GLOBAL BRIEF
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Editorial comment
Mike Borland, director, FIRSTGLOBAL GROUP

...And the worldwide financial market volatility just keeps on and on. The positive for us is that the emotional impact on "spectators" tends to be a lot less as investors have been conditioned to expect it, and to concede that this volatility is part of the price we have to pay for the excesses of the past and for necessary "recuperation". Put differently we could say that this is (for the meanwhile at least) the "new normal".

Looking at the global economies, the Chinese economic growth rate is slowing and Europe "will go into recession" ---but there are some promising signs of improvement in the US and even possibilities in Japan - and some positive growth in emerging market economies such as Brazil which has now surpassed the United Kingdom's size as an economy. So there are some compensating factors and to be sure, the sun will shine tomorrow, and there will always be opportunity and plenty about which to be positive.

The Firstglobal Group will have been in existence for ten years during the second quarter of 2012 and, in our next edition of Global Brief, we will share some of our proud history with our readers.

In this edition we consider what investors should be doing in uncertain times, we look at some tax considerations around the recent Budget, we also look at the impact of further Exchange Control relaxation and finally we include a potentially alarming article on the Accrual System in marriage and its possible effects on death or divorce. As usual we include as an Addendum, our FGAM Fund review.

Enjoy the read.

Uncertain times require a focus on the basics
By Nic Andrew, head, Nedgroup Investments

Negative news headlines, enormously complex macro-economic issues, extreme market volatility and often contra-dictory comments from the experts... There are an almost overwhelming number of factors influencing the market. These range from the US fiscal deficit and bungled dealing of manag-ing the debt ceiling by Washington, to S&P downgrading US government debt (the "ultimate" risk free asset for so long), to Greece's expected default, the knock-on effect on the rest of Europe and the impact that would have on confidence and longer term economic growth.

The combination of factors and their inter-connectedness aggravate the situation and further muddy the outlook. Although experts normally differ in their opinion (as that is what creates a market), one has rarely seen such extreme and often opposite views as are being currently expressed. An example of this is the inflation debate where there seem to be very compelling arguments for both deflation (slow growth, unem-ployment, excess capacity and austerity measures) and inflation (loose monetary policy, excessive stimulation and higher food and commodity prices).

Amidst all the uncertainty what should we investors do?

• Focus on the long term

It is near impossible to predict short term market movement and it is easy to be unsettled by extreme volatility. There are signifi-cant advantages and opportunities to astute and patient investors who are able to look through the short term noise and to retain focus on their long term goals and overall plan.

When assessing performance of one's investment, we recom-mend measuring equity investments (high growth objective) over rolling 7 year periods, balanced investments (medium growth objective) over rolling 5 year periods and lower risk investments (capital preservation objective) over rolling 3 year periods.

• Diversify

There are few free lunches in investing and diversification is one of them. At times like this when the range of potential outcomes is so wide, it makes sense that to diversify one's portfolio by investing amongst assets that are not highly correlated.

For the South African investor this includes having a reasonable offshore allocation.

Similarly if one appoints a number of different managers, it makes sense to appoint managers who are different and them-selves provide diversification benefits.

• Focus on Valuation and quality

Many studies have shown that the price one pays for an asset is the most important determinant of your end result. The most successful investors are able to ignore short term market turmoil and momentum and identify opportunities where assets are driven below their fundamental value.

A focus on value provides an important anchor that helps prevent panic selling of existing holdings which may be driven below their fair valuation and provides the conviction to invest when all are selling.

Another characteristic of market declines is that indiscriminate-selling often means little distinction is made for individual company characteristics. The result is that high quality companies (which normally and rationally trade at premiums) are sold down with the market to very attractive levels. Purchasing these high quality companies at attractive prices has typically proved to result in very satisfactory investment outcomes. Currently, where mandates allow our managers have found some excellent opportunities of purchasing high quality global companies at very attractive valuations.

• Awareness of the danger of emotions

It is completely natural for investors to feel the emotions of fear and panic. Investors are well served to be aware of the dangers of re-acting emotionally and put in place the structures and framework to manage their natural re-actions.

A good understanding of the principles outlined in this article should assist in developing and sticking to that framework. Many of the best investment managers are well aware that they too are at risk of behaving emotionally and apply disciplined processes to ensure that they stick to their well thought out plans and philosophies.

• Manager selection is important

There are a number of principles we look at when selecting investment managers to manage our client's monies. We assess a manager's performance over the full market cycle, as we are well aware that no manager will consistently outperform over short periods. Our research suggests that top managers have historically produced the bulk of their out-performance (up to 80%) in poor market conditions.

• Expectation management of returns and volatility

Few commentators would deny that the issues facing the global economy are material and that the environment is significantly less benign than it was for much of the latter part of the twentieth century. Many of the previous tailwinds such as long-time leveraging, political stability and capital market friendly legislation have now turned into headwinds.

For South African investors the experience of the last decade has been above average returns (the average general equity fund has produced about 17% per annum.)

Investors should prepare and expect lower returns than the last decade, and in all likelihood with continued high levels of volatility.

• Understand the risk of not taking risk

Despite the expectation of lower returns going forward, this does not mean that investors should not take risk. With interest rates (both nominal and real) at low rates, investing too much of one's portfolio in cash seriously increases the shortfall risk or risk of running out of money. Our longer term expectations are still that quality growth assets (such as well-run companies, with high returns on capital, strong barriers to entry and high cash generation) purchased at current levels will reward patient investors.

Investors undoubtedly face challenging circumstances. Applying these principles should assist them in navigating the choppy waters and ultimately achieving their investment goals.

The Recent Budget Announcements and Tax

Editor's note

The recent budget announcements are plain for all to see. There are some noteworthy aspects of this that deserve some additional brief comment.

1.

In Global Brief Q2 of 2011, we noted the proposal to change the basis for Retirement Annuity contributions with effect 1 March 2012. In an apparent last minute about turn, the deductibility of RA contributions remains unchanged at the greater of:

- 15 % of taxable non-retirement funding income;
- R3500 minus current pension fund contributions;
- R1750

It is noted in the Budget commentary that changes along the lines of the initial proposal (ie to allow a 22.5% deduction subject to a minimum of R12 000 and maximum of R200 000) will be introduced in March 2014.

2.

The surprise increase in Dividends tax from the anticipated 10% to 15% and the increase in the inclusion rate for calculation of Capital Gains Tax (25% to 33.3% for individuals and 50% to 66.6% for Trusts) makes it all the more important to consider the tax shelter (and consequent potential improved investment returns) offered within tax sheltered structures such as Retirement Annuities and Endowment investment products.

3.

One could ponder the fact that the increase in CGT, especially against Trusts, could be an indication that Trusts as a tax planning tool, will continue to come increasingly under the SARS spotlight.

4.

Add to this the fact that (according to rumours) Estate Duty as a means of tax collection is inefficient and being phased out, and one gets the gist of where the "Fiscus" is going with CGT.

5.

This in turn means that you might be well advised to look to retirement annuities as a source of Estate Planning as well as a source of tax and retirement planning.

Relaxation of Exchange Control

Editor's note

We bring to your attention some of the recent developments regarding further relaxation of Exchange Controls.

• There has been consolidation of cross border payments under the single discretionary allowance of R1m per calendar year in that it now includes alimony and child payments over and above the amount provided in the Court Order; wedding expenses and a foreign capital allowance. No tax clearance certificate is required for these transfers which means that R1m per annum can be invested offshore without having to apply for a tax clearance certificate. Please note that the usual allow -ance documentation will have to be submitted as required by the specific Authorised Dealer. The Financial Surveillance Department (FSD) is prepared to consider applications for additional funds on a case by case basis.

• SA companies will now be allowed to make bona fide outward foreign direct investments outside the current line of business of the company (excluding passive investments). The FSD will consider applications in excess of the R500m per calendar year which can be approved by the Authorised Dealer.

• The policy relating to "loop" structures has been amended in that SA companies can now acquire 10 to 20% equity/voting rights in a target foreign entity which may hold investments/ make loans into any Common Monetary Area country.

• The FSD has approved applications for remittance offshore by individuals of significant amounts in excess of the R4m annual allowance for investment purposes. These approvals in the case of individuals, include the requirement to report on an annual basis and to make appropriate disclosure of the foreign investments and income earned thereon. They have also approved certain transfers from trusts, but in addition to the requirement to disclose and report, an Advance Tax Ruling has to be obtained from S A Revenue Services. There is however some uncertainty with regard to future approvals and we are waiting for clarity in this regard.

The importance of understanding the accrual system and the effect it will have on your death or divorce

By Patricia Holburn, Editor, Money Marketing

Most people these days are highly aware of the importance of having an up-to-date Last Will and Testament. However, not many are aware of the effect that the accrual system will have on the dissolution of their estate.

According to Madelein Marais, a fiduciary services expert at Private Client Holdings, it is crucial to take into account the effect of the accrual system when drafting your will as it can have far reaching effects on you and your loved ones. It is thus imperative that clients understand the implications of the accrual system, the effect it will have on their respective estates and that they make adequate provision therefore.

If married out of community of property with incorporation of the accrual system the accrual comes into effect on dissolution of a marriage, whether it be by death or divorce. The accrual system has contributed to a fair and equitable division of assets on divorce - however the effect the system has, on the interpre-tation of wills drawn without regarding the accrual system, become more evident as time goes on.

Accrual system – can be a cruel system

Marais advises on the possible pitfalls involved with the popular ANC with Accrual. "At Private Client Holdings we have often seen that clients do not consider the effect of the accrual system when drafting their wills. It is the first thing that jumps to mind at the time of divorce but the last when happily married and merely drafting a will. This can however be a huge mistake with dire or unintended consequences."

The accrual system, which derived from the Matrimonial Property Act 88 of 1984 allows each party to retain their own separate affairs during the course of their marriage. However at the dissolution of their marriage either by death or divorce the accrual system will come into effect. To calculate the accrual each party's estate at the time of marriage will be adjusted in line with inflation (CPI) this will be called the commencement value.

The following are however excluded from the accrual calcula-tion:

1.
Any asset excluded from the accrual system under the ante-nuptial contract as well as any the proceeds of the sale of such asset and the replacement asset.

2.
An inheritance, legacy or donation which accrues to a spouse during the marriage, except in so far as the spouses may agree otherwise in their antenuptial contract or in so far as the testator/trix or donor may stipulate otherwise, as well as any other asset which has been acquired by the spouse by virtue of his/her possession or former possession of the inheritance, legacy or donation.

3.
Any donation between the spouses, is not taken into account in either estate.

4.
Any amount which accrued to a spouse by way of damages, for example defamation or pain and suffering, other than damages for patrimonial loss.

"Put simply, what happens then," says Marais, "is that the monetary value of the smaller estate is subtracted from the monetary value of the larger estate. The difference between the two is then split, and the party with the larger estate pays half of the difference between the two estates to the party with the smaller estate."

Marais explains that an accrual claim in favour of the surviving spouse is a claim against the estate of the deceased spouse, and ranks as a liability that has to be paid before the estate passes onto the heirs or beneficiaries in terms of the will.

Should the accrual claim be against the surviving spouse, it is a claim in favour of the estate and regarded as property in the estate. This accrual claim needs to be paid to the estate by the surviving spouse and needs to be provided for. Should no provision be made then a situation can arise where the surviving spouse has to deal with the loss of their partner and then still be obliged to pay an accrual claim to their spouse's deceased estate.

"Death is a traumatic experience filled with loss and grief. Having to deal with unforeseen and unplanned for financial concerns merely compounds this grief."

"It is therefore imperative that the accrual claim, if applicable, be taken into account in the liquidity analysis of the estate planner, and should specifically be provided for. Should no provision be made it can lead to the scenario where estate assets may have to be liquidated in order to settle this claim, possibly to the detriment of heirs and beneficiaries or vice versa where the surviving spouse have to pay cash into the deceased estate to settle the claim!"

"If each spouse leaves their entire estate to the survivor, then the accrual will not cause a liquidity shortfall. The difficulty comes in when the deceased leaves some or all of his estate to a third party," cautions Marais.

"Liquidity is the cash available to cover all your liabilities, estate administration expenses and pay estate duty, without compromising your heirs and beneficiaries."

Consider the following example: Both spouses had not brought any assets into the marriage. The surviving spouse accumulated an estate of R5 million. The deceased (husband), however, accumulated a large estate consisting of mostly fixed property and business interests. His estate at the date of his death is worth R35 million. He bequeaths his estate to his children of a previous marriage. In this scenario the surviving spouse (wife) will be entitled to an accrual claim of R15 million, calculated as follows – R35 million less R5 million = R30 million/2 = R15 million. This claim must be settled prior to heirs receiving their share. Clearly there will be a liquidity shortfall in the estate that was not the intention of the deceased.

There are however various financial planning tools and ways to structure your will to avoid these unwanted scenarios. Being all the more reason to do proper estate planning.

"As these examples highlight, the death of one spouse in a marriage with Accrual can lead to much additional trauma if not planned correctly. Estate planning is an essential part of financial planning and an estate liquidity analysis should always be done including the calculation of the accrual on death, where applicable.

Remember that your estate liquidity analysis needs to be conducted and reviewed on a regular basis to ensure that it satisfies the changing needs and circumstances to avoid dire or unintended consequences," concludes Marais.

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