission but still needs to be recorded at the institution used to remit the money offshore.

It is possible to remit larger amounts in excess of R5 million, but that will require a well-motivated application to the SARB. Once offshore investors can invest wherever they choose and the capital does not need to be returned to South Africa.

**BRENTHURST WEALTH** uses a range of fund managers and funds to construct offshore portfolios, including its own fund, the Brenthurst Global Balanced Fund managed by Glyn Owen from Momentum International.

Other fund firms included in the portfolio of funds used by Brenthurst includes Franklin Templeton, Investec, Ashburton, Black Rock and others.

Brenthurst advisors use the “menu-approach” to constructing global investment portfolios, selecting the funds from a menu of approved funds in line with the investment objectives and risk profile of their respective clients.

We have to emphasise, once again, that the decision to take money offshore must be based on a decision to invest for the long term and in order to achieve diversification. We are not basing this recommendation on only the view that the rand could weaken in the short term.

## ***NON -DISCRETIONARY INVESTMENTS:***

Investors with non-discretionary investments, which includes instruments such as retirement annuities, living annuities and preservation funds (provident and pension funds) are restricted in terms of the offshore exposure that they are permitted.

These restrictions are determined by Regulation 28 from the SA Treasury which provides strict guidelines to investment funds as to what offshore exposure they can obtain within their funds. Currently the maximum offshore exposure is set at a maximum of 25% of the portfolio and is obtained by making use of a mechanism known as “asset swaps”.

Most asset managers in SA are at maximum offshore exposure levels in terms of this guideline, which has boosted the return of their funds over the last two years.

## ***INVESTMENT RETURNS:***

The investment returns enjoyed by our clients since we recommended an increase in offshore investments are influenced by (a) timing of the repatriation of rands to US dollars and (b) choice of funds or asset classes.

Some of the first movers who invested offshore when the rand was trading at between R6:50 and R7 to the US\$ have recorded exceptional returns so far.

## ***UPDATES***

The year 2012 has been another exceptional year for **Brenthurst Wealth**. We have bedded down our national footprint in our offices in Cape Town, Pretoria and Johannesburg.

Assets under management have grown to in excess of R2 billion and we have extended our range of services to taxation, drawing up of wills, estate planning and the executorship of estates.

Our office in Pretoria, in particular, has grown substantially and we have been forced into purchasing larger premises to cater for our ever-growing client base. Details of this move will be communicated early in the new year.

We are particularly proud of being chosen as one of the top investments planning firms in the country by the Financial Planning Institute of SA.

WE ARE NOW AN APPROVED PROFESSIONAL PRACTICE® WITHIN THE FPI, ONE OF THE FIRST FIVE, WHICH REFLECTS A COMPANY WHICH OFFERS INVESTMENT ADVICE OF THE HIGHEST STANDARD, HAS A NATIONWIDE PRESENCE AND HAS MORE THAN 60% OF ITS ADVISORS QUALIFIED AS CERTIFIED FINANCIAL PLANNER® PRACTITIONERS, INCLUDING MY NAMESAKE MAGNUS JNR. WHO QUALIFIED RECENTLY.

But we do not have a business without our clients and for this we thank you.

We are looking forward to another successful year. We are busy planning some very exciting initiatives for our clients next year, including more informative investment seminars which will include international speakers.

We wish all our clients a happy and restful holiday period and look forward to being of service creating and protecting your personal wealth in the year 2013.



# OFFICES CLOSING:



BRENTHURST WEALTH OFFICES WILL BE CLOSING AT 12 NOON, FRIDAY 21<sup>ST</sup> DECEMBER 2012 AND OPENING AGAIN ON MONDAY 7<sup>TH</sup> JANUARY 2013

In case of emergency all financial planners will be reachable on their cell phones over this time .

TO ALL OUR CLIENTS, FRIENDS & BUSINESS ASSOCIATES WE WISH YOU A MAGICAL CHRISTMAS, WONDERFUL HOLIDAY SEASON AND A FANTASTIC NEW YEAR.

**In 2013:**

**RISK** more than others  
think is safe;

**CARE** more than others  
think is wise;

**DREAM** more than others  
think is practical;

**EXPECT** more than others  
think is possible!

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