



INDEPENDENT WEALTH MANAGERS

Authorised Financial Services Provider Number 3145

NEWSLETTER THIRD QUARTER – 2010



From the Directors...

In July 2010 we made reference to various negative events that had resulted in many gloomy headlines predicting a double-dip recession. The past 3 months have displayed some signs of improvement in global financial and economic markets. However, our third newsletter of 2010 provides an indication of the volatility still present and an outlook on various indicators. Despite some signs of recovery, there is definitely a way to go and our expectations for future returns will need to be realigned with current conditions.

The strength of the Rand continues to surprise investors; according to the IMF, the rebound in the Rand is one of the strongest among emerging markets, and has been largely driven by capital inflows. The IMF views the appreciation as a source of legitimate concern and suggests that it could hinder the economic recovery.

	SPOT	% MOVE YEAR TO DATE		% MOVE PREVIOUS 12 MONTHS	
Gold \$/oz	1,311	19.92	↑	32.05	↑
Oil Brent spot	82.11	2.48	↑	18.88	↑
ZAR/USD	6.96	5.66	↑	7.30	↑
ZAR/GBP	10.97	7.44	↑	7.20	↑
ZAR/EUR	9.49	10.47	↑	12.37	↑
All Share (J203)	29,456	5.60	↑	18.25	↑
Resources (J210)	48,477	-7.08	↓	10.43	↑
Financials (J580)	8,305	12.54	↑	19.14	↑
Industrials (J257)	25,010	15.74	↑	26.33	↑
S&P 500	1,136	1.88	↑	8.56	↑
FTSE 100	5,549	2.51	↑	8.08	↑
Nikkei 225	9,369	-11.2	↓	-7.54	↓
DJ-EURO50	275	-7.36	↓	-4.40	↓
Nasdaq	2,354	3.75	↑	12.52	↑

NOTE: Values as at 30 September 2010

Chains of habit are too light to be felt until they are too heavy to be broken.

Warren Buffett

The trend of low interest rates continues globally. In September, the SA Reserve Bank opted to drop the Repo Rate by a further 50 basis points to 6%. The current prime interest rate (9.5%) is the lowest South Africa has experienced since January 1981. In making the decision to cut rates, the Reserve Bank highlighted the following:

- Inflation has surprised on the downside (3.5% in August 2010);
- The growth momentum in the domestic economy has slowed; and
- The global economic outlook remains depressed.

The first article of this newsletter deals with the volatility of equity markets and the anticipated direction of share prices given the reaction of global monetary policy and perceived corporate health. It was written by Alwyn van der Merwe, who is the Director of Investments at Sanlam Private Investments. The second article was written by Coronation and was published in the third issue of Corolab, 2010. This article includes valuable insight into the argument for greater exposure to growth assets after retirement. The source of the argument stems from the outlook provided on various indicators, such as inflation and interest rates as well as anticipated returns.

We again would like to take this opportunity to thank you for your ongoing support. Should you have any queries or require any additional information, please don't hesitate to contact us.

Greg, Maureen and Shaun

Successful investing is anticipating the
anticipations of others
John Maynard Keynes



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EQUITY PRICES: UP, DOWN OR SIDEWAYS?

Alwyn van der Merwe



Private Investments

Shares have markedly appreciated over the past two weeks; despite this recent increase in share prices, equity prices have been directionless since the fourth quarter of 2009. This lack of direction, however, has also been associated with enormous volatility. In a directionless volatile market investors and clients simply start to doubt the primary trend of equity prices and therefore also the wisdom of investing in a temperamental asset class.

This volatility, in our view, is merely a symptom of investor indecision. The question is whether the current economic slowdown will degenerate into a renewed business cycle contraction or the dreaded double-dip scenario. If the answer is the latter, then the recent drop in equity prices since April is just the beginning of a major cyclical breakdown. However, if the perceived risks are not game-changers then the recent shakeout has created another opportunity to buy equities at cheap levels.

It is not uncommon for economic recoveries to lose momentum after the initial firm recovery. As the pace of recovery decelerates, however, it becomes extremely tough to predict whether it is simply a slowdown or the introduction of the next contraction. Only hindsight will tell. Clearly the market needs to digest various risks. The interbank market in Europe is tightening and the

corporate credit market in the region is not functioning. Chinese authorities, meanwhile, have introduced measures to restrict speculation in their property market, which will likely introduce single-digit growth numbers in an economy where double-digit growth has been the norm. Global fiscal consolidation is likely to raise deflationary fears. Finally, recovery in the US labour market is not meeting expectations.

Do these risks suggest a double-dip scenario? In their third-quarter strategy report, the *Bank Credit Analyst* argued that the world has experienced two double-dip patterns after the Second World War. In both cases it was shock-induced. In the early 1970s it was an oil shock and an ill-timed spike in interest rates and in the 1980s, Paul Volcker's battle against inflation also saw high interest rates doing the damage. If we assume no policy mistake or external shock the global economy is likely to muddle through. In fact, to date we have seen the opposite. Economic authorities have generally demonstrated an inclination to keep policy rates at low levels so as not to derail the fragile economic recovery.

We have also highlighted in previous publications that the health of corporate has improved materially over the past two years. Firstly, the profitability of corporate both in Europe and the US has improved as was evidenced in the first-quarter reporting season, with a continuation of this trend in the initial stages of the second-quarter earnings season. Secondly, companies have also utilised the past two years to recapitalise their balance sheets. A combination of higher



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margins and stronger balance sheets should eventually lead to a much needed increase in capital spending.

The tug-of-war between good and evil creates uncertain behaviour in equity prices. This uncertainty might well prevail for the rest of the year until investors gain more conviction regarding the strength of the recovery.

Ultimately, we buy companies and not an economic story. We have just experienced a so-called lost decade for equity performance in many developed world markets. Equity prices are now trading at palatable levels both globally and locally and hence we would argue for equity exposure to at least match the risk profile of investors. Unlike developed world equity markets, SA equities have rewarded investors richly since 2003.

We would suggest an increased global equity exposure going forward.

By Alwyn van der Merwe,
Director of Investments
Sanlam Private Investments

Published August 2010

CORONATION 
FUND MANAGERS

COROLAB 2010: ISSUE 3 THE INCOME AND GROWTH CHALLENGE

Investors who are near or already in retirement face the most challenging of investor needs: investing for both immediate income and long-term growth. The key challenge is to ensure a sustainable living standard by balancing the needs of today with those of the future. The past 10 years have been very good to investors in local assets, and many retirees that expect a repeat of this experience may not be well positioned to cope with the tougher investment environment that is presently unfolding.

Given our lower return expectations for all the domestic asset classes, we believe investors with insufficient growth assets in their retirement portfolios may find themselves desperately vulnerable later in retirement. As such, we believe that most income and growth investors do not have enough exposure to growth assets, partly as a result of this exceptional period of superior performance.

In this issue, we discuss the most important considerations that investors with income and growth needs should take into account to ensure that their retirement planning is appropriately prudent.



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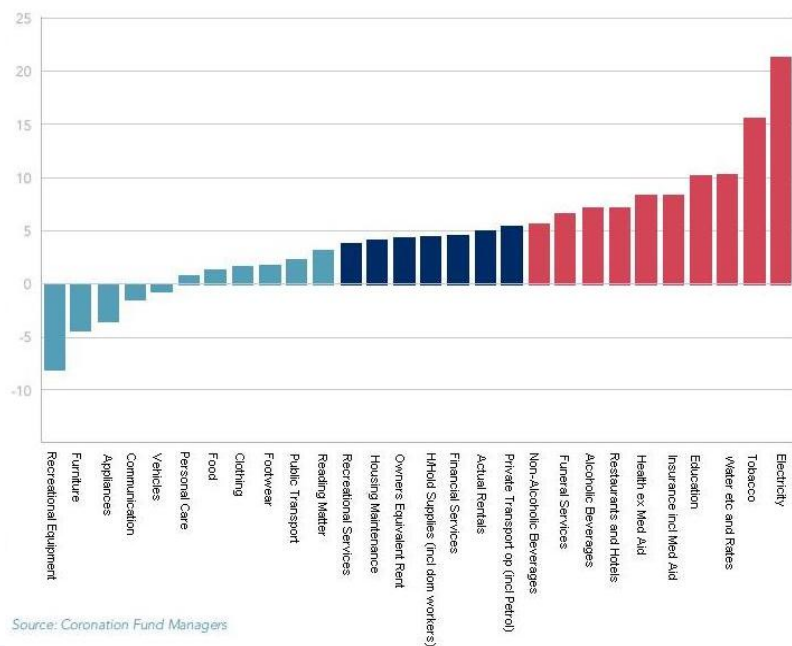
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Plan for higher Inflation

Headline inflation, as quoted in the media, is based on the ‘average’ South African’s basket of goods. However, older individuals in the higher income categories often have disproportionate exposure to healthcare, municipal rates, water and electricity in their basket of goods and services. All of these will continue to increase faster than quoted headline inflation (see Figure 1 for an example of how different spending categories influence the current inflation rate). Therefore, the prudent planner will likely conclude that it is sensible to make provision for a higher personal inflation rate than that recorded in the headline number.

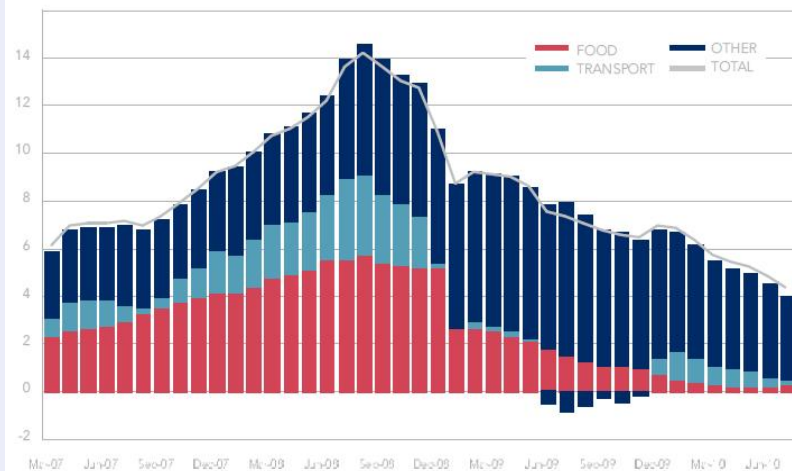
If one looks at the historical sources of inflation (Figure 2), it is notable that food and transport contributed significantly to the spike in inflation towards the middle of 2008. At that time, the price of oil reached \$140 per barrel and the rand was trading at around R7.81. Today these two components are contributing almost nothing to overall inflation – but this will change eventually. Food and transport are big drivers of inflation and are unlikely to remain at current levels. The prudent planner will make provision for a significantly higher inflation rate than the current rate of 3.7%.

FIGURE 1 WHAT IS YOUR PERSONAL INFLATION NUMBER?
The CPI basket as at 31 July 2010



Source: Coronation Fund Managers

FIGURE 2 INFLATION CONTRIBUTION AS AT 31 JULY 2010



Source: Statistics South Africa



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Plan for lower Returns

Expect interest rates to remain lower for longer.

The growth momentum of the global economy has started to slow. In the US, the rate of employment has fallen and weaker house sales are being recorded. Even the Chinese economy has lost momentum after a very strong run. In Europe the problems are even greater, with countries such as Greece, Spain, Portugal and the UK being forced to adopt tighter fiscal policies, cutting government spending and raising taxes in a bid to repair their poor financial balances.

We believe that central banks will keep interest rates at exceptionally low levels for as long as necessary. While many fear deflation, we believe the risk of keeping interest rates at close to zero for an extended period of time and printing money will ultimately result in inflation coming through in future.

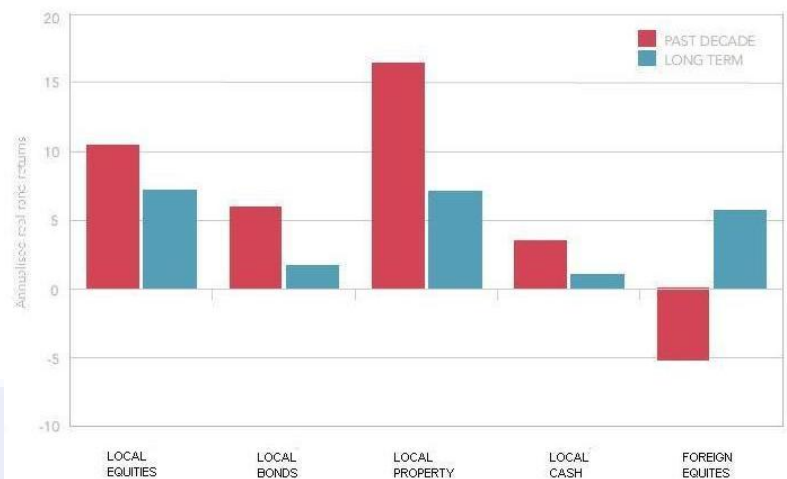
Against this background, we believe income and growth investors are at risk if they do not have enough growth assets in their portfolios. Growth assets are the most reliable means of protecting one's capital against the eroding effects of inflation.

The last decade is not a good basis for expected return forecasts.

Investors in local assets have been handsomely rewarded over the past 10 years. Equities and listed property in particular have delivered very strong real returns, while cash and bonds also did well. However, in Figure 3, we show that these returns are in fact far ahead of their

long-term averages, and foreign equities are too far behind (as illustrated by the MSCI World Index). Using the past decade's performance as a guide for future returns therefore offers a poor basis for prudent retirement planning in our view.

FIGURE 3 ANNUALISED LONG-TERM REAL RETURNS PER ASSET CLASS
Past decade (to June 2010) versus last 110* years



* Shorter history for foreign equities (40yrs) and local property (30yrs)
Source: Deutsche Bank, I-Net Bridge, Triumph of the Optimists – Dimson, Marsh and Staunton

In order to explain why we believe local assets are likely to revert to their long term averages, one needs to consider the source of the past 10 years' returns.

The return on any asset class consists of two parts: income and capital appreciation / depreciation. In turn, the capital appreciation / depreciation leg consists of growth in earnings (in the case of equities) or rentals (in the case of listed property) as well as the positive or negative effect of a rerating of the asset class (in other words, how much more (or less) investors are willing to pay for an asset class).



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Figure 4 shows that local shareholders benefited from company earnings that grew significantly faster than South Africa's overall GDP (6% after inflation for the All Share Index versus 3.6% for the economy) as a result of a decline in tax rates, muted real wage growth and expansion abroad. While equities have enjoyed a positive rerating of 1% p.a. over the past 10 years, the impact of earnings growth on the asset class's total return has been far greater.

We believe that for company earnings to grow at a faster pace than the economy in which they operate is unsustainable, and we therefore expect lower returns from this asset class over the next 10 years.

Investors in income-generating investments such as bonds, and particularly listed property, benefited from a structural rerating made possible by a large decline in inflation and interest rates over the 10-year period. For this effect to be repeated, inflation in SA would need to fall to the 2%–3% range over the next 10 years, which we believe is unlikely. Given that distributions (in the case of listed property) and coupons (in the case of bonds) have already come down from the levels of 10 years ago. We believe that, for prudent retirement planning, investors need to assume a derating of these asset classes, rather than a rerating.

In Figure 5 we provide a 10-year forecast of what we believe the different asset classes are likely to deliver, solidifying why we believe it is prudent for income-and-growth investors to have enough exposure to growth assets in their portfolios.

FIGURE 4 ASSET CLASS RETURN ATTRIBUTION FOR THE PAST 10 YEARS
To June 2010

	ALL SHARE INDEX	LISTED PROPERTY	ALL BOND INDEX
TOTAL RETURN	16.4%	23.3%	12.2%
EARNINGS (DIVIDENDS, DISTRIBUTIONS OR COUPONS)	3.4%	12.1%	10.8%
CAPITAL GROWTH	13.0%	11.2%	1.4%
– EARNINGS/DISTRIBUTION GROWTH	11.9%	5.0%	–
– RATING	1.0%	5.9%	1.4%
INFLATION	6%	6%	6%

Source: I-Net Bridge and Deutsche Bank

FIGURE 5 10-YEAR FORECAST FOR LOCAL AND OFFSHORE ASSET CLASSES

	PAST 10 YEARS	10-YEAR FORECAST*
GROWTH ASSETS		
LOCAL EQUITY	17.0%	10–12%
GLOBAL EQUITY	2.3%	13–15%
PROPERTY	23.2%	9–10%
INCOME ASSETS		
BONDS	13.2%	8–9%
CASH	10.3%	7.5–8.5%
INFLATION	6.8%	6%(+?)

Source: I-Net Bridge, Deutsche Bank, *Coronation Fund Managers



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Plan to live Longer

While it is rather unsettling to think of one's own mortality, most of us underestimate the investment horizon that needs to be planned for in retirement. Advances in healthcare technology and improvements in nutrition mean that people are living longer, and therefore life expectancy is increasing. For example, if you are a South African female retiring at 65, you can expect to live a further 20 years (see Figure 6 below). But your effective time horizon may be longer as you may live beyond the average retiree. The prudent approach would therefore be to plan your affairs to have a sustainable income for at least 25–30 years. At a 6% inflation rate, this means that you will require nearly 6 times (allowing for inflation) the level of income at the end of your planning horizon than at the start, just to be able to buy the same amount of goods and services.

What are the implications for retirement planning?

We have illustrated so far that the typical retiree needs to plan for a horizon of 25–30 years, can expect a relatively high inflation rate and, for at least the next decade, should expect returns to be more subdued than over the last 10 years. The prudent planner's response to this backdrop will include moderating income drawdown rates and ensuring that their portfolios are adequately exposed to growth assets.

To illustrate why we argue for the inclusion of growth assets in a post-retirement income portfolio, consider the 'actual impact of inflation analysis' in Figure 7. This table compares the actual results that would have been achieved by investors drawing different levels of income from two portfolios with differing risk profiles.

FIGURE 6 SOUTH AFRICAN LIFE EXPECTANCY AT RETIREMENT AGE

RETIREMENT AGE	MALE	FEMALE
60	81	84
65	82	85
70	84	86
75	85	87

Source: Actuarial Society of South Africa



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The first option is a very conservative income assets only portfolio, and the second a moderate risk income and growth portfolio, with a roughly even split between income and growth assets over time. We have used the average money market fund for the former and the Coronation Capital Plus Fund as an example of the latter. The analysis is performed for the period July 2001, when Capital Plus was launched, to June 2010. Over this period, the average money market fund returned 9% p.a., with a very low standard deviation of 1%, while Capital Plus returned 15% p.a. at a standard deviation of 8%.

The first point to note is how quickly inflation erodes purchasing power. The table indicates that, if you drew an annual income of R70 000 in 2001, you need R122 221 to buy the same basket of goods and services today. The second point is that Capital Plus (the portfolio with roughly 50% invested in growth assets) was a lot more effective in generating income over the period regardless of the initial income rate selected. For example, if your initial income rate was set at 9% in 2001, you need to draw 11% from Capital Plus today, while your income requirement from an average money market fund would have already breached 17.5% – the maximum drawdown rate for a living annuity.

FIGURE 7 ACTUAL IMPACT OF INFLATION ANALYSIS

INCOME RATE IN 2001	3%	5%	7%	9%
Capital invested in 2001	1,000,000	1,000,000	1,000,000	1,000,000
Annual income in 2001	30,000	50,000	70,000	90,000
Annual income in 2010 (effect of actual CPI)	52,381	67,301	122,221	157,142
Capital in 2010, if invested in MMF (9% p.a. @ 1% SD)	1,445,000	1,134,100	889,161	696,729
Capital in 2010, if invested in Capital Plus (15% p.a. @ 8% SD)	2,263,122	1,775,337	1,391,906	1,090,671
INCOME RATE IN 2010				
Coronation Capital Plus	2%	5%	9%	11%
Average money market fund	4%	8%	14%	MAX

Source: Coronation Research



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Drawing too high an income at the start of your retirement and/or expecting too high a rate of return is as dangerous as investing too conservatively. Consider the 'income rate and return analysis' in Figure 8. This table shows a variety of possible initial income rates, from 2.5% to 17.5%. This range represents the current legal drawdown limits applicable to living annuities. It also shows a variety of potential annualised net investment returns that may be earned, from 2.5% to 15%, in the columns. Each cell in the resulting table represents the number of

years before income, (adjusted for inflation of 6%), will start declining. Another way to think about this is how many years you have before your standard of living will start to decline in the different scenarios. At a rate of return of 15% p.a. (historically achieved by Capital Plus), any initial income rate up to 7.5% represents a sustainable income, as income will continue to grow in line with inflation for at least 50 years. However, note what happens when the expected return drops by 2.5% and 5%: the period of sustainability drops dramatically to 22 and 13 years respectively at a drawdown rate of 7.5%.

FIGURE 8 INCOME RATE AND RETURN ANALYSIS

		NOMINAL NET INVESTMENT RETURN P.A.					
		2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
SELECTED INCOME RATE P.A.	2.5%	21	30	50+	50+	50+	50+
	5.0%	11	14	19	33	50+	50+
	7.5%	6	8	10	13	22	50+
	10.0%	4	5	6	7	9	20
	12.5%	2	3	3	4	5	7
	15.0%	1	1	2	2	2	3
	17.5%	1	1	1	1	1	1

Source: Asisa Standard of Living Annuities with additional calculations by Coronation Research

Given our expectation for lower returns, we do not believe that initial income rates above 6%–7% will be sustainable for most retirees (and then only from a portfolio with adequate exposure to growth assets.) It is however important to note that returns will not be optimised by investing only in shares and property as the returns on growth assets can vary from year to year. For example, the local equity market had a standard deviation of 20% over the past decade, while studies show that the real returns from an income and growth portfolio is optimised with a standard deviation of 10% or less.

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