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BRENTHURST RANKED BEST
BOULIQUE WEALTH MANAGER IN SA 2017
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AT INTELLIDEX WEALTH MANAGER AND
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A DECADE OF WEALTH DESTRUCTION

By Magnus Heystek, Investment Strategist & Director Brenthurst Wealth Management

FOR more than 100 years to the end of 2010 an investment on the Johannesburg Stock Exchange produced the highest annual average returns in the world, according to a major study by Swiss bank Credit Suisse. Since then the returns on the JSE have collapsed to amongst the lowest in the world.*

This has been a consequence of two major events, one global and one local, which happened almost at the same time. The first was the collapse of the global commodity boom—which was the major driver of the economic boom period from 2003 to 2010—which roughly coincided with the 9 years of misrule, corruption and state capture under the ANC and its ex-president Jacob Zuma.

Each and every South African investor is now paying the price in the form of below-inflation returns on residential property (over ten years now) and more than 5 years for investments linked to the Johannesburg Stock Exchange (JSE). Most retirement funds have also not beaten the inflation rate over 1, 3 and 5 years.

In short: most middle-class wealth is under threat and this is to be seen in almost all spheres of society where it can be measured. Housing sales, overseas trips, membership of medical aids and new motor car sales: these have all been in decline for many years now. The residential property market is in a severe slump and even the former recession-proof Cape Town market has grinded to a halt in recent months.

Where it cannot be measured the decline in wealth is anecdotal and increasingly visible. Golf courses empty, private schools battling to retain their students and a general increase in crime associated with unemployment, now at record levels around 28% of the labour force.

The big question is whether this trend can be turned around (cyclical) or has the problem become more deep-rooted and of a more structural nature, which has much more serious consequences to investors and their advisors alike.

It has long been the view of Brenthurst Wealth that the shift in economic fundamentals is more deep-rooted, almost tectonic, and that adjustments to investment strategies are required to offer protection to the long-term consequences of these underlying changes.

What is of concern is that SA's investment industry has been particularly silent on the wealth-destroying effects of the governing party's socialistic economic and financial policies. It is rare to find any critical comment on government from the massive investment industry, for obvious reasons.

The industry receives very generous tax concessions from Treasury and to criticize government and its economic policies would jeopardize this cozy, but mutually beneficial arrangement: the industry gets to manage trillions of rands of pension money (as a result of generous tax-incentives) and the government in exchange gets a very efficient tax-collection agency for free! Any whiff of criticism would be a career-ending move, as we have seen many times in the past.

THE VALUE OF INDEPENDENT ADVICE

It is therefore up to independent investment advisory groups such as Brenthurst Wealth to offer an objective and often-times critical assessment of the investment landscape and its prospects. This has not made us very popular with the local asset management industry. There are many things the industry would prefer to remain unsaid or swept under the carpet.

The fact remains that since 2011, or thereabouts, there have been several turning points, some global and some local, that have had a major impact on the personal wealth of each and every South African. People with no assets or investments feel it in the form of rising unemployment and rising cost of living. Middle-class and upper-middle class South Africans feel it in the form of stagnant asset values and rising taxes.

The only beneficiaries have been individuals and businesses with offshore assets and incomes respectively, or those who acted on the advice, as was the case with Brenthurst Wealth clients, to dramatically increase offshore assets over these seven years.

This has been a major turning point for investors on the JSE, many who have been reluctant to take money offshore on the basis that offshore somehow is more risky than local investments. However, the majority of investors and fund managers have missed this crucial divergence which has now produced a decade of sub-optimal returns and over the past 3 to 5 years, below-inflation returns.

When combined with below inflation returns on the residential property market, does this mean that the average SA investor has lost substantial ground against inflation and also against the global purchasing power of the US dollar? In short, without direct offshore assets in investment portfolios, most South Africans have become depressingly worse off with a plunging rand and investment assets producing no real return over 5 years (equities) and over 10 years as far as residential property is concerned.

This is having a significant impact on overall wealth creation in general and more specifically on countless savers approaching retirement with inadequate capital.

As it is, most SA pension, provident and retirement funds have not beaten the inflation rate over 1, 3 and 5 years now. This is a consequence of the fact that these funds are bound by Regulation 28 of the Pensions Act, which limits their offshore exposure to only 30%.

Expect to read and hear more about this unless the situation changes dramatically, which seems unlikely. In fact this trend could get worse under certain circumstances.

GLOBAL COMMODITY CYCLE COLLAPSED

The global commodity cycle has been very important to South Africa's economic fortunes over many decades, and was also partially the reason why the JSE was a great investment destination for global investment capital for most of the 20th century. As a foremost producer of gold, coal, platinum, diamonds and other precious and non-precious metals SA attracted substantial inflows of foreign capital.

At one stage in the mid-1980's the Anglo American Corporation was so powerful that it made up almost 80% of the market capitalization of the Johannesburg Stock Exchange, owning major or controlling shares in just about every major local company. One reason was exchange control, as it could not invest money offshore so it kept on buying all the major companies on the JSE.

Today Anglo is a shadow of its former self, the gold mining industry has collapsed and from being the number one gold producer with 1 000 tonnes per year in 1980 it is now only the 8th largest producer, with an annual production of a mere 150 tonnes and declining rapidly. South African now earns more foreign exchange from the sale of coal, platinum and soon iron ore.

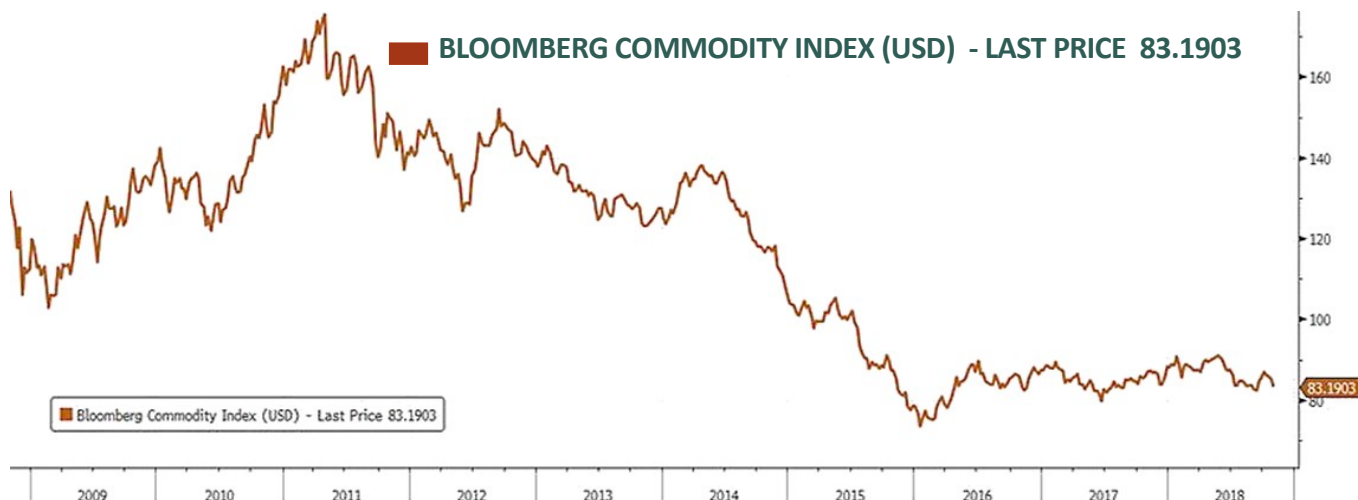
Who could have predicted that 20 years ago?

And yet, every radio and TV-station still faithfully starts their hourly news broadcasts with the.... gold price (sic). What a waste of time, as the gold price has very little impact today on the fortunes of South Africa and its people. Old habits die hard, it seems.

In recent decades the global commodity boom was driven by the almost insatiable demand for coal, iron ore and other base metals by China since it became a member of the World Trade Organisation (WTO) in 2001. All commodity producing countries benefited including Australia, Chile, Canada and South Africa.



BLOOMBERG COMMODITY INDEX COLLAPSES



As can be seen from the accompanying graph this boom came to a shuddering halt in around 2011, as a result of China adjusting its economic course in order to increase domestic consumption rather than relying on importing raw materials from commodity producing countries and then manufacturing low cost goods for export markets.

This resulted in a dramatic shift in the prices of our exports, terms of trade (more goods have to be sold for the same or lower price), which had a major impact on SA's balance of payments, flow of money and the exchange rate of the currency.

This too coincided with the start of international credit downgrades by the international credit ratings agencies and ultimately the downgrade to junk-status by two of the three large agencies, S&P Global Ratings and Fitch.

SA's credit rating remains under severe threat and any downgrade to sub-investment grade by Moody's in the near future would have a major impact on the currency, the interest rates on the country's debt and the country's ability to repay this debt over time.

ZAR-USD EXCHANGE RATE 10 YRS OF DECLINE



RUINOUS REIGN OF JACOB ZUMA AND THE ANC: R400BN HAS LEFT THE COUNTRY

The misrule of the country under Jacob Zuma since 2009, when he was elected as president until he was fired in February 2018, has left behind a shattered economy, a sharply weakened rand and a massive outflow of foreign capital. In fact, since 2014 an estimated R400 bn has left the country's bond and stock market, resulting partly in the massive under-performance when compared to the rest of the world.

It remains a mystery why this massive outflow has not received more prominence in the media, but is one of the financial indicators we follow most at Brenthurst when deciding on investment recommendations and asset allocations.

Outflows have been consistent since the beginning of 2014 and with the exception of a couple of months of positive inflows surrounding the ascendency of Cyril Ramaphosa as head of the ANC in December 2017 and for two months thereafter, has massive amounts of foreign money been flowing out of the JSE and bond market.

In October this year another R8bn left our shores, the largest outflow of money since the dark days of international sanctions in the mid-80's. This also explains the dramatic collapse of average values of shares on the JSE year to date. As at 13th November the JSE was down 18%, one of its worst performances in many years.

We do not foresee a turnaround in the fortunes on the JSE until such time as this massive outflows of foreign capital slows down or reverses. Foreign investors have been unnerved by the government’s handling of its finances and the finance portfolio, with seven ministers of finance in 8 years. This does not augur well for policy certainty and long-term confidence in the economy.

The JSE has also been dragged down by the sharp decline in the share price of its largest company Naspers, which is down almost 33% from its peak of R4 000 per share to levels around R2 600 earlier this week.

It has been suggested for several years now that the massive share appreciation of Naspers, which at its peak earlier this year made up 22% of the market capitalization of the JSE, has been disguising the poor performance of large sectors of the JSE, especially companies greatly exposed to the SA economy. This has now come true and the mid-cap and small-cap shares have lost between 30 and 50% in many cases.

Yet at investment presentation after presentation local fund managers try to make a case for greater investment onto the JSE. We have resisted this urging as our research does not support this view.

SA companies are under enormous pressure to make profits as a result of the weak economy (the only OECD-country currently in a recession), volatile labour relations, rising electricity costs and regulatory uncertainty in several key sectors of the economy.

Developments on the global front also don’t help. This year has been characterised by a rising US dollar, buoyed by rising US interest rates, which has led to a massive sell-off in emerging markets, including South Africa. Interest rates in SA are set to start rising soon and stock markets normally don’t do well when interest rates start creeping higher. Another reason to remain underweight SA shares.

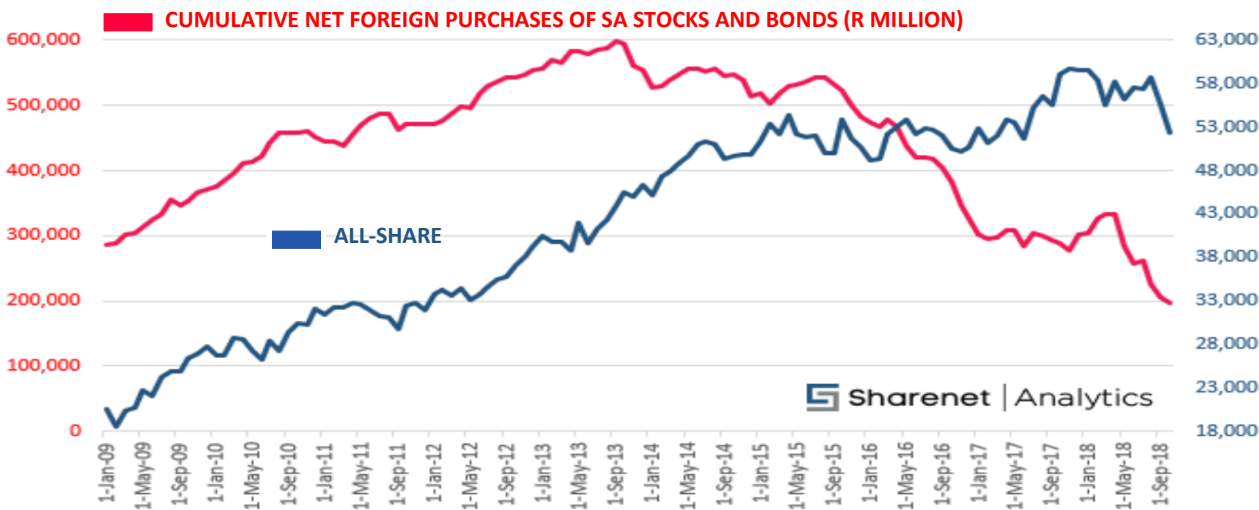
The end result is that over the past ten, seven, five, three and one years, foreign investments have substantially outperformed the local stock market (refer to table). SA investors who did not increase offshore investments during this time have suffered a severe reduction in their personal global wealth.

INVESTMENT RETURNS

5 Year Return	10 Year Return	15 Year Return
Foreign Equity 11.8%	SA Real Estate 12.6%	SA Real Estate 15.3%
Diversified 7.1%	Foreign Equity 11.9%	SA Equity 13.7%
SA Cash 6.9%	SA Equity 10.4%	Foreign Equity 10.4%
SA Bonds 6.1%	Diversified 10.2%	Diversified 10.2%
SA Real Estate 6.0%	SA Bonds 8.0%	SA Bonds 8.0%
SA CPI 5.3%	SA Cash 6.7%	SA Cash 7.3%
SA Equity 3.7%	SA CPI 5.2%	SA CPI 5.7%



OVER ZAR 400BN LEFT OUR SHORES, AS AT OCT 2018



FOREIGN INVESTMENTS VERSUS LOCAL INVESTMENTS

The local investment industry, until recently, was not a great proponent of offshore investments. They only became cheerleaders for offshore investments when they could not hide the massive under-performance of the JSE versus global investment markets anymore. The reason is simple: it makes more money with local assets under management as the fee structure of international fund houses is substantially lower than local funds. The local asset industry has one of the highest cost-structures in the world and therefore it stands to reason that local investments are preferred.

As an example, the recently launched BRENTHURST WEALTH GLOBAL EQUITY FUND, which only invests in exchange traded funds (ETF's) has a total cost structure of just over 1%, compared to 2-2,5% of the more popular offshore funds owned by SA companies.

Another reason why the local industry does not strongly recommend offshore investments is the fear (a real one) that the money taken offshore will be invested with international competitors. This fear is real as many of the best-performing sectors in the world (health care, technology, 4th industrial revolution funds) do not feature amongst the SA-owned companies, mainly due to scale.

Most investors know by now that the year 2018 has turned out to be a "annus horribilis" in many respects. The economy has slumped into a recession (two quarters of negative growth), unemployment has reached a new record high of almost 28% of the labour force, the rand has weakened from R11,50 to lows of R15,70 earlier this year, and returns on the JSE have been negative by 16% so far this year.

The Medium Term Budget Review delivered by the new finance minister Tito Mboweni further revealed the depth of SA's fiscal problems. SA's total debt, now standing at around R3 trillion, already costs taxpayers an estimated R158 billion per year in interest costs alone. Any further downgrade by Moody's will lead to an increase in interest cost in order to service this debt and potentially a further outflow of foreign capital.

The SA Reserve Bank earlier this month released its second annual financial stability review and highlights the following risk factors of having a "high" probability of happening:

- ◆ **Decline in global economic activity.**
- ◆ **Uncertainty about land expropriation raises uncertainty about property rights, which could lead to uncertain investor sentiment.**
- ◆ **Governance issues at State Owned Enterprises and possible bail outs which could exacerbate SA's already fragile financial position.**
- ◆ **Consumption expenditure constrained by VAT increases and high petrol prices.**

We would love to tell you that things are about to get better and that the weak performance on the JSE, in particular, will suddenly turn around and start galloping ahead. We simply do not see that in any piece of economic statistic at this point in time. However, we will be the first to inform you when we start seeing any green sprouts of an economic revival. **FOR THE TIME BEING WE REMAIN UNDERWEIGHT SA EQUITIES AND OVERWEIGHT SA CASH, AND GLOBAL EQUITIES**

AS ADVISORS WE HAVE BEEN CONSISTENT IN OUR RECOMMENDATIONS TO OUR CLIENTS TO REDUCE LOCAL EXPOSURE AND INCREASE OFFSHORE EXPOSURE.

To some clients, who have an international lifestyle we have recommended a 100% offshore exposure, which has been a great recommendation. Have enough cash in SA (which earns a high interest rate) to fund local liabilities and have the balance of investment portfolios invested fully offshore. We think that this trend will increase over time as investors become more accustomed to offshore investments, despite the short-term volatility at times due to the vagaries of the SA rand.

***Over 100 years up to 2010 the average returns on the JSE was 7% in USD terms, followed closely by Australia and United States. Since 2011 the JSE has produced zero return in USD.**

CONSULT AN ACCREDITED FINANCIAL ADVISOR TO DEVISE AN INVESTMENT PLAN SUITED TO YOUR INDIVIDUAL REQUIREMENTS, CIRCUMSTANCES & GOALS

BRENTHURST RANKED BEST BOUTIQUE WEALTH MANAGER IN SA 2017 & RUNNER-UP 2018 INTELLIDEX WEALTH MANAGER AND PRIVATE BANKS AWARD

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