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STERLING
PRIVATE WEALTH

Inside this issue

Welcome
Graydon Morris

Would you believe we are already half way through the year. The 2014 Soccer World Cup has been won by Germany, and we have recently emerged from a record breaking Platinum Belt strike that has devastated many families in the North-West region of South Arica, as well as many families around the country that rely so desperately on this income.

We hope that a greater sense of understanding and co-operation between business, labour and government will be evident in future. As we catch our breath at half time for 2014, we can scarcely believe that the JSE ALSI is already up 11.05% YTD at the time of writing, following the caution our Wealth Managers have been advocating for some time. This is an ever present issue with trending markets; they can become really stretched before the elastic band snaps. We shall continue to position our clients in a diversified manner to manage downside risk and to ensure our investor experience through the cycle, not just at selected snapshot points, is favourable. Sterling Private Wealth prides itself on its risk management, a quality and characteristic often overlooked after a 5 year trending equity market. It is only when the tide goes out that one realises who has been swimming naked.

We have negotiated many of our valued clients and families through the Global Financial Crisis, successfully, and are fully prepared to do so again, if and when necessary. The ZAR has remained relatively flat for the year, following an extremely weak 2013. We note the recent strength of the GBP and the potentially overheated UK property market. All eyes are on this area over the next 24 months. The Global Equity Market, as measure by the MSCI World Index is up around 6% in US$ so far this year.

We have included a few very interesting snippets in this Sterling Times. Not least of these is a focus on the Investment Strategy and Commentary around the Norway Sovereign Wealth Fund. Sovereign Wealth Funds are major players in Global Financial Markets. We have listed below the size of a few of these funds, for your interest :

Kuwait	$ 290	Billion
Chile	$ 44	Billion
Malaysia	$ 34	Billion
Azerbaijan	$ 32	Billion
Botswana	$ 7	Billion
Vietnam	$ 3	Billion
Norway	$ 612	Billion (it owns 1% of the World's liquid assets)

We have included a broad Economic Overview in this mid-year edition kindly prepared by Dr Alex Pestana of our valued Asset Management partners, Counterpoint Asset Management. The Counterpoint business continues to grow steadily and we are proud to be associated with this team that brings such vast investment experience and depth to our wealth management offering. These associations and integrations in the wealth management and asset management arenas are becoming more commonplace as the benefits to both parties become more clearly evident. We believe our clients can only benefit from this association.

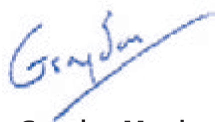
An interesting piece on the ongoing debate around Passive versus Active management, in this case particularly within the SA Equity Market, is provided. This is a guest piece by Brandon Zietsman.

Further to this, we continue to build on our behavioural finance theme, and Joubert Strydom has further commentary provided in a brief insightful note on this issue.

Our business continues to grow from strength to strength. The physical presence and footprint we have in Cape Town and Kwa-Zulu Natal complements our Sandton roots perfectly. These areas are gaining traction and leading to the wonderful procurement of clients over the past while. We truly thank those clients who continue to refer like-minded investors and associates to our doors.

We hope never to let you down.

Regards



Graydon Morris
Founding Director

Investment Strategies of Major Global Market Participants

Most investors know about Yale University and the extraordinary success of its endowment portfolio under the guidance of the redoubtable David Swensen. Indeed, many families have tried to emulate Yale's approach to asset management, for obvious reasons. Yet, those families – and even most institutional investors who have tried to copy Yale – have failed. The reasons for these failures are many, but these are the main stumbling blocks: few investors have the huge asset base Yale boasts (about $20 billion); almost no one was as early into venture capital and buyouts investing as Yale; it's a rare investor who can match the talent and dedication of Yale's in-house investment staff or investment committee.

By contrast, almost no one has heard of the Norway Government Pension Fund (NGPF). Here are a couple of facts about the NGPF.

First, it's now the largest sovereign wealth fund in the world - $612 billion, at recent count. Compare this to the largest US pension fund, CALPERS, which has about $230 billion. Second, its investment track record is quite good, and Edwin Truman recently awarded the NGPF top position on his "scorecard," ahead of 53 other sovereign wealth funds from 37 countries. Finally, and most important, it's only a modest exaggeration to say that the NGPF is the "anti-Yale" in its investment approach.

We're guessing that few of our clients have ever heard of the chief investment officer of this remarkable fund, the "David Swensen" of sovereign wealth funds. His name is Yngve Slyngstad, and he works for (are you sitting down?) a bank , specifically for the Norges Bank, Norway's central bank based in Oslo. One important reason why no one has heard of Mr. Slyngstad is that Norway uses a "team model," rather than the "star" model embodied by David Swensen. This suggests that to the extent the Norway Model may be of interest to family investors, it ought to be a lot easier to imitate than the Yale Model.

The "Yale Model"

When we think of the Yale Model, although it's a bit of a caricature, we think of these characteristics:

- A strong equity orientation, thinking of equity in its broadest sense. Only about 4% of the Yale portfolio is invested in bonds;
- A very large willingness to trade liquidity for return. Including hedge, private equity, and real assets (natural resources and real estate), roughly 82% of Yale's portfolio is illiquid;
- A firm belief in active management. Yale owns almost no index-like investments;
- The "star" model of endowment management: virtually every important decision at the Yale Investments Office is made by David Swensen.

The "Norway Model"

Again, it may be slight exaggeration, but looking at the Norway Model what we see is that it's "virtually the opposite of the Swensen model.

For example:

- Norway relies almost exclusively on publicly-traded securities;
- The proportion of active management in Norway's portfolio is de minimus , because the fund is constrained by a very small tracking error policy;
- Norway owns no private equity, and little hedge;
- While Yale owns almost no fixed income, Norway's strategic benchmark includes a 40% weighting to bonds;
- Until 2008, Norway owned no real estate;
- Norway follows a rigorous socially responsible investment policy that eliminates many securities from its investable universe (and therefore, according to Modern
- Portfolio Theory, Norway's returns should be constrained);
- As noted, Norway follows a team approach in which the staff operates by consensus and the investments are closely supervised by an Advisory Council, a Strategy Council, and even a Council of Ethics.

Similarities to Family Investors

There are characteristics of the Norway Government Pension Fund that would seem to make it simpatico with family and wealthy individual investors:

Remarkable wealth. We'll start with the proposition that Norway is to other countries what wealthy families are to other families – in other words, Norway is a very rich place. Even before oil was discovered in the 1960s, Norway was an affluent society, but today it is often ranked as the wealthiest country in the world on a per capita basis.

Worrisome aspects of wealth. Like wealthy families everywhere, Norway worries about the possible negative consequences of its wealth. Some of these consequences affect only countries, but others will be familiar to families and private HNW investors. For example, if Norway were to spend its oil revenue as it came in, or to spend too much of the NGPF every year, it could reduce the incentive for its citizens to become educated and productive. Similarly, every wealthy family worries about raising entitled, unproductive children content to feed at the family trough.

Sensible spending. Norway has seriously constrained spending from the NGPF to roughly 4% of the fund's value, a sustainable rate for a tax-exempt institution and well below what most American institutions spend. Private charitable foundations in the US, for example, are required by the US Government to spend 5% of their assets every year, and most endowed institutions have spending rules that result in spending between 4.5% and 6.5% per year. Moreover, the spending rate changes depending on how well the Norwegian economy is doing. If things are going well, spending from the NGPF is reduced, while during slow economic periods spending is increased. This policy acts as a break on government spending in Norway.

Stewardship. Norwegians believe strongly in the notion of stewardship. Specifically, they believe that the benefits of the oil boom shouldn't be enjoyed simply by that segment of the population that happens to be alive while the revenue is flowing. Instead, the revenue from oil production should be stewarded so that it can continue to be enjoyed by future generations of Norwegians. Clearly, this parallels exactly the view that well-managed families have of their stewardship obligations.

Governance. The NGPF is well-governed. As noted above, the fund follows a "team" approach, rather than a "star" approach. The fund is managed by Norges Bank Investment Management, reports up to the Norwegian Ministry of Finance, and is advised by a Strategy Council and a Council of Ethics. There are also outside consultants and advisors. Wealthy families, too, struggle with governance, wanting to be both inclusive and effective, two goals that are often in conflict.

Socially responsible investing. Finally, as noted above, Norway believes that its wealth should be invested ethically. As a result, the NGPF is subject to a variety of environmental, social and governance (ESG) considerations that constrain its ability to invest. Ethical investing is also a prominent feature of many family portfolios, and it seems to resonate especially with younger members of wealthy families.

Implications for Family and HNW Investors

Not everything about the NGPF is applicable to or an object lesson for family investors – after all, not that many families or investors are investing nearly $600 billion! But the implications for family investors are nonetheless significant:

NGPF's core beliefs. The Norway fund believes that (a) markets are largely efficient, (b) diversification is an important risk control, (c) the equity risk premium will be the main source of returns, (d) the fund should be managed to a specific benchmark, (e) external managers are important, especially for less liquid market sectors, and should be carefully selected and monitored, and (f) the fund should be managed with reference to socially responsible criteria. Except perhaps for the last of these core beliefs, most families would agree with the NGPF.

Size matters (or maybe not). Most discussions of capital market participants divide investors into institutional players (e.g., pension funds, sovereign wealth funds, large endowed institutions, banks, mutual funds) and retail investors. But wealthy families fall in-between these two extremes, rarely investing as much as the big institutional players but investing much more than a typical retail investor. As a result, some of the advantages of size also accrue to wealthy families, assuming the family is experienced enough and well-organized enough to take advantage of their size. For example, assuming a reasonable level of spending, many wealthy families are deploying vastly more capital than will ever be needed by living generations, and hence they have very long investment time horizons, much like the NGPF. The NGPF is able to take a long view, accepting a certain amount of volatility and illiquidity in exchange for higher expected returns. The specific investment strategies available to large, long-term investors are discussed below.

Is it possible to sustain a long-term view? Many investors – colleges and universities, for example – have investment lifetimes that are, for all practical purposes, infinite: Harvard, William & Mary, St. John's, and Yale are already more than three hundred years old and still going strong. Yet very few of them invest as though this were true. The problem, as the NGPF found out, is that a long-term outlook can become awkwardly short-term when the markets crash. In 2008, for example, the NGPF, after many years of excellent performance, experienced truly poor results. The overall fund was down -23% (nearly 400 basis points below its benchmark) and the equity portion of the fund lost 40% (modestly below its benchmark). The bond portion of the fund lost only -0.53%, but this was a whopping 660 basis points below the benchmark. Howls went up across the land (the land being Norway) and Parliament was in an uproar. Expert advice was solicited and numerous analyses of the fund's failures were published. There was a real danger that the fund would pull in its horns and revert to a cautious, lowreturning strategy that wouldn't put it in the headlights again. (That did not happen, and fortunately, as is so often the case, Norway's portfolio has recovered strongly.)

Families, of course, face the same problem. When times are good, portfolio risk rises and everyone is happy. But when the market turns down and the risk dog bites, the temptation to flee the field of battle can be overwhelming. In the case of the NGPF, the consensus of opinion was that the fund had failed to alert the public and policymakers to the possible risks inherent in the portfolio, resulting in a very negative surprise. The implications of this episode are clear for families: make sure the appropriate family members are fully educated about the risks and rewards of the investment strategy, well in advance of those risks coming home to roost.

Diversification. Diversification is a core value at NGPF, but it's a value that has been slow in coming and which still has a ways to go. Emerging markets equities weren't added to the NGPF portfolio until 2000, corporate bonds until 2002, inflation-linked bonds until 2005, small caps until 2007 and real estate until 2008. There is still no exposure to private equity, although this issue is under discussion. Fortunately for the NGPF, the missing asset classes didn't harm performance until – well, until they did. Just before the market collapse in 2008, the NGPF, riding the wave of enthusiasm engendered by years of good results, raised its equity allocation from **40% to 60%** of the portfolio. Obviously, this was **bad timing in the extreme, and it illustrates the dangers of attempting to time the markets.**

Norway (family and private investors take note) would have been better served to make such a major change in portfolio allocations over an extended period of time. Among the lessons for families are these. First, it's better to build a diversified portfolio from the beginning. Second, if you are going to make major portfolio changes, either make them slowly over time or make them in a counter-cyclical way. The best time for the NGPF to have increased its equity allocation would have been 2009, not 2007. Avoiding inadvertent indexation. When you are investing almost $600 billion, one of the great dangers is that you will end up owning everything in the market. The NGPF, for example, owns about 1% of every listed company in the world. For them, indexing is an intentional, probably unavoidable, strategy. While families aren't anywhere near as large, many investors portfolios are so overly diversified and include so many managers that, when you really drill down, what you find is a big and expensive index fund. If a family investor really has so little conviction in its active managers that it's unwilling to concentrate among a few of them, it would be a lot cheaper just to buy a real
index fund.

Goals-based investing. Maybe the most important aspect of the NGPF is how rigorously it has been designed for the goals it was established to meet. The fund wasn't designed to outperform the Yales of the world, nor was it designed to avoid market risk and simply preserve capital. As noted above, the purpose of the fund was to exercise stewardship over a non-renewable asset (oil revenues) and to avoid the Dutch disease. Its mandate is to maximize purchasing power (on an international basis) subject to risk levels that are acceptable to the fund's managers and, most important of all, to the people of Norway . The fund doesn't much care what returns other sovereign wealth funds are achieving, since those funds presumably have different goals and risk tolerances. Since inception in 1998, the NGPF has returned just over 5% per annum with a Standard Deviation of 7.67%, has outperformed its benchmark and has beaten inflation by nearly 3% per year. The question of whether this is good or bad versus other funds isn't important.

It has been highlighted by our office many times before, but our investors time horizons truly are long term in nature, and we have shared the above with you that you may consider some of the implications of these strategies in your own financial lives.

Economic Overview
Dr Alex Pestana

Dr Alex Pestana – Portfolio Manager *B.Sc. (Hons), B. Soc.Sci., M. Phil and PhD*

After completing his Ph.D., Alex did his postdoctoral studies in Paris with Nobel-prize winner Sir Derek Barton. Alex started his investment career at Capital Alliance Asset Management as a quantitative analyst and economist. He joined Fleming Martin Asset Management in 1997 as head of Fixed Interest, where he took the bond fund to first place in the bond fund unit trust category. Alex joined Sanlam Investment Management's fixed interest team in 1999, and after three years joined the SIM strategy team. He received the coveted SIM CEO award for his contribution to the Sanlam group in 2002. He was appointed chief investment strategist in 2004, a position he held until 2007 when he joined Steve Mills in the Absolute Return boutique, where they jointly managed a range of multi asset class funds. Alex joins Counterpoint Asset Management in the role of portfolio manager responsible for fixed interest.

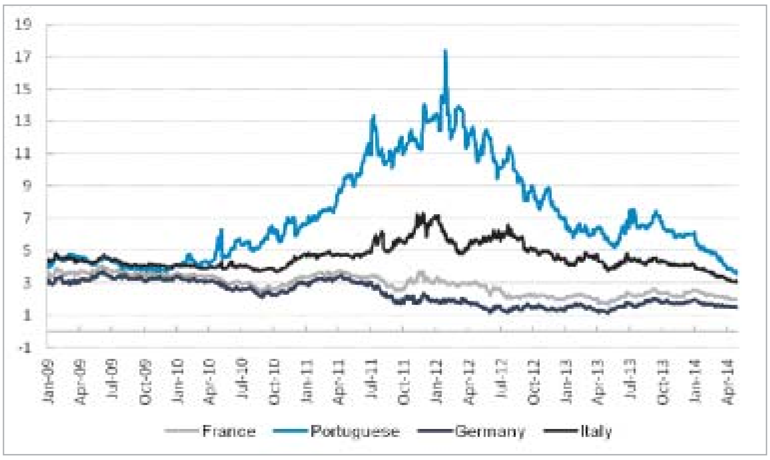
In his spare time, Alex loves to swim and play squash. He enjoys language and speaks five languages and drinking wine. He re-started playing the piano two years ago and has as his goal the playing of a few Bach pieces in counterpoint!

Disappointing economic GDP numbers from the US, soft data from the global economy in general and the expectation of a stimulus package from the ECB kept global equities markets buoyed during May, giving lie to the old adage of "Sell in May and Go Away". Many equity markets continued to grind out new highs during the month, including the S&P500 (2.3% up for the month) the German DAX30 (1.9%) and our very own JSE All Share index (1.6%). The MSCI World Free index rose 2.1% during the month, while the MSCI emerging markets index returned 3.5% in USD in May. Persistent low yields in developed market bonds ensured that the Barclays Global Aggregate bond index returned 0.59% in USD over the month.

Most asset classes in South Africa had a good month. The JSE All Bond index returned 1.16%, the Barclays/ABSA Govt inflation-linked bonds index 1.91%, whereas the JSE Preference share index (-0.39%) and the SA listed property index (-1.26%) both underperformed cash (0.48%) over the month. All in all, it seems as though the liquidity fuelled rise in the markets is still on, not least into the local bond market as the global search for yield seriously resumed in May.

Central bank fuelled liquidity continues to be a powerful driving force in the world. Financial markets have responded very well to it. Indeed, the sinking bond yields in peripheral Europe of late have caused commentators to speculate that the market is front-running the expected ECB's impending stimulus package.

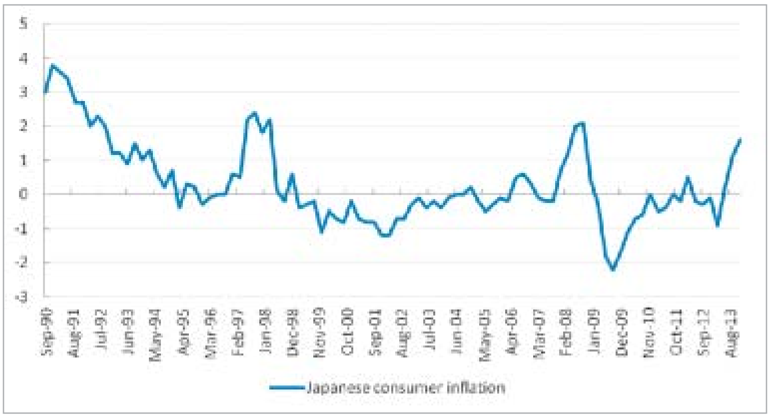
Chart 1: Sinking European Government bonds yields (10y) – market front-running the ECB?



Source: Bloomberg

On the level of the economy the huge monetary stimulus certainly appears to have worked well in the US and the UK, however in Europe the situation is less clear, with parts of the region appearing to be faltering, and in Japan a few high inflation prints seem to be causing a rethink of the regions continued massive stimulus.

Chart 2: Japanese consumer price index - reason to rethink BOJ stimulus plan?



Source: Bloomberg

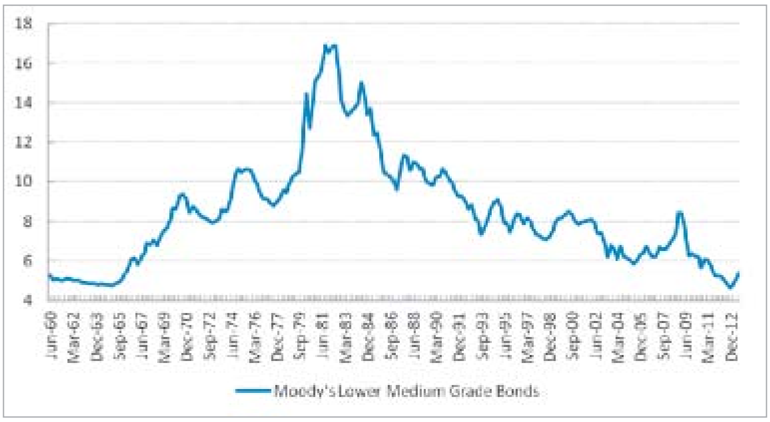
In as far as equity markets correctly anticipate the earnings that should follow from the growth generated by such stimulus, they are correct to discount those earnings upfront and rise ahead of the news. However, it is not clear that those earnings will be delivered, or for that matter that growth will e.g. emerge in Europe.

Central Bankers – a Different Breed, but issuing warnings…

Central bankers as a profession, given the import of their actions, are by definition a dour, serious, uncharismatic lot. It's as though people undergo a personality change when becoming central bankers, or at best take on a split personality. They have clear briefs and goals which they have to follow resolutely, with conviction, within their stipulated policy framework. Their goal usually comprises a combination of a steadily growing economy with full employment and low inflation. Central bankers tend to focus on economic fundamentals in their communication and speeches; it is rare indeed for a central banker to issue pronouncements on markets, which in a sense are derivatives of the performance of the macro- and political economy.

Against this background it is thus noteworthy that of late, various central bankers, especially Fed officials, have come out of their shadows to pronounce on markets. Most explicit was Dallas Fed President Richard Fisher in a speech on the 9th April 2014. *"Alongside these signs of rebound (in the economy) have been some developments that give rise to caution. […]..the market capitalization of the U.S. stock market as a percentage of the country's economic output has more than doubled to 145 percent—the highest reading since the record was set in March 2000 […] Junk-bond yields are nearing record lows… […] Covenant-lite lending is becoming more widespread. In my Federal Reserve District, 96 percent of which is the booming economy of Texas, bankers are reporting that money center banks are lending on terms that are increasingly imprudent."*

Chart 3: Moody's BAA grade bonds –yields towards new lows again?



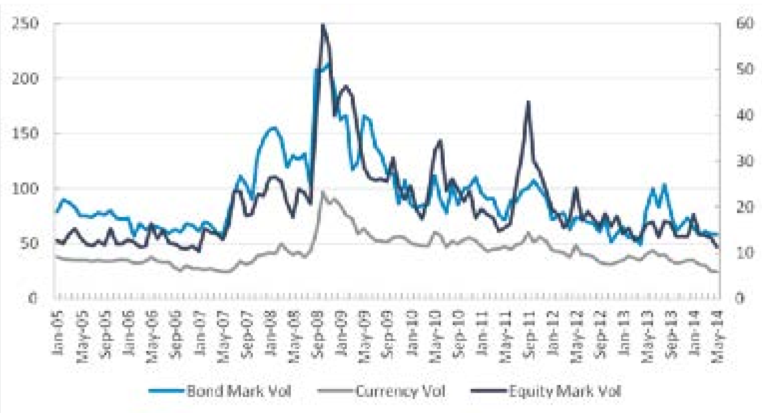
Source : Bloomberg

Fisher goes on to reveal the two hats he wears: *"The former funds manager in me sees these as yellow lights. The central banker in me is reminded of the mandate to safeguard financial stability. As I said recently in a speech in Mexico, we must watch these developments carefully lest we become responsible for raising the ghost of irrational exuberance."*

Here we have clear warning and concern from an FOMC voting member as to his perceived overvaluation of markets. Governor Fisher is not alone to warn. On the 19th May Philadelphia Fed President Charles Plosser warned that central bankers have become too "highly interventionist in their efforts to manipulate asset prices and financial markets in general as they attempt to fine-tune economic outcomes. While the motivations may be noble, we have created an environment in which "it is all about the Fed". Market participants focus entirely too much on how the central bank may tweak its policy, and central bankers have become too sensitive and desirous of managing prices in the financial world... I do not see this as a healthy symbiotic relationship for the long term." Plosser is warning against the market ignoring fundamentals and overly-relying on continued central bank liquidity – this is the danger.

Bundesbank board member Andreas Dombret warned in an interview of the 20th May that "market calm hides risks amid search for yield". On the same day BoE deputy governor Charlie Bean said that low levels of volatility in financial markets are "eerily reminiscent" of the run-up to the financial crisis even as central banks face the challenge of unwinding their huge stimulus programs.

Chart 4: Currency, Bond and Equity market volatility very low – complacency?



Source : Bloomberg

BOE governor Carney said in an interview that *"When we look at domestic risk, the biggest risk to financial stability and therefore to the durability of the expansion, those risks centre in the housing market and that's why we are focused on that."*

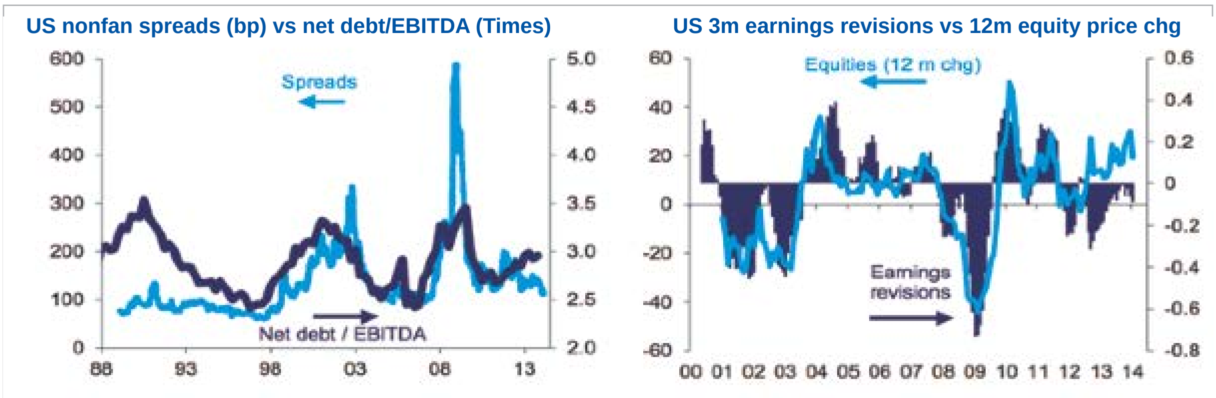
Chart 5: London House Prices – rising too strongly?

Source : Bloomberg

Fed governor Tarullo warned on the 25th February this year: *"Still, there are areas where investors appear to have been very sanguine regarding certain types of exposure and modest in their demands for compensation to assume such risk. [There has been] greater investor appetite for risky corporate credits, while underwriting standards have deteriorated, raising the possibility of large losses going forward."* Even Fed Chairperson Janet Yellen commented that small-cap stocks were showing pockets of possible overvaluation in a comment after a recent speech.

It is almost as though central bankers have come to face the consequences of their policies and are recoiling from the inevitable situation they have created, human nature being what it is. These speeches are gallant, well intended warnings – perhaps even mild attempts at moral suasion. Central bankers want to pare market participants back from the pain of the boom-bust scenario that inheres in excessive reactionary zeal to their abundant provision of liquidity. But we all know it never works as smoothly as that. Given the behavioural forces operating in markets, all it takes is a fringe of market participants to game the liquidity taps and the risk-taking race is on. Nonetheless, warnings from outside central bank circles abound. Here are two charts by Matt King illustrating the decoupling of two markets from their fundamental drivers. This is where the potential for loss lies.

Chart 6: Spreads no longer following leverage, equity markets running ahead of earnings revisions

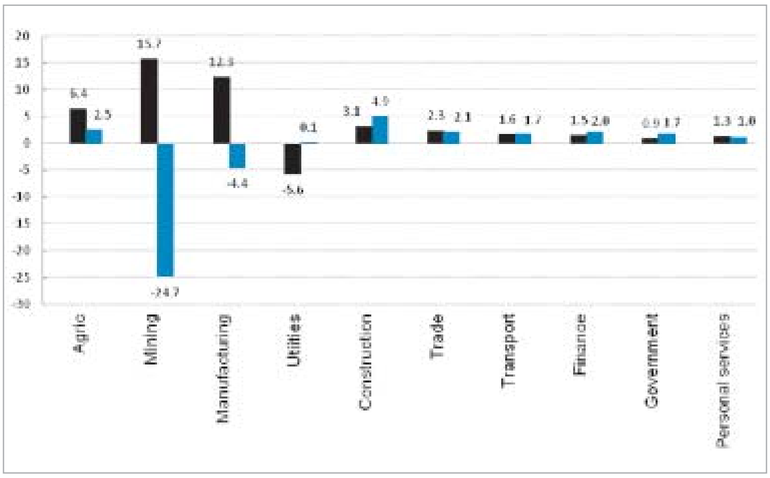


Source : Citi Research, www.businessinsider.com/matt-king-charts-2014-4.

South Africa – Slipping, Slipping

News coming out of South Africa during the month of May has not inspired confidence. Q1 2014 GDP slumped to 1.6%y/y, -0.6% q/q. This was the economy's first contraction since Q2 2009. Fractious labour remains a problem, the platinum belt strike is yet to be resolved. The extent to which the strike affected mining is clear: Q/Q mining growth contracted by 24.7% after growing 15.7% in Q4 2013, which in effect subtracted 1.3% from headline Q/Q GDP. To add fuel to the situation, the National Union of Metalworkers of South Africa (NUMSA) has just announced that it is considering a nationwide strike if its current talks with employers over wage increases fail. At the last MPC meeting, the SARB revised down its GDP forecast for the local economy from 2.6% to 2.1% for 2014. Economists we consult fear that the SARB could be well behind the curve, with economic growth probably struggling to eke out a performance in the 1.5% range.

Chart 7: Mining a huge drag on South Africa 1st Quarter 2014 GDP



Source : Statistics South Africa

In addition, the announcement of the new cabinet was not met with enthusiasm by political analysts. The cabinet has been once again expanded to comprise a total of 35 ministerial portfolios. Apart from the expense, how effective can a cabinet meeting be with that many people? In particular the new finance minister, Nhlanhla Nene, competent though he might be, is considered not to have the gravitas to stand up to other ministries in the fight to keep spending in check. Worries are also being voiced that Tina Joemat-Peterson, who was ineffectual and controversial minister of agriculture, is to head the crucial Energy ministry.

The trade deficit, after showing promises of narrowing during the first three months of the year, suddenly widened in April to ZAR -13bn. Analysts had been expecting a deficit of ZAR -11bn. This could give rise to renewed widening of the current account deficit, which will certainly put pressure on the rand. Further weak data included a really bad Kasigo PMI index reading for May, at 44.3 well below the market's expectation of 47.8. The NAAMSA Total Vehicle Sales index was down 9.2% year on year… All in all, a rather dreary performance from the local economy.
All of the above could result in the downgrading of South Africa's credit rating during June. The ZAR, (and bond yields to a lesser extent - these have been anchored by international bond yields), has once again resumed its weakening trend after reaching a high of 10.27/USD on the 13th May. We have long argued that the ZAR, despite being undervalued, will remain under pressure given the weak fundamentals which appear to be deteriorating even further as we write. It doesn't make for a confident picture over the medium term.

Index Funds: How Strong is the Case in South Africa

Guest Article by Brandon Zietsman

In this article we examine the argument for passive versus active investment management, the case for indexation as a suitable vehicle for capturing passive returns, and the evidence that such strategies have delivered what they claim to. The case for passive investing relies largely on the assertion that active management, on average, does not deliver index-beating returns . This is indisputable, but we need to probe further.

In our investment world, a high conviction 50% allocation to resource stocks means that you are fully on top of the of the European debt crisis, the demand for Chinese manufactured goods and Chinese infrastructure spend; geopolitical events in the Middle East, just about everything that drives our currency (deficits, inflation, and interest rates), domestic labour issues and the likely direction of government policy. Then to top it all, even if you get all of this right, you have to figure out how much of this is factored into prices already. In the face of such conviction, we could be forgiven for assuming that we are dealing with ego, ignorance or both.

Let's take the edge cases: it's (a) impossible to reliably add value through active management and (b) good managers will always produce superior returns. Both are statistically improbable. The argument that markets are NOT informationally efficient is pretty strong, in which case skilful managers (which means way better than the average) should be able to produce superior returns. Score one for active management?

BUT, how reliably can we identify these managers? As it happens, it's very, very hard to use historical data to prove anything. These mythical manager figures DO exist out there, but how will we recognise them when we see them? Disappointingly, the most sophisticated of quantitative models yield very little predictive power, although they help us in many other ways. Score one for passive?

Ignoring for now the unresolved arguments for active versus passive, let's look at market cap-weighted indexation as a passive strategy. There are some very theoretical and some very practical reasons for using indices as a passive strategy. So far as the former goes, magical qualities ascribed to the "market" portfolio in Modern Portfolio Theory can be chucked out, although debunking this would take a whole separate article. So far as the practical reasons go:

- Indices are in the public domain
- They are (mostly) investable
- The holdings are transparent
- Performance is verifiable
- Relative performance is thus measureable

This is all good in that it is easier to hold passive managers to account. But what else should we be considering?

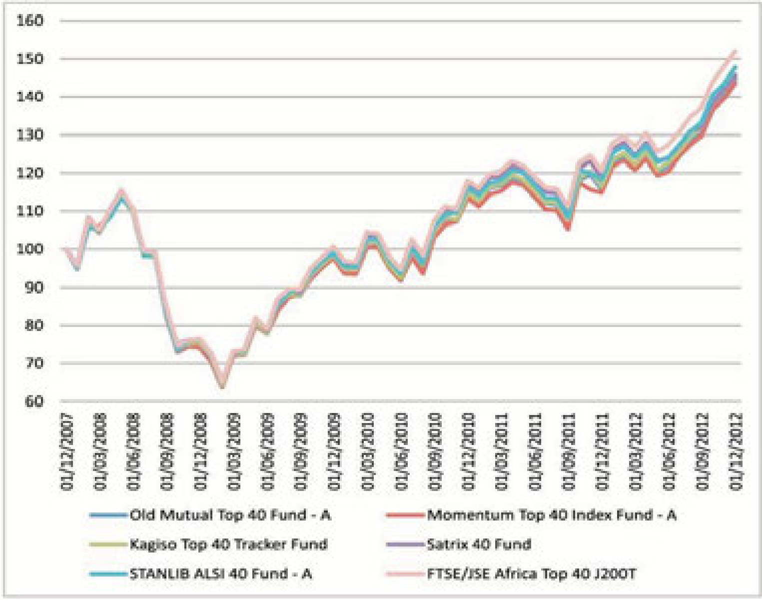
- There is no real significance to capitalisation-weighted benchmarks from a risk/reward perspective;
- Market cap-weighted indices suffer performance impairment from mean-reversion factors;
- Local indices may suffer distortions, such as long-term average resource weights in SA, or significant exposures to a small number of individual stocks;
- Headline indices may carry risk that is still diversifiable;
- Trading costs are incurred to reduce index tracking error; tracking error is a relative-risk concept that has no connection to "real" risk.

These last points, the "negatives", weigh more heavily on my views than the arguments for or against passive. Ignoring the transparency benefits of headline indices, it is a relatively simple task to construct a benchmark independent of market cap that is based on fundamental risk concepts. It is also relatively easy to capture the BENEFITS of mean-reversion by rebalancing to a benchmark; that is, selling when stocks rise and buying them when they fall. Equally, if you are not fanatical about tracking error you can save on trading costs.

In fact, this is exactly what indices like RAFI seek to do. You would have to twist my arm very hard to convince me that their four fundamental factors have any real predictive power. You can persuade me, however, that their using weighting factors independent of price (and, hence, market cap) sidestep the negatives I have highlighted whilst capturing many of the positives above.

So, on balance, you can argue that market cap-weighted indexation is a sub-optimal way of capturing passive returns. Notwithstanding, how have they actually performed? I confine my limited analysis to the retail market and, hence, unit trusts funds. The reason simply being that for most IFA's, instruments such as ETF's are simply not available on most LISPs.

There are lots of funds tracking lots of indices; I have simply chosen funds that track the Top 40. It is a clean, full-replication index and it should technically be easier for managers to mimic performance. The universe of funds that track this index is small, so we can impartially include all of them.



The chart shows that all these funds underperform the index to a greater or lesser degree, which is what we expect; index performance less fees. But do fees account for all of it (using the same time period)?

	FTSE/JSE Africa Top 40 J200T	Old Mutual Top 40 Fund - A	Momentum Top 40 Index Fund - A	Kagiso Top 40 Tracker Fund	Satrix 40 Fund	STANLIB ALSI 40 Fund - A
Total return (TR)	**52,10%**	44,73%	43,67%	45,94%	45,53%	47,83%
Total underperformance	**0,00%**	-7,37%	-8,43%	-6,16%	-6,56%	-4,27%
Annualised return (AR)	**8,75%**	7,67%	7,52%	7,85%	7,79%	8,13%
Gross underperformance		-1,07%	-1,23%	-0,90%	-0,96%	-0,62%
Total Expense Ratio0		,72%	0,60%	0,70%	0,46%	0,48%
Residual underperformance		-0,35%	-0,63%	-0,20%	-0,50%	-0,14%

On average this underperformance adds up to about 1% per annum. How well might our investor have done in the average general equity fund?

From an "apples with apples" perspective, we need to compare the general equity sector with the full-weighted All Share as this better reflects the opportunity set. Over the five years in question, this sets a more demanding hurdle.

	FTSE/JSE Africa Top 40 J200T	Top 40 Index Fund Average	FTSE/JSE Africa All Share J203T	SA - Equity - General
Total return (TR)	52,11%	45,50%	56,79%	45,57%
Annualised return (AR)	8,75%	7,79%	9,41%	7,80%
Annualised difference		-0,96%		-1,61%

It seems that Index funds do a bit worse than we might expect, but the argument that they do better than the average manager seems well-supported (relative to benchmark that is – the Top 40 could well outperform the All Share over the next 5 years). Is the average manager the right yardstick? I mean, with respect, there is a load of junk out there!

I did a highly imprecise, scientifically unsound experiment that will never stand up to half-decent scrutiny. I just picked 10 funds that everyone knows and knew well five years ago; there have been no collapses of big names during this period (survivorship bias). They are simply the usual suspects that attract advisors at road shows. Some of the funds were superstars five years ago and have declined; whilst others are on the rise (incidentally, I would rank one of the worst performers here in the top two funds to look out for going forward and one of the best performers absolutely stone last!) So how well did they do?

FTSE/JSE Africa All Share J203T	56,79%
Absa General Fund - R	57,64%
Allan Gray Equity Fund	57,75%
Coronation Equity Fund - A	72,65%
Foord Equity Fund	83,47%
Investec Equity Fund - A	37,88%
Momentum Equity Fund - A	45,91%
Nedgroup Investments Rainmaker Fund - A1	51,35%
Old Mutual Growth Fund - A	38,56%
SIM General Equity Fund - A	58,42%
STANLIB Equity Fund - A	28,23%
Prudential Equity Fund	65,77%
SA General Equity Average	45,57%
Average of my selection	54,19%
My selection, 0.25% fee discount	56,12%

Bad science aside, the results are intriguing. Our "known" brands did about 10% better than the much-illustrated "average" fund. In fact, when you deduct 25 basis points from full retail fees (which is what you actually experience on most platforms) these active funds basically delivered the same return as the All Share after fees. However, there is absolutely no way that I'd put money with more than half the names listed. If I could more or less pick the right five (and the real universe of choice is much bigger), the potential for getting it right is real, but you need to put the same time into manager evaluations that they are putting into analysing shares!

Where does that leave us? For what it's worth, here are my subjective conclusions:

- If you don't feel that you are in a position to really pick managers (and humility here is good), you could do a lot worse than passive;
- If you are going to go a passive route, wholly or in part, you might want to consider options such as RAFI which avoid a number of the pitfalls;
- If you are going to pick active managers, beware of historical performance data and reputations! Spend more time on their approach, processes, insights and credibility;
- If you don't have access to these managers or the analysis tools, it "seems" that the better known managers are a safer bet (the paradox is that I believe the gems are often the less well-known).

Conclusions

Let me now climb off the fence and show some conviction! In the SA market, I declare my preference for an active style at a securities level – different arguments affect asset allocation. The good guys do exist out there, but it's pretty onerous finding them. My preference (if anyone cares!) is for managers who can tell me in detail about the management team in a firm, its competitive challenges, supply chain management, tax bombs that could hit, risks in the operational environment. I prefer managers that talk about businesses, not shares. I really don't want to see another graph of historic PEs, standard deviation bands and intrinsic value. I want to know how they derive their insights and then, critically, what they do with them. A good manager should be able to clearly articulate their approach; it's your job to decide whether it's credible, sustainable and verifiable! Whatever you do, if you are going to pick cowboys, blend them with something else that is sensible (a passive core, perhaps?)

A bit of "marketing history"...

...and why passive has gained so little retail traction: The original forays by passive product-providers into the consumer investor market targeted the end-investor and openly promoted disintermediation (investment banks, as it happens, often place a low store of value on the role of advisors). This wasn't a bad strategy in that it's easy to show how fees can erode value. It was a bit disingenuous though and didn't succeed anywhere as well as hoped. The savvier guys, and then the rest, started courting advisors. The argument still lay in the superiority of passive over active.

The next stumbling block was a head-on encounter with investors' predilection with active management, with their attachment to the doyens of the fund management industry whose every word was hungrily consumed in Saturday papers. No-one had really figured out that bespectacled propeller-heads buried in their spread sheets in the bowels of investment banks were going to face some stiff opposition! Again, when the savvier providers got this, they stopped bashing active management and endeavoured to show how well passive and active can work together.

Behavioural Economics: Winning this battle is critical to long term success

Joubert Strydom, Director

It's a real challenge protecting clients and ourselves from natural "thinking mistakes".

Behavioural economics has drawn our attention to the fact that the central assumption of traditional economics – that we behave rationally, often fails to hold. The truth is that we are 'hard wired' by evolution to behave irrationally in many situations. Left unchecked, this tendency can lead to wrong decisions at crucial times. Perhaps more than any other financial planning area, investing mistakes can have the most devastating consequences for a client's wealth. Here are some of the traps and ideas about how we can steer clear of them.

Anchoring Information

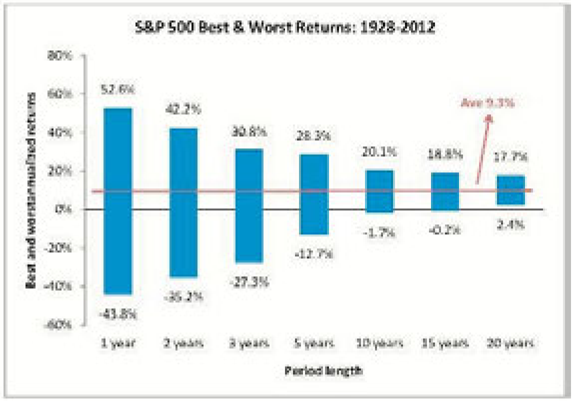
Human beings are naturally inclined to attach too much significance to irrelevant starting points. For example if an investment a client purchased for R20 has fallen to R5 he or she tends to be reluctant to sell – even if the signs are that it will head lower yet.

When clients refer to past values we need to emphasize (again and again) good investment decisions are always about present and likely future values and cash flows, which have very little to do with what may have happened in the past.

Loss Aversion and Risk Taking

People hold on to investment gains and are quite disinclined to sell losers, hoping to recover (and surpass) their original position. So they tend to sell winners, and hold onto losers.

We can counter this by adopting disciplined and forward-looking asset allocation and security selection strategies. This helps force our thinking towards rational and away from emotional frameworks.



Over-Optimism

Evidence, like that in the above table, shows market variability and how long it can take to achieve positive returns after experiencing periods with significant volatility and negative returns. And yet we human beings – including experienced financial advisers – have a stubborn tendency to think we'll do better than average.

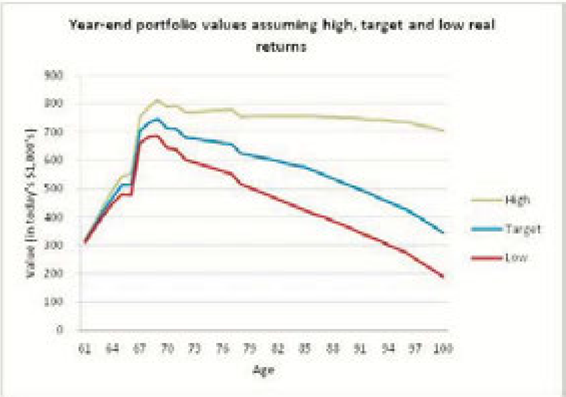
To address this, we need to be sure we look at this sort of data – and show it to clients – frequently. We use risk profiling discussions to explain the implications of seeking higher returns from higher risk strategies, and repeat this process at ongoing reviews.

Investment risk profiling firm has produced sobering research showing that as risk profile rises the probability of achieving expected returns falls.

Another way to counter over-optimism is to focus on what will happen if actual returns are lower than expected, or if the sequence of actual returns works against the investor, lower than average returns early on negatively impact long-term outcomes, even if overall average returns are as expected.

To take account of risks like this we need to focus projections on what would happen if clients live longer than their statistical 'life expectancy', and if returns are at the low end rather than the middle of the ranges suggested by research. So rather than focusing on high-

end returns, as shown on the graph in the Graphs below, we should consider using graphs without the green line (high-end) in them when explaining potential outcomes to a client.



Framing

People tend to be heavily influenced by the way information is presented. As we well know from our continuous interaction with the asset management industry, fund managers often take advantage of our 'willing blind spots': focusing on positive results and reasons things could turn out well.

We address this by placing less emphasis on the sometimes overly-positive marketing material produced by fund managers, and doing our best to present bad news as well as good news.

Overweighting the Recent Past

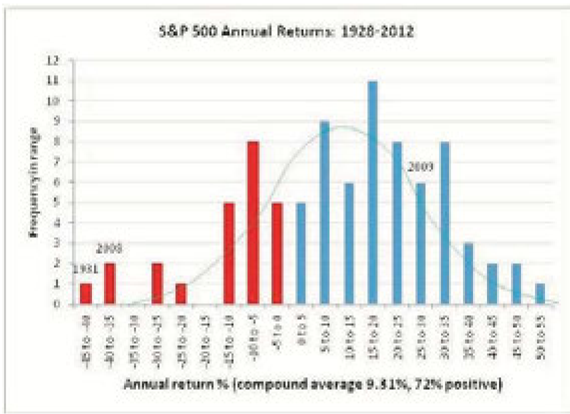
People tend to believe recent patterns will continue. After one good period we expect another. After a bad period we expect worse. In reality – all other things being equal – the higher the return over one period, the less likely you are to get a high return the following period. We continuously remind ourselves and our clients that a good investment approach must be disciplined and may be counter-intuitive at times: following the crowd, especially when our old enemies Fear and Greed are out in front, usually means getting carried away.

Comfort from Statistics

Finally, people are also prone to taking too much comfort from statistics. Figure 3 shows the annual returns from the S&P 500 over the past 85 years to the end of 2012. The average annual return over this period was 11.3% per annum, with positive returns (the blue bars) in 72% of those years. But this is the simple or 'arithmetic' average (the result founded by adding all the annual returns and dividing by 85). However, the results actually achieved by long-term investors are not simple averages but compound (or 'geometrical') averages. Over this same period the compound average return from the S&P 500 was 9.3% per annum. Still pretty comforting, on the face of it. Especially when compared to 3.6% per annum – the result for an investor staying in 3 month Treasury Bills over the same 85 years. The difference of 5.7% per annum is the S&P 500 'risk premium', the 'reward' for the extra risk taken by those who invest in shares.

Of course this comparison ignores some other important components: tax, costs, and inflation. Tax has more impact on the returns from Treasury Bills than on share market returns, but costs are higher for those investing in the share market. So let's assume overall difference – the 'risk premium' – is not much changed by tax and costs. But the impact of inflation is vital. Over the past 85 years US inflation averaged 3.1% per annum. So inflation reduced the spending power of invested capital by almost as much as interest added each year for an investor in Treasury Bills – and tax would have meant that real returns were negative. The share market alternative looks pretty good by comparison.

But there are other problems with the comforting picture painted above. Most importantly investment returns DON'T actually fit the 'bell shaped' curve of a statistical 'normal distribution'. You can see this by comparing the green bell shape in Figure 3 with the bars representing the actual distribution. Of particular concern is the fact that where the actual results differ most from the 'normal' curve is to the extreme left – the lowest returns are a lot lower than simple statistics would lead you to expect. This kind of pattern is typical of long-term investment returns, which can be prone to out-of-the-blue 'black swan' events leading to negative results.



The sobering message for share market investors wanting an increased risk buffer, is that they need to factor in extra downside risk – something few investors or advisers seem to do. Once again disciplined processes and conservative assumptions seem to be the key.

Conclusion

Wealth Managers need to watch the natural biases to which we and our clients are all susceptible. As in the biblical story, most of us find it easier to see the speck in another person's eye than the log in our own!

We have to become good at throwing the rational wet blanket over our natural over-optimism.

We take on tremendous responsibilities for preserving and growing our clients' wealth. The crucial first requirement for us here is to help you avoid wealth destroying mistakes. Sticking to disciplined asset allocation and security selection processes, adopting conservative assumptions, and developing systems and processes that force us to consider options that don't come naturally are important ways to ensure we really add the value our clients expect.

Half Year

Currencies						
Description	**Classification**	**Currency**	**Exchange Rate**	**Week**	**Month**	**Year-to-Date to end June 2014**
ZAR/USD	ZAR/USD	ZAR	10.72	-0.42%	-1.42%	-2.14%
ZAR/Pound	ZAR/GBP	ZAR	18.25	-0.77%	-2.94%	-4.80%
ZAR/Euro	ZAR/EUR	ZAR	14.56	-0.73%	-0.99%	-0.91%
Dollar/Euro	USD/EUR	USD	1.36	0.29%	-0.41%	-1.19%
Yen/Dollar	YEN/USD	YEN	102.07	-0.03%	-0.29%	3.17%

Commodities						
Description	**Classification**	**Currency**	**Commodity Price**	**Week**	**Month**	**Year-to-Date**
Gold	Gold Spot	USD	1318	3.25%	5.50%	9.72%
Brent Crude Oil	ICE Brent Futures	USD	115	2.18%	5.73%	5.94%
Platinum	Platinum Spot	USD	1461	1.86%	0.61%	6.55%
Copper	LME 3 month Copper	USD	6725	1.05%	-1.75%	-8.63%
Silver	Silver Spot	USD	21	6.37%	11.30%	7.57%

Global Equity Indexes (Total Return)						
Description	**Index**	**Currency**	**Index Value**	**Week**	**Month**	**Year-to-Date**
Global	MSCI World*	USD	1,748	1.25%	2.07%	6.82%
United States	S&P 500	USD	3,549	1.22%	1.99%	7.05%
Europe	Euro Stoxx 50	USD	6,116	0.92%	2.22%	8.72%
Britain	FTSE 100	USD	5,081	0.86%	0.08%	3.26%
Germany	DAX	USD	10,016	1.04%	0.73%	4.85%
Japan	Nikkei 225	USD	22,387	1.67%	4.90%	-5.03%
Emerging Markets	MSCI Emerging Markets*	USD	1,050	0.23%	2.52%	5.95%

Half Year

South African Equity Indexes						
Description	**Index**	**Currency**	**Index Value**	**Week**	**Month**	**Year-to-Date**
All Share	JSE All Share	ZAR	"6,565"	0.98%	3.36%	12.41%
Top 40	JSE Top 40	ZAR	"5,926"	1.03%	3.67%	13.09%
Shareholder Weighted	JSE SWIX	ZAR	"14,739"	0.76%	3.88%	13.57%
Small Companies	JSE Small Cap*	ZAR	"54,296"	0.69%	-0.19%	10.83%
Resources	JSE Resource 20	ZAR	"3,225"	2.17%	0.73%	4.85%
Industrials	JSE Industrial 25	ZAR	"10,592"	0.69%	3.37%	11.15%
Financials	JSE Financial 15	ZAR	"6,791"	0.33%	2.69%	16.41%
SA Listed Property	JSE Listed Property	ZAR	"1,472"	1.79%	2.55%	5.49%
Preference Shares	JSE Pref Shares	ZAR	"1,681"	-0.31%	-0.35%	1.12%

South African Fixed Interest						
Description	**Index**	**Currency**	**Index Value**	**Week**	**Month**	**Year-to-Date**
All Bond	BESA ALBI Index	ZAR	450	0.65%	0.69%	3.08%
Inflation Linked Bonds	BESA CILI	ZAR	215	0.31%	0.94%	6.68%
Cash	STEFI Composite*	ZAR	302	0.11%	33.00%	0.11%

*Price Index (not Total Return)

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