THE STERLING TIMES 4

JUNE 2012

STERLING
PRIVATE WEALTH

Inside this issue

The Half-Way Mark

Graydon Morris

Dear valued clients and friends

As we near the end of the 2nd quarter, it is worth reflecting on a year-to-date of two halves.

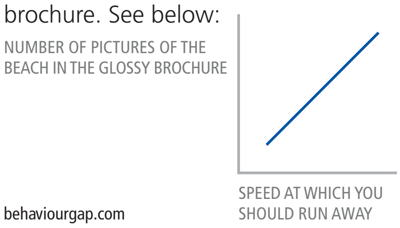
We started the year with global markets powering ahead, a strong Rand, and the risk button well and truly “on”. What a change the period post 31 March 2012 brought with it. To quote Mohamed El-Erian, co-CIO of PIMCO, it became a period of ensuring a “return of capital, and not a return on capital”.

As has been highlighted previously in our communication to our clients, 1 July marks our ten year anniversary of the commencement of the exciting journey that has been the development and growth of Sterling Private Wealth. For this journey to date, we thank our clients, business partners and loyal staff for a wonderful journey. We thank you all so very much.

At this point it is well worth focussing on what our business, which we hold so dear, stands for. Our point of departure has not changed. At all times, we strive to provide:

- A return to really long term advisory relationships;
- Good old fashioned service, with new age thinking;
- A simple, understandable, repeatable and well considered process, delivered through uncomplicated and transparent structures;
- Client investment flexibility;
- All matched by personalised service.

I’m sure you’ve all noticed the glossy brochures put out by the traditional financial services industry that inevitably have pictures of a retired couple from the back holding hands walking across the beach. If it’s not a couple, then it’s pictures of a family on the beach or of a sailboat near the beach. We’ve adopted a theory that the speed you should run away from the potential relationship is directly correlated to the number of beach pictures in the glossy brochure. See below:



behaviourgap.com

The above is even more critical as our client base gradually ages.

The world is getting older. As an indicator of this, I include below an excerpt of a recent Mark Barnes Business Day column:

“Many of us are going to live too long. Time will be in abundance — we’ll have more of it than we’ll know what to do with, and certainly more than we can afford.

There are plenty of theories on longevity, but in essence, I believe, your baseline longevity (how long you’ll live without interference either way) is determined by genetics.

Of course you can make a difference. "Bacon and Cigarettes for Breakfast" Bill will probably die before his sister, "Muesli and Carrot Juice" Clara. Although it was once famously said that if you don’t smoke, drink or have sex, you may not actually live any longer, but it will certainly seem that way.

Life expectancy varies significantly around the world, from 83,5 years in Andorra to 36,5 years in Mozambique (South Africa isn’t great, coming in below 50).

There are many other comparison metrics, and much is lost in these averages. Rich people live longer, educated people live longer, women live longer … retired people are alive for longer.

So, if you’re a retired, female, Japanese mathematics professor living off a good pension in Singapore (who still gets it occasionally), and if your grandfather still wants to swim the channel but just can’t remember where it is, then you are probably going to live forever.

That is a major problem. There are going to be lots of you.

The group of over-65s is growing faster than the group of under-fives. In 1950, there were about 200-million more under-fives than over-65s. By 2010, that difference had dropped to 130-million but the youngsters still had it. By 2050, there will be more than 1-billion more over-65s than under-fives. The crossover point is around 2016, before the Brazil Olympics.

French President Francois Hollande has just passed legislation to reduce the retirement age in France from 62 to 60. How does he hope to finance that?

Of course life expectancy improves with age. In those days, if you made it to 15, you were likely to make it to 30 and so on. As recently as 100 years ago, the life expectancy in the civilised world was about 42, compared with the current world average of 67,2.

Medicine has made huge advances over the past century. More recently, though, longevity owes more to medical technology and engineering in our quest for everlasting life. Hip replacements, bypass surgery, eye lens repair — physical fix-it is the next phase.

Eventually our planet won't cope and people over a certain age will be required to renew their licenses to live. I predict that, within 100 years, after a certain age (say 130) you'll have to prove your net contribution to the wellbeing of the world or you'll be put in the queue of people who don't come back."

Well, we hope that the above fate never befalls any of our cherished clients!

Back to the markets…..

We truly live in extraordinary times. Our conservative portfolio positioning has meant, that, particularly when measured in ZAR, our client portfolios have weathered the storm that is 2012 to date, very well. Many of you will bear testament to this as we evaluate the positions at our portfolio reviews.

We remain committed to defensive, value orientated manager selection, conservative allocation of assets and to doing what we do best, managing the behavioral aspects of our client's decision-making.

We have included a few pieces of interest in this Sterling Times edition. A guest piece by Greg Hopkins hones in on possible value in Europe, a contrarian view that may well deliver value over the next decade. In addition, we provide an overview of manager selection and the performance discrepancy over time, between top and under-performers. This, I am sure, will be of interest.

James Guimaraens, one of our valued partners, has detailed a few practical points in terms of the Estate Execution process, an inevitable but often distressing part of our lives. We end with a piece evaluating the importance of dividend based investing, by our select SA dividend focused fund.

We hope you enjoy this content. Until later in the year…..

Graydon Morris
Founding Director

Selecting Quality Equity Managers in SA

There are two schools of thought concerning the current state of world economies and markets.

The first says "this time is different". The world is different to how it previously was two decades or even one decade ago. The financial crisis of 2008-2009 was unique and world economies face issues that never existed previously (like the Japanese earthquake, tsunami and subsequent nuclear meltdowns) and classic economic theory can therefore no longer be used.

The other school says that that although the issues are different, and the recent financial crisis was the worst in 80 years, there have always been unpredictable issues affecting markets and there have been many financial crises through history. Economic theory still holds true because markets are essentially mean-reverting over sufficient time periods.

Whilst the above debate continues to rage on, what is generally accepted – by many domestic asset management houses – is that over the medium-term (next decade or so), the South African equity market is not likely produce the same returns it did over the previous decade and that the market will likely, as a whole, move sideways.

If this is to be the case, how will this sort of market affect the performance of our selected active managers? Will the spread between the historically well- and poorly-performing funds increase (or decrease) and hence will undertaking manager selection become more or less important for one's investment?

In order to answer the above questions it is worth looking at the rolling 1-year returns of the broad-based domestic equity funds over the last 10 years. In particular, it is revealing to look at the best and worst returns of these funds over this decade and the range of the 1-year returns they brought in over this time.

In the chart below the rolling 1-year returns of these funds have been plotted. The left-hand axis posts the rolling one year total returns of the best-performing (green) and worst-performing (red) funds for each of these periods and as well as the total return of the FTSE/JSE All Share Index (black dotted line).

The right-hand axis plots the range (spread) between the highest and lowest returns of the best and worst-performing funds over those periods and is represented by the shaded blue area at the bottom of the chart.

A dotted navy-blue horizontal line shows what the average of the range of returns (the spread) was over the period (31.5%).

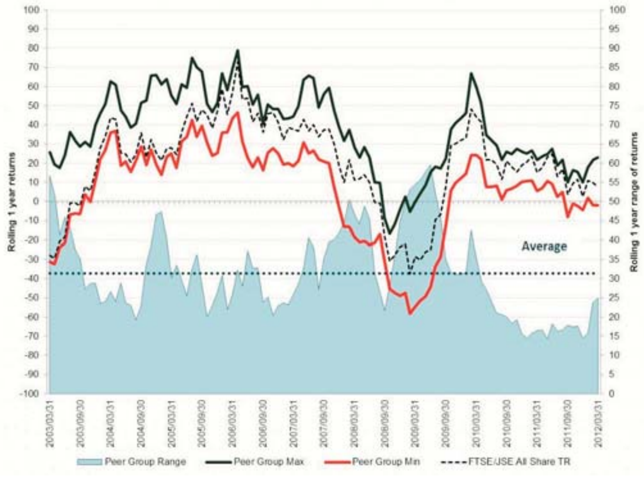
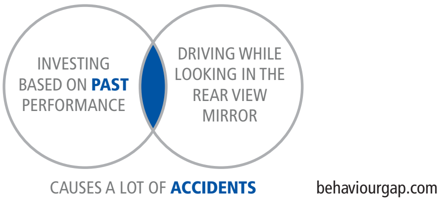


Figure 1: *Rolling 1 year returns of Domestic Equity funds (General, Growth, Value and Large Cap sectors) over the 10 years to 31 March 2012*
Source: Morningstar®

It is clear to see above that the range of returns between the best- and worst-performing funds over each period dropped significantly over the last three years and has been well below the average for the last two. There has been an uptick in the range of returns over the last 3 months, but it still remains below the average.

The 1-year total return for the FTSE/JSE All Share Index in 2011 was a miserly 2.6%. This was the worst 1-year performance of the index since August 2009. What is interesting is that the range of returns of domestic equity funds at this time was at its lowest (14.5%) in the ten years we looked at. It may be argued that this would tend to support the notion that a muddling through market would result in less of a difference between the best- and the worst-performing funds.



This may entice some to think that passive or indexation-type funds are the way to go for the next little while. What must be highlighted from the data examined here is that during the times of stress when markets are crashing, the spread of returns can increase drastically – just look at early 2003 and the middle six months of 2009 when the range of returns surged past the 50% mark. The worst performing fund over one year during the financial crisis had a 55% drawdown, while the best fund just broke even.

If we return to the original question about the range of returns between the worst- and the best-performing funds, it does appear that the spread has decreased and has recently been low compared to the average. This however does not mean that manager selection becomes less important. On the contrary, we believe that it becomes more important, especially when the range of returns is larger than the return of the market at the time

Just look at the last six months in the chart above. Rolling 1-year returns of the All Share index have been no more than 12%, while the range of returns for the same period was more than 15%. Even with the best-performing funds outperforming the Index, because the range of returns is greater than the index return, this has resulted in the worst funds not only underperforming the index but also producing negative returns!

The Sterling Team
Adapted from a Piece by Greg Flash

Is there value in Europe?

There is a lot of bad noise surrounding Europe right now and when that happens, contrarian value managers start to smell blood in the water. The valuations of many great companies are at near-record levels which would normally be an indicator that it's time to buy. Let's take a look at some of the evidence.

A few interesting charts crossed our desk over the past week.

The first points out that Dutch bond yields are now at 500 year lows (Figure 1).

The second (Figure 2) is telling us that Europe has underperformed the US by over 3 standard deviations, when measured over the past 20 year timeframe.

The pervasive fear enveloping Europe has opened up some interesting anomalies.

The market capitalisation of all Greek Equities is now the same as just one South African company – our own Aspen Pharma ($4.8bn). Aspen is around the 25th largest in our South African screening universe.

Across the pond, US bond yields also made 220 year lows during the week, a record that was set in November 1945. Truly interesting times.

Given the clearly Armageddon-like headlines emanating from the European region, these charts will likely surprise few people. What they might indicate however is the extreme pessimism that is currently being reflected in current market valuations.

History has taught us that stock markets are often very good at pricing the news headlines of the day. As Albert Edwards, a man often described as being a "perma-bear" points out, the macro environment always looks awful when the market is cheap. On the subject of bears, we listened with interest this last week to a thought provoking interview with financial historian Russell Napier titled "Uber-Bear sees Value in Europe". To see this interview, please **click here** or go to **video.ft.com/v/16559325 38001/Uber-bear-sees-value-in-Europe**.

Napier, a self confessed bear himself, has recently become a European bull and points out that Europe is now close to the 1982 Cyclically Adjusted Price Earnings (CAPE or Shiller P/E) ratio lows which marked the start of the last great bull market (see Figure 3 below).

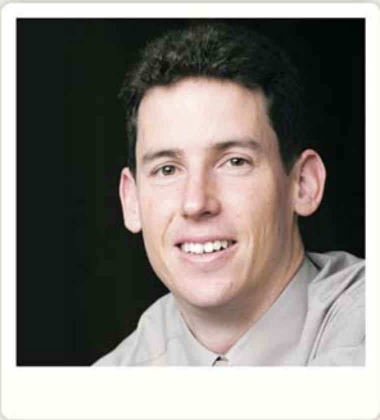
The chart below was struck in March of this year – updating the chart with the recent sell-off will show that we are moving even closer to those 30 year lows.

We agree with the view that valuation metrics do not give us an indication on the timing of the bottom of the market, although they do highlight where value might be found for above average future returns. They also highlight areas to look for potential significant margin of safety.

Greg Hopkins
PSG Global Equity Fund Manager

The Practicalities of Assisting with a Deceased Estate

James Guimaraens Director, Sterling Private Wealth



Acting as an executor or being involved with a deceased estate is something most of us will have to do at some point in our lives. We do, however, sometimes lose sight of the actual personal, emotional and practical aspects involved when those who are in the unfortunate position of having to deal with an Estate, require close hand-holding. Whether it is a close family member, a friend or a colleague, this is a duty and an experience that is both complex and stressful. Only when you are personally confronted with the responsibility and obligations associated with a deceased estate do you realise the magnitude of what is required.

Executor

The appointment of an appropriate executor is the most obvious issue regarding an Estate, and we spend considerable time discussing this with clients where we assist with estate planning. The executor appointed in the Will can either be a natural person, or a professional executorship firm (such as a Specialist Trust Company, Bank or Legal Firm). If you have appointed a friend or family member, they will be required to sub-appoint a professional and licensed executor to actually take responsibility.

We encourage our clients to appoint a natural person who can act independently in assessing and appointing a professional executor. The appointed person needs to be familiar with the family circumstances, finances, and any special issues that must be accommodated. When sub-appointing a professional executor, ensure that the firm has ongoing experience and relationships with both the Masters Office and SARS, as this limits unnecessary delays in winding up an estate.

Where you are appointed an executor for someone who is particularly close to you, do not underestimate the emotional stress you will experience. We strongly advise that you keep in mind someone who can assist you in fulfilling some of the practical requirements noted below.

When a professional executor is sub-contracted to provide the required legal and professional services, ensure you receive a documented quote. The fee is quoted either as a percentage of a fixed Rand amount, and this will depend on the size and complexity of the Estate.

Responsibilities

Ensure that the relevant requirements and responsibilities are discussed and agreed. The executors will require assistance to obtain much of the initial documentation required. It is worth spending time discussing exactly what is required if you wish to minimise delays and unnecessary frustration.

Undertaker Services

Due to the practicalities involved with the body of the deceased, the executor will be under pressure to nominate an undertaker as quickly as possible. If you are not in an emotional state conducive to this, ask for assistance from a friend or family member. It is astounding the vast difference in fees and charges from different undertaker firms. Do not rely on a recommendation from the hospital or nursing home.

Medical aid

Ensure that the medical aid company is advised, and that the surviving spouse is now added as the main member. There have been cases where the surviving spouse has unknowingly lost their cover as they were simply a dependant on the scheme, and premiums have been stopped.

New Will

If you have a joint Will and your spouse has passed away, it is essential you have a Will drawn up as soon as feasibly possible. The joint Will is now held by the executors, and the surviving spouse therefore must draw up a new Will. Individual Wills are generally more accommodating, but must in due course also be reviewed.

Dividend investing

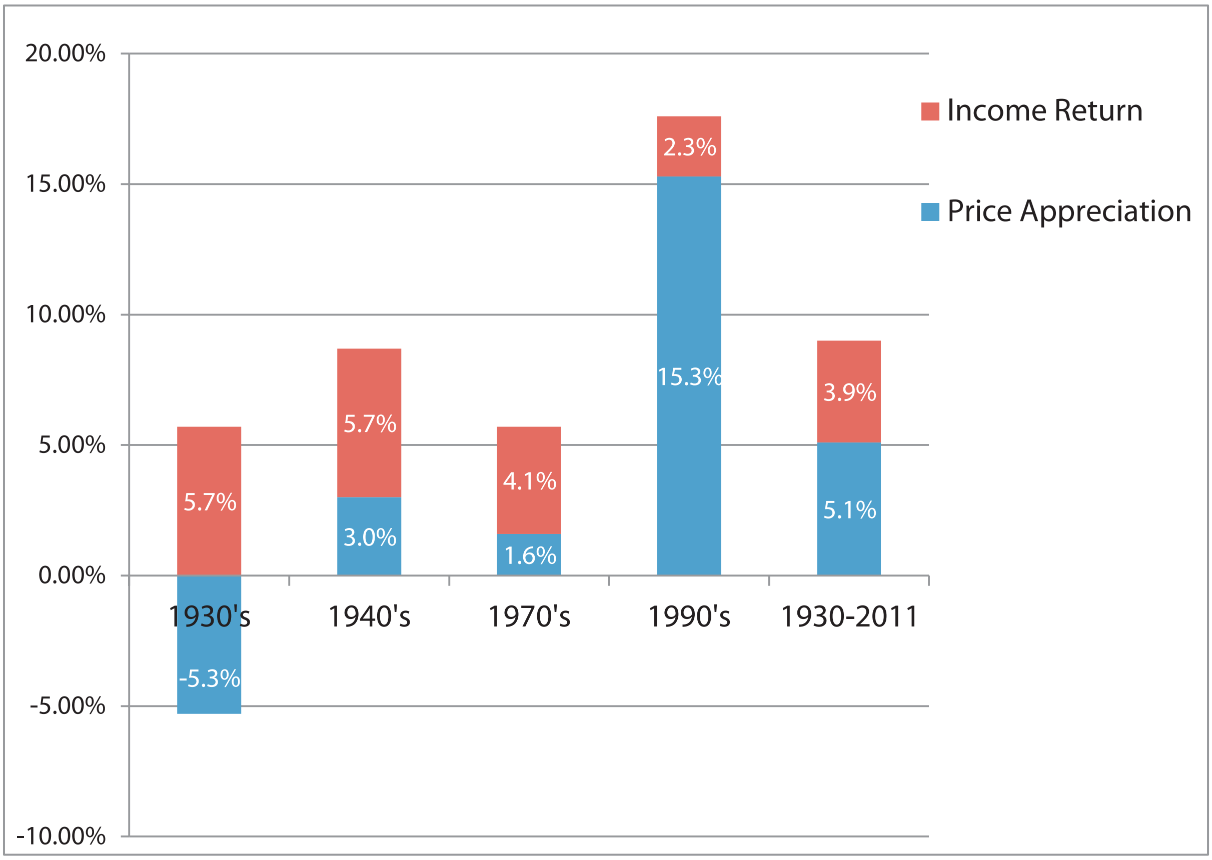
Investing with a focus on dividend yield has a number of benefits that make it an appropriate strategy for many investors. From a psychological point of view it is very comforting that even in severe bear markets you receive a healthy income stream, making it easier to stomach nervous markets and volatility. Investing in high yielding stocks also implies some level of cheapness which acts as a further buffer against market declines.

Over time dividends have made up a very large portion of investors returns, although the variation is large depending on the period. Dividends are usually more important during tough market environments, but when markets are flying (South Africa 2003-2008), they are less important than price appreciation.

The history

Using the S&P 500, where there is more data available, some of the historic data is shown below.

Historic S&P 500 Income and Price Contributions to Return



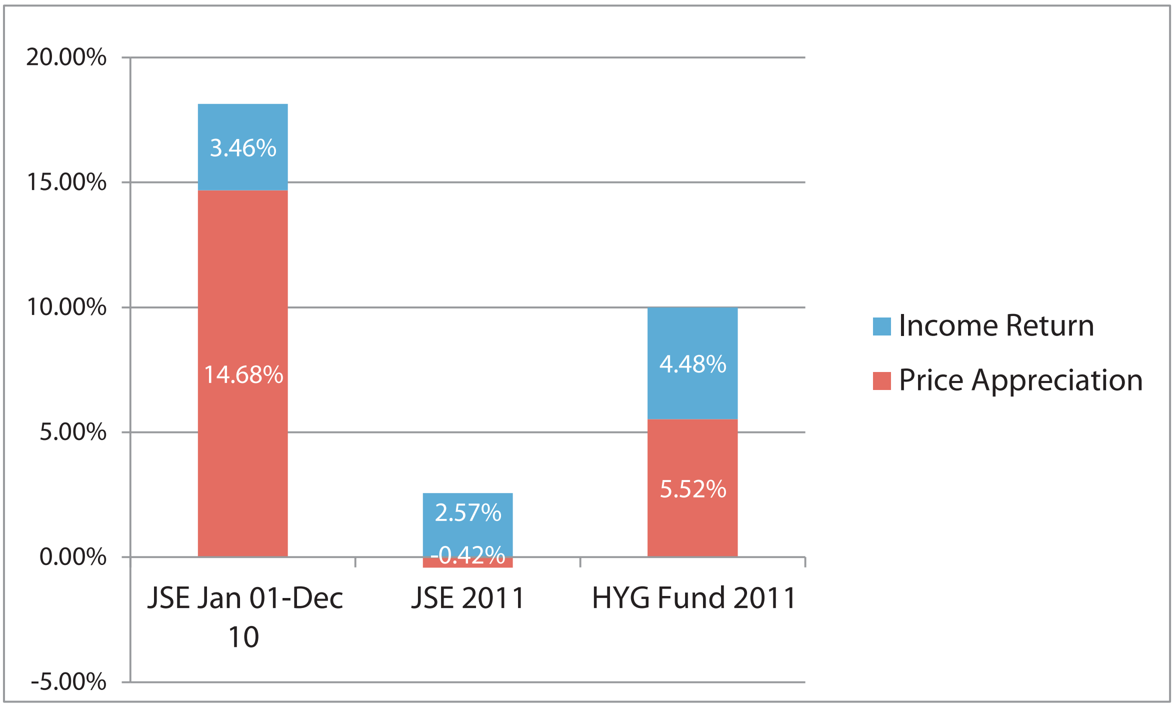
Over time dividends make up nearly half of the total return investors receive, but there are times when dividends are less important (bull market of the 1990's), and times when they make up the lions share of the total return (1940's and 1970's). In bear markets like the 1930's they are the only source of return!

The South African experience of the last decade has also been one where the dividend component has been less important as the market has gone through a generational rally. We have been arguing that the likelihood of this reverting towards a more moderate split between dividends and capital appreciation is very high. This is in line with our view that South African assets are well priced (ie no longer cheap) and that investors should not expect the elevated returns of the past decade to be repeated, making the dividend component of returns all the more important.

Shown on the next page is the JSE data for the past decade, together with the JSE and PT High Yield Growth

Historic JSE Allshare and HYG Fund

Income and Price Contributions to Return



We have used the 2011 data merely as an indication of the merits of dividend focused investing in a low total return environment.

Our approach to dividend investing

Our investment process has evolved over the years in an attempt to get the right balance between the importance of dividend yield and other valuation methodologies. Focusing just on dividend yields can lead to investing in expensive companies that are paying out unsustainably high amounts of their earnings to support that yield. Examples of companies that are on high dividend yields, but are not cheap on other metrics in our view are Kumba Iron Ore and Vodacom. We have owned both companies in the past, but currently own neither despite their high dividend yields. Another way of illustrating the same point is that if Billiton (a company we do own) paid out the same portion of its earnings as Kumba it would be on a 10% dividend yield ! This balanced approach to dividend investing will enhance the consistency of returns in the long-term.

Current positioning and outlook

The High Yield Growth Fund is currently very cautiously positioned as we lack conviction and are battling to find great ideas. The shares we would like to own – high quality companies with defensive earnings profiles – are all very expensive, largely as a result of foreign demand. The sector that has been out of favour and where valuations are now attractive is the commodity sector, but dividend visibility is not good. We have been cautiously accumulating select commodity shares (eg Billiton, Sasol, Impala), but retain a healthy cash and preference share weighting as we patiently seek opportunities. While the macro environment lends itself to short-term thinking we remain focused on the long-term and valuations. There will be periods when this patient approach results in us lagging the market in terms of total return, but it will lead to consistent risk adjusted returns in the long-term, together with a healthy and growing stream of dividend income.

Sandy le Roux
Fund Manager, Personal Trust International

Market performance

investment market performance

period to 31 May 2012	Index	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
South African equity	JSE All Share Index	5.1%	16.4%	5.9%	16.6%	14.80%
South African equity	SWIX	9.2%	18.2%	7.0%	17.2%	16.6
South African fixed interest	SA All Bond Index	11.1%	10.6%	9.0%	8.8%	10.80%
South African property	SA Listed Property Index	19.5%	21.7%	12.5%	20.4%	25.3
South African cash	STefI (3 month NCD's)*	5.5%	6.2%	8.1%	7.9%	8.60%

*Short Term Fixed Interest Index**

investment market performance

period to 31 May 2012	Index	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
international equity	MSCI World (unhedged) Index (USD)	-11.0%	9.0%	-4.1%	2.6%	4.0%
international fixed interest	Barcalays Capital Global Aggregate (unhedged) Index (USD)	2.3%	6.0%	6.5%	5.3%	6.8%
international property	UBS Global Investors Index					
	"(USD, unhedged, net divs)"	-5.1%	21.7%	-5.4%	3.2%	8.8%
US dollar	LIBID 7 Day (USD)	0.2%	0.2%	1.3%	2.2%	2.0%
euro	LIBID 7 Day (EUR)	0.7%	0.6%	1.7%	2.0%	2.2%
pound sterling	LIBID 7 Day (GBP)	0.6%	0.6%	2.1%	2.9%	3.3%

breakdown of local share market performance by sector

period to 31 May 2012	% of ALSI	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
Top 40	82.0%	2.9%	15.2%	5.4%	15.9%	13.6%
Mid Cap	15.0%	17.2%	23.6%	9.9%	20.8%	22.6%
Small Cap	3.0%	13.9%	19.5%	4.3%	17.6%	24.4%
oil and gas	5.0%	4.2%	10.1%	10.8%	n/a	n/a
basic materials	30.0%	-14.8%	4.8%	-1.3%	12.3%	10.8%
industrials	6.0%	19.1%	20.0%	5.1%	16.8%	18.6%
consumer goods	18.0%	19.5%	30.6%	17.7%	25.0%	16.0%
health care	2.0%	29.5%	30.9%	14.6%	21.7%	20.2%
consumer services	11.0%	23.7%	34.8%	15.5%	23.4%	27.2%
telecommunications	7.0%	0.0%	10.7%	8.5%	18.1%	26.3%
financials	21.0%	18.2%	22.3%	4.9%	13.7%	15.1%
technology	0.0%	29.7%	36.9%	14.8%	22.2%	13.5%

The FTSE Group and the Dow Jones Indices have created a new definitive industy classification standard. The Industry Classification Benchmark indices were implemented by the JSEon 1 January 2006

Market performance

breakdown of international market performance by country

period to 31 May 2012	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa	
United States: S&P 500	-2.6%	12.5%	-3.1%	1.4%	2.1%	
Germany: DAX	-14.1%	8.2%	-4.5%	5.0%	2.7%	
United Kingdom: FTSE 100	-11.4%	6.3%	-4.3%	1.0%	0.4%	
France: CAC	-24.7%	-2.7%	-13.1%	-4.4%	-3.4%	
Japan: Nikkei	-11.9%	-3.6%	-13.7%	-3.9%	-3.1%	
Hong Kong: Hang Seng	-21.3%	0.8%	-2.0%	4.3%	5.1%	

all returns are calculated in the respective local currencies and are based on index levels

currency exchange rates

period to 31 May 2012		1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
ZAR/USD	8.5006	-20.0%	-2.3%	-3.5%	-3.2%	1.4%
ZAR/EUR	10.5131	-6.7%	2.3%	-1.9%	-3.4%	-1.4%
ZAR/GBP	13.0997	-14.7%	-0.7%	1.4%	-0.9%	0.9%
ZAR/JPY	0.1086	-23.1%	-8.3%	-11.6%	-7.7%	-3.2%
USD/EUR	1.2364	16.7%	4.6%	1.7%	-0.1%	-2.8%
USD/GBP	1.5408	6.9%	1.7%	5.1%	2.4%	-0.6%
USD/JPY	0.0128	-3.8%	-6.3%	-8.4%	-4.6%	-4.5%

Market performance

economic indicators

economic growth	%	inflation	%
SA real GDP growth "(3rd quarter '11, annualised q-oq) "	2.7%	SA CPI (y-o-y change for October)	6.1%
US real GDP growth "(3rd quarter '11, annualised q-oq) "	1.9%	US CPI (y-o-y change for October)	2.3%
Euro area real GDP growth "(3rd quarter '11, annualised q-oq) "	0.0%	Euro area CPI (y-o-y change for November)	2.4%
Japan real GDP growth "(3rd quarter '11, annualised q-oq) "	4.1%	Japan CPI (y-o-y change for October)	0.5%
global developed markets real GDP growth "(3rd quarter '11, annualised q-oq) "	1.3%	G7 CPI (y-o-y change for October)	2.1%
interest rates		**commodities**	
SA repo rate	5.50	gold (London PM fix in USD as at 30 November)	1558.00
SA prime overdraft rate	9.00	y-o-y % change	1.4%
US Fed Funds rate	0.25	platinum (London PM fix in USD as at 30 November)	1405.00
ECB refinancing rate	1.00	as at 30 November)	-23.1%
BoJ overnight call rate	0.10	brent crude oil (USD)	102.75
BoE repo rate	0.50	y-o-y % change	-11.7%

Market performance

investment market performance

period to 30 June 2011	Index	1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
International Equity	MSCI World (unhedged) Index (USD)	30.5%	0.5%	2.3%	5.4%	4.0%
International Fixed	Barclays Capital Global	10.5%	6.0%	7.1%	6.2%	7.4%
Interest	Aggregate (unhedged) Index (USD)					
International Property	UBS Global Investors Index "(USD, unhedged, net divs)"	39.0%	2.6%	0.7%	7.7%	10.9%
US Dollar	LIBID 7 Day (USD)	0.2%	0.6%	2.2%	2.5%	2.3%
Euro	LIBID 7 Day (EUR)	0.7%	1.2%	2.2%	2.2%	2.5%
Pound Sterling	LIBID 7 Day (GBP)	0.6%	1.2%	2.9%	3.4%	3.6%

breakdown of international market performance by country

period to 30 June 2011		1yr	3yrs pa	5yrs pa	7yrs pa	10 yrs pa
United States: S&P 500		28.1%	1.0%	0.8%	2.1%	0.8%
Germany: DAX		23.6%	4.7%	5.4%	8.9%	2.0%
United Kingdom: FTSE 100		20.9%	1.9%	0.4%	4.2%	0.5%
France: CAC		15.7%	-3.5%	-4.3%	0.9%	-2.7%
Japan: Nikkei		4.6%	-10.0%	-8.7%	-2.7%	-2.7%
Hong Kong: Hang Seng		11.3%	0.4%	6.6%	9.0%	5.6%

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