



INDEPENDENT WEALTH MANAGERS

Authorised Financial Services Provider Number 3145

NEWSLETTER FIRST QUARTER – 2010



People don't care so much how much you know
until they know how much you care.

(Sir John C Maxwell)

From the Directors...

2010 is well on its way. It is with great pleasure that we present our first newsletter for 2010. We as a team felt the need to engage in more continuous informative communication with our valued clients. The objective of such communication is to provide up-to-date and relevant information for your perusal and education. We trust that you will find the content that follows both interesting and valuable. Should you have any queries or require any additional information, please don't hesitate to contact us. In addition, should you wish to provide any input for future communications, your suggestions are most welcome.

	SPOT	% MOVE YEAR TO DATE		% MOVE 12 MONTH ROLLING	
Gold \$/oz	1104	-0.59	↓	22.86	↑
Oil Brent spot	80	1.49	↑	-2.14	↓
ZAR/USD	7.383	-1.19	↓	18.07	↑
ZAR/GBP	11.051	7.60	↑	20.00	↑
ZAR/EUR	9.936	8.08	↑	23.02	↑
All Share (J203)	28735	3.21	↑	34.45	↑
Resources (J210)	51843	-1.20	↓	33.86	↑
Financials (J580)	8038	9.78	↑	27.64	↑
Industrials (J257)	22367	4.58	↑	38.25	↑
S&P 500	1173	4.54	↑	28.11	↑
FTSE 100	5672	5.82	↑	32.78	↑
Nikkei 225	10996	3.41	↑	27.33	↑
DJ-EURO50	293.64	-1.54	↓	36.13	↑
Nasdaq	2385	4.57	↑	60.27	↑

*All figures correct as of March 26, 2010

This newsletter contains three articles written by industry specialists. The first article was published in December 2009 and was written by Allan Gray Portfolio manager, Sandy McGregor. This article poses interesting suggestions regarding the failure versus triumph of markets during financial crises and provides an alternative view to the last 18 months. The second article was written by Rob Macdonald, Head of Xchange Solutions Nedgroup Investments. Rob suggests that the financial crisis emphasises the role of behavioural finance in the challenge of learning from our mistakes. The last article deals with Trusts, which offer many benefits that are often overlooked, such as the advantages of a trust as a member of a close corporation. It was written by Walter Geach, who is a Consultant to Independent Wealth Managers and a Professor, and author of 'Trusts, Law and Practice'.

We would like to take this opportunity to thank you for your continued support. We as a company value the relationships we have with our clients and your interests are our priority at all times.

Greg, Maureen and Shaun



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THE TRIUMPH OF MARKETS

Sandy McGregor

ALLAN GRAY

It was a communist article of faith that ultimately capitalism would destroy itself. Accordingly, during the 1920s, the Communist Party of the Soviet Union commissioned the economist Nicolai Dmitriyevich Kondratieff to advise when this would happen. After giving the matter much thought, Kondratieff came up with two conclusions. Firstly, capitalism would not end or collapse. Market-based economies have an astonishing ability to reinvent themselves and to emerge resiliently from economic crises. Secondly, there is a market cycle of about 55 years. On the basis of this cycle, he predicted the travails that would follow 1929. Why 55 years? Kondratieff did not offer an explanation, but his work points to the probable answer. Fifty-five years represents two generations. People do learn from their mistakes but not from history. Their behaviour changes with personal experience. A new generation with different experiences tends to repeat the mistakes of the past.

Kondratieff did not find favour with his Soviet masters. The Great Soviet Encyclopaedia restricted mention of him to one sentence: 'This economist was reactionary and wrong'. He was exiled to a labour camp in 1932 where writer and future Nobel Prize winner Alexandr Solzhenitsyn once had a fleeting sighting of him. Kondratieff was executed in 1938. However, his insights remain valuable and very relevant to our current economic situation.

Have markets failed?

It is commonplace to read, and hear comment on the financial crisis which has unfolded over the past two years, that the market economy has failed. British Prime Minister Gordon Brown has said that markets are discredited. The reality is somewhat different. Indeed, many individuals have been made to look very foolish. 'How did economists get it so wrong?' was the title of an article written by Nobel Prize winner Paul Krugman. Again this is nothing new. In 1300 Dante consigned the equivalent of errant economists, whom he called soothsayers who make false prophesies, to the lowest circle of hell. However, errors by individual bankers, economists and politicians do not mean markets are wrong. Over time markets, which are the aggregation of human behaviour, expunge error in a Darwinian process which rewards success and eliminates what is unsustainable.

Prior to 2007 a set of unsustainable imbalances was developing on an astonishing scale.

They included:

- Property bubbles financed by reckless borrowing
- Reckless lending by banks
- An almost total absence of saving in many countries, including the United States
- Massive trade imbalances and an Asian growth model based on exports
- An overheated global economy forcing commodity prices up



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It was apparent that we were on a path which could not last. The uncertainty was how we would get off it. Many market participants believed that somehow we would muddle through without too much suffering. However that was not to be. Market forces acted with a vengeance and astonishing rapidity. As a result the behaviour of individuals and institutions has changed dramatically. Within two years:

- The private savings rate is up strongly and, in all probability, the baby boom generation will remain significant savers. The shock of what has happened has fundamentally changed the way people regard the future and is creating a savings culture.
- Irresponsible lending and imprudent borrowing have practically ceased. There is much talk of the need to regulate banks to ensure that the bad practices, which contributed so massively to the debacle, are not repeated. In reality, the experience of the past two years has so changed behaviour that it will not be necessary to regulate bankers for a generation.
- Asian countries are increasingly redirecting their economies to domestic rather than export-driven growth.
- The shortage of commodities has eased significantly.

The triumph of markets

Recessions are an essential part of the process of economic growth. To a large extent, growth is synonymous with rising productivity and efficiencies. During long periods of prosperity inefficiencies and bad practices accumulate. In a recession these are eliminated, or at least reduced, and a platform is created for the next expansionary wave. What we have experienced recently is therefore not a

failure but a triumph of the markets. Within two years market forces have imposed necessary adjustments and changes in behaviour which the political system would never have done. Much of what was unsustainable has been eliminated and the world economy is now building foundations for the next up cycle.

As world trade and the financial system imploded after Lehman's collapse, many commentators sought parallels with what happened in the 1930s. This is a misreading of history. The present recession has far more in common with the downturns of 1975 and 1982.

The recent recovery of markets has followed a path similar to what happened in those two years. It is encouraging that 1976 and 1983 witnessed strong growth, which gives confidence about the prospects for 2010. One intriguing parallel with 1975 is the sense of shock that the financial collapse caused.

Between 1948 and 1974 the world experienced a continuing boom with relatively minor recessions. So events of 1975 took everyone by surprise. The same thing happened in 2008 when a generation of businessmen and investors had been lulled into complacency by what has come to be called the Great Moderation – 25 years during which markets were increasingly stable and benign. In both cases, the lessons of history were forgotten.



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The political response to one crisis may create another

While the world's economy is recovering we still face considerable dangers, partly due to what may be unintended consequences of governments' reactions to the crisis. Political systems do not readily accept the harsh judgement of markets. Too many people have been hurt in what has been the most severe downturn since 1982. The response has been to slash interest rates and to print money in the hope that this will alleviate the pain. While this has proved to be a short-term panacea there will be longer-term costs. In effect, governments are trying to prevent the adjustments required by market forces. Those economists who advocate money creation as the solution to our current economic problems have much in common with a French minister of agriculture in the 1930s who, in order to increase the sale of wine, advocated wine as a cure for alcoholism. Money creation is like a drug, a difficult habit to break. Newly printed money is finding its way into asset prices. There is the danger that, in their response to the consequences of one asset bubble, governments are going to create another. If there is another bubble, it is a certainty that market forces will again take their toll.

By Sandy McGregor
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Published December 2009



WHEN INVESTING, THE REAL CHALLENGE IS TO LEARN FROM OUR MISTAKES

Rob Macdonald



To many, the sub-prime crisis and the subsequent market turmoil of 2008 and early 2009 seem a distant memory. After all, local and international equity markets bounced back in 2009. It is amazing how market bubbles offer many lessons, but in spite of these, history has shown that we proceed to make the same mistakes again.

It is understandable that we may have forgotten the lessons of the Tulip bubble in the 1600s, when investors believed that Tulip bulbs were the greatest investment opportunity that the world had ever seen. However, it is less than a decade since we experienced the trauma of the technology bubble bursting at the start of the new millennium. We may wonder why our memories are so short, but more importantly we should ask, when it comes to investing, why are we not able to learn from our mistakes?

In the US, after the market meltdown of late 2008, regulators tried to understand what caused the sub-prime bubble. In his testimony to Congress, former Federal Reserve Chairman, Alan Greenspan, expressed his exasperation at the fact that banks were lending money cheaply to people who could not pay it back. He



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made the following observation about the financial instruments on which Sub-prime mortgages were based: “To the most sophisticated investors in the world, they were wrongly viewed as a “steal”. Why did nobody at the time see that cheap loans to bad borrowers for overpriced properties, was a recipe for disaster? As Richard Thaler, a leading behavioural economist, and Cass Sunstein, a Harvard Law School professor put it, “Why did Mr Greenspan, along with the rest of the world’s regulators, fail to foresee that this could happen? We think their mistake was to neglect the role of human nature”.

Behavioural finance studies over the past few decades have revealed the many ways that investors undermine their investment outcomes because of their fallible human response and reactions to changing circumstances and choices. Two key “all-too-human frailties” that Thaler and Sunstein believe impacted significantly on the sub-prime crisis were that of:

- Bounded rationality, and
- Limited self-control.

Bounded rationality implies that human beings find it difficult to deal with complexity. As Thaler and Sunstein put it, “People are not stupid, but when things get complicated they flounder: they suffer from bounded rationality”. Bounded rationality describes the fact that human beings, regardless of their intellectual capability suffer from limited time, limited information about various possibilities and their consequences and limited capacity to process information that is available.

For example, in the sub-prime crisis, borrowers didn’t appreciate the complexity of the mortgages they were taking out, while on the lending side there was ever-increasing complexity of the derivatives underpinning the packaged mortgages.

Limited self-control implies that as humans, we often give in to temptation. This explains why money is made from selling diet drinks, diet supplements and gym memberships! In the sub-prime situation, the temptation was for individuals to refinance their mortgages with low interest rates in the belief that property prices only rise.

How can we manage complexity and resist temptation? If being human means that when it comes to investing we have inherent limitations, how can these limitations be managed to save ourselves from ourselves? Thaler and Sunstein argue that regulators need to help people manage complexity and resist temptation. This may be a sensible suggestion, but the problem is that at the coalface when investment decisions are made, it is not the regulator who is making the investment but ordinary investors, many with the help of a financial advisor.

A useful starting point would be to recognise that our limitations are both in our head (complexity) and in our heart (temptation). So we need to manage how we think as well as how we feel. Warren Buffett, the world’s most successful investor put it very clearly and simply, when he said, “To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What’s needed is a sound intellectual framework for making



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decisions and the ability to keep emotions from corroding that framework.” The framework of which Buffett speaks is like having a diet plan. But often the diet plan is not enough. It simply provides the blue print and invariably we need a dietician or some form of “coach” to help us be accountable to that blue print. In the world of wealth management, the equivalent would be a financial plan and a financial advisor. If an investor has a clearly documented financial or investment plan, then any decisions that they make should be based on that plan, rather than on the latest fad or fancy. And when the latest fad becomes too tempting, the advisor can step in and ensure accountability to the plan, thereby preventing emotions from corroding the plan.

By Rob Macdonald

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Published January 2010



TRUSTS AND BUSINESS STRUCTURES

Walter Geach

Trusts have many benefits

A trust has many advantages including asset protection, estate duty savings and a saving of capital gains tax that can arise on death. But trusts are still not used as often or as effectively as they should in setting up business structures, often because people do not realize what is, or what is not, allowed by law. Take close corporations as an example. If a person holds his or her interests in a close corporation directly, the member's interest is not protected from creditors, from estranged spouses or from SARS on death. But if the member's interest is held by a trust, the interest is fully protected. People should be aware that the Close Corporations Act does allow a trust to hold a member's interest, that is to say, a trust can effectively be a member of a close corporation. This is so, whether the trust is a testamentary or a trust that is set up during the lifetime of the planner.

Membership of a close corporation and trusts

The Close Corporations Act provides that 'a natural or juristic person in the capacity of a trustee of an *inter vivos* trust may be a member of a corporation' provided certain requirements are met.



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The following are those requirements:

1. Requirement one: a juristic person cannot (directly or indirectly) be a beneficiary of the trust. This means that if a juristic person (such as a company or close corporation) is a beneficiary of the trust, even a discretionary beneficiary of the trust, then the trust cannot be a member of the corporation.

2. Requirement two: if at any time the number of beneficiaries of the trust who are *entitled* to receive any benefit from the trust, when added to the number of members of the corporation, is greater than ten, the membership of the trustee shall cease. What this means in practice is that the number of 'entitled' beneficiaries must be counted, and this number, together with any other members, if any, cannot exceed ten.

In this disqualification clause it is interesting to note that the word '*entitled*' is used. It is suggested that whilst a discretionary beneficiary is '*able*' to obtain benefits from a trust, such beneficiary is not '*entitled*' to such benefits until trustees exercise their discretion in that beneficiary's favour.

Therefore discretionary beneficiaries must only be counted in determining whether this disqualification clause is operative when they have become entitled to

benefits from the trust. This will be when the trustees exercise their discretion in their favour. What this means in practice is that a discretionary trust, or a number of discretionary trusts, can be members of a close corporation, and this is so even if there are, in total, more than ten discretionary beneficiaries.

In other words, individuals should rather let their trusts be members of a close corporation rather than hold their interests themselves. And, if properly structured, up to ten trusts can be the members of a single close corporation.

Conclusion and recommendation

There are a great many advantages for a trust to be a member of a close corporation, or for a number of different trusts to be members of a close corporation. The nature, type and number of trusts that qualify to be members of close corporations are wider than many people realize. Trusts can also be shareholders of companies, and can similarly offer many advantages.

By Walter Geach

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