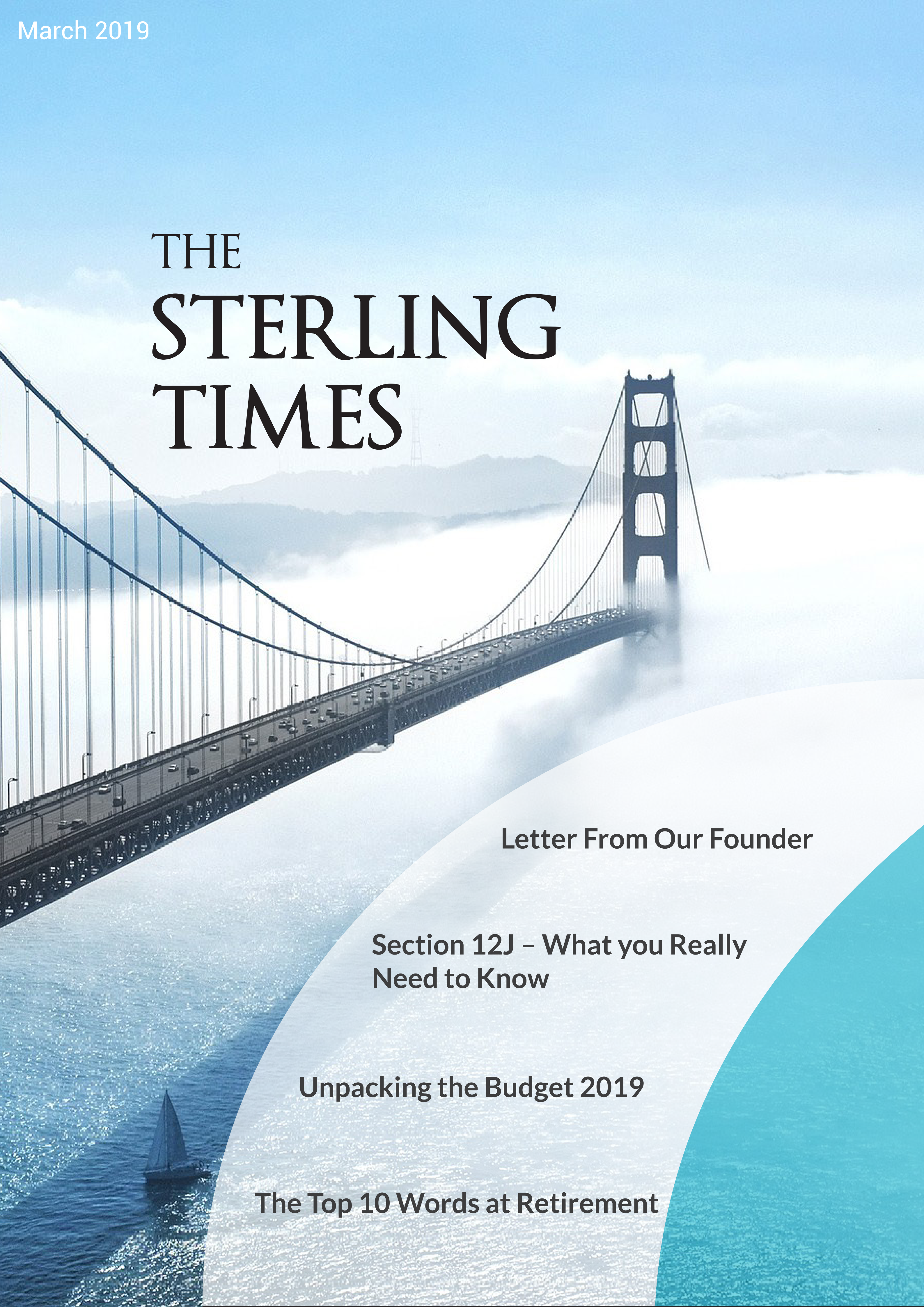


March 2019

THE STERLING TIMES

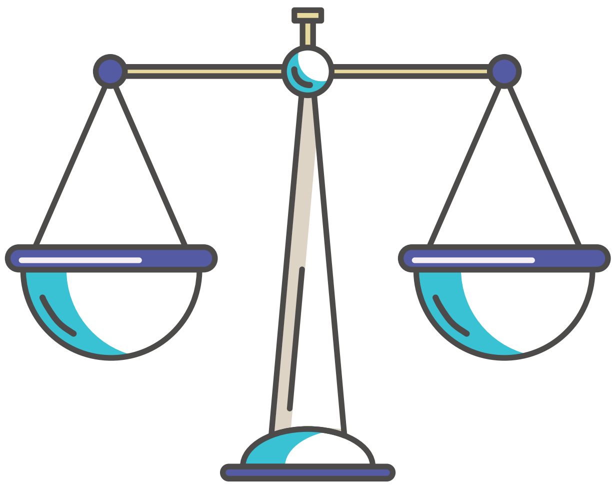
We are pleased to announce that, in the investment world, the beginning of 2019 has been substantially more positive than the back end of 2018, which led to most asset classes and investment opportunities ending with negative (in some cases, deeply negative) results.

Such is the volatility and madness of “Mr Market”. 2018 ensured that Wealth Managers and Planners earned their keep, preventing skittish investors, concerned at short-term price movements, from making catastrophic decisions to abandon ship. To some extent this resilience has been paid off but is only truly evident and measurable over much longer periods.

This has been one of the toughest five-year periods in South African equity market history. Only 1% of the time has such a period resulted in a future five-year period not significantly better than cash and inflation.

After a difficult 2018 for emerging markets, we are pleased that these portfolio positions have rebounded strongly into 2019. Fundamentals suggest some very good upside in this area in the coming years. Investors need to keep their nerves as these positions are notoriously volatile.

As always, our diversified, sensible and balanced views will stand our clients in good stead in the coming years. We are delighted at the performance over the past 12 months, and indeed longer, of our Counterpoint Asset Management team’s portfolios. Under the leadership of industry veteran, Sam Houlie, the team is solid, settled and inspired. They are very important to our wealth offering and add tremendous insight into our Model Portfolio management. The result is that our Model performances are all above peer group and sectors since inception. Well done to all involved in these projects. We know full well that this feat is impossible to achieve year in and year out, but are pleased at the results to date, nevertheless.



COUNTERPOINT™
ASSET MANAGEMENT

We are very excited at two specific new developments at Sterling Private Wealth. Firstly, Ashley Petyt joined the Cape Town office late last year. Ashley is fresh from UCT and studying towards her CFP. She is enthusiastic, focused and ambitious. She has settled in really well, and we look forward to having many of you meeting her in due course.

More recently, in early February 2019, Lisa Kaplan joined Sterling as a Wealth Manager. She is a CFP, a Stellenbosch graduate, an alumni of Redhill School in Johannesburg, and enjoys over six years' experience at both Investec and PSG. We look forward to integrating both Ashley and Lisa into our team, and to having them add value to all our clients' lives as Sterling continues to grow. The future growth of Sterling is largely reliant on the wonderful client referrals we have historically been so blessed to have received from our existing and valued clients. Please keep them coming. We are ever-grateful for these references.

Lisa has penned an article on the very topical Section 12J Company options. It is a comprehensive and well-researched piece – we hope you enjoy it. Joubert Strydom, a Sterling Director has put together a piece on the recent budget that we expect you to find very informative. Retirement is a topical subject for many of our long-standing clients, and to this end, Russel Gibson shares his thoughts on what retirement means to many, based on the results of a recent US study.

We hope you enjoy the read.

Graydon Morris

Founding Director
Sterling Private Wealth

STERLING
PRIVATE WEALTH

Section 12J – What you Really Need to Know

By Lisa Kaplan, Wealth Manager, Sterling Private Wealth

With intensified Section 12J marketing efforts around tax season and the quantum of tax revenue wastage, it's not surprising that this tax incentive is attracting attention. But is there substance to the hype? And if so, is it for you?

In an effort to boost private investment, and ultimately economic growth of local SMEs, SARS introduced Section 12J in 2009 and made a few favourable amendments to the incentive in 2014, after which it gained traction. The aim in stimulating SME access to equity finance is to concentrate investment expertise in favour of the small business sector, which will ultimately expand the tax base. Qualifying and registered Venture Capital Companies (VCCs) are intended to be marketing vehicles that will attract retail investors – they appear to be doing this quite well.

Individuals, companies and trusts can invest, and the incentive allows a 100% write-off of the contribution against taxable income. Thus, offering up to 45% immediate tax relief, provided the investment is held for a minimum of five years. The investment is deductible against all types of income incurred in the year of investment – salaries, bonuses, capital gains and interest. Important to note, is that the base cost is deemed to be zero for capital gains tax going forward.

The annualized benefit of the tax saving can be accounted for as follows:

R 1 000 000	→	The investor invests R1,000,000 as a lump sum investment into a qualifying fund.
R (450 000)	→	The tax benefit to the investor, assuming a marginal tax rate of 45%.
R 550 000	→	After accounting for this tax benefit, the investor is effectively placing less capital at risk.
R 1 000 000	→	Assume investment returns are 0% to measure the tax impact, i.e. you get back what you invested.
R (180 000)	→	As the base cost is deemed to be zero, your capital gain is calculated on the full investment amount. Effective CGT rate for an individual is assumed at 18% (40% inclusion rate x 45% marginal tax).
R 820 000	→	After paying CGT, the investor walks away with an after tax amount.

Over a five-year period this equates to an annualized benefit from this tax incentive of approximately 8,3% per annum if your investment does nothing – this is significant, although it does not account for fees or inflation. Nevertheless, it is never wise to make an investment decision based solely on a tax benefit. Blindly placing capital at risk, when you don't know what you're actually investing in increases your risk of losing that capital, meaning you could actually lose more (R550,000) than you saved (R450,000) in the first place…

So, what exactly would one be investing in?

By February 2018, the industry had raised R3,7bn and this is expected to have grown to approximately R5bn by the end of February 2019 – although relatively fast growing, this is by no means large for the asset management industry. There are currently around 150 different approved VCCs, with a number of broader areas of focus, such as smaller scale hospitality property, student housing, junior mining exploration, asset-backed rentals and SME investment.

Venture Capital and Private Equity are inefficient asset classes, meaning there is a wide dispersion of investment returns among managers, particularly when compared with other asset classes. This means that an investor's returns are dependent on being able to select a manager with the ability to deliver. This is where it gets challenging, with many of the Section 12J VCCs being relatively new to the industry, a long-term track record is not always easy to come by – this makes performance measurement, manager comparison and ultimately selection incredibly difficult.

It is also crucial for investors to understand where they stand on the risk spectrum – this is a high-risk asset class, higher than traditional equity investments, meaning there is potential for both significant growth and significant loss, together with significant volatility along the road to any particular outcome. Any interested investors who genuinely struggled to stomach the last few years in the market should probably take a step back. Besides, for the five-year minimum term required to receive the tax incentive, this is a long-term investment due to the level of risk and innate illiquidity. Thus, it heightens the importance of making the correct manager selection from the outset, as well as truly understanding that for this asset class – five years is very much a minimum, not a target.

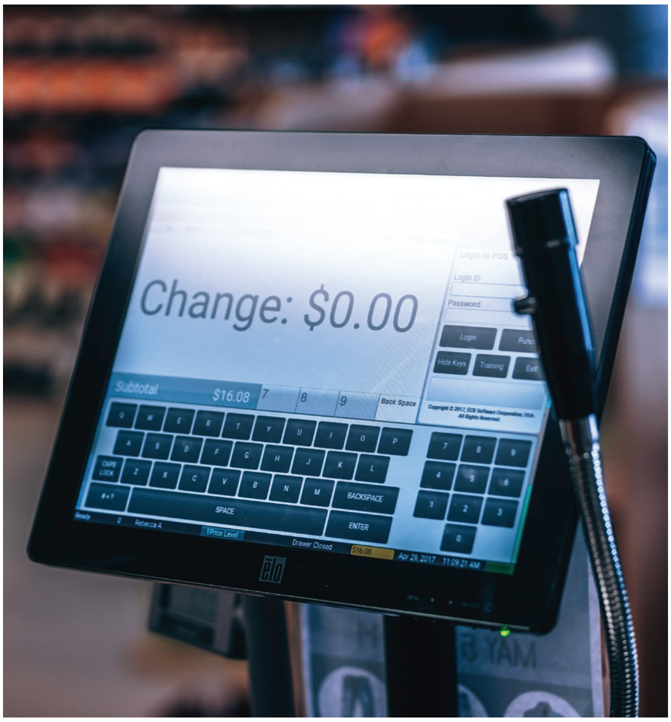
Understanding one's exit strategy is critical. These assets are inherently illiquid – you are buying shares in a VCC fund who are using your capital to buyout or take meaningful stakes in SMEs who need funding to unlock their growth potential – how does this translate into you ultimately walking away with cash in your account or a liquid asset on your hands? Stakes need to be sold, meaning a buyer market needs to exist. This is not a simple unit trust redemption.

What do VCCs distinctively do? Typically, they do not hold high dividend yielding assets or properties. Does this make it a poor investment? Not necessarily. Does this make it slightly lower risk? With the income return and dividend yield factor, perhaps. But understand, an income yielding investment is not normal for this particular industry and likely created to be suitable benefactors of the flows directed from the Section 12J incentive. There are many other examples of VCCs shaking up (or rather dulling down) the status quo.

Whilst this does not infer that the VCCs referred to above are non-compliant or non-qualifying, there are a number of firms with very generous interpretations of the legislation. National Treasury recently effected amendments to narrow the scope for potential abuse. Whilst solid governance and more defined legislation is of course positive for the industry, proactive amendments may have a financial impact on those not adhering to the true spirit and intention of the legislation. For example, walking away with a tax deduction and an investment in luxury homes may not be in the primary interest of stimulating the economic growth of SMEs and effectively broadening the tax base through upliftment.

Finally, let's talk fees and returns...

Fees are not legislated by Section 12J, thus investors must ensure they are aware of potentially excessive fees. Typical fees for the industry are based on a lower upfront fee (1% - 2%), an annual fee (2% - 2,5%) and a performance fee or carried interest (around 20% - 30%) on amounts above the initial investment – some Section 12J VCCs charge performance fees on the full initial investment, thus you are being charged for tax savings you decided to incur, as if it was the manager's performance that yielded you this return, I strongly believe this is unethical. Performance fees are relatively high (in my opinion, anything above 2 and 20 is too high) but are intended to align manager and investor interests by incentivising the manger to deliver.



The returns in these funds are able to be presented either gross or net of taxes, fees and expenses (including carried interest or performance fees). As we've seen above, the tax impact is meaningful, thus if VCCs are using the net investment capital as the basis for their Internal Rate of Return (IRR) calculation, the tax relief will materially inflate the IRR, as will the impact of not accounting for fees. If tax is included in this IRR, it is probably also assumed at the maximum marginal rate of 45%.

IRRs are also quoted on an annualised basis, but returns do not typically come through on an annual basis and SMEs are often loss-making in the first few years. These types of assets can see returns coming through in a j-(shaped)-curve, with expenses and fees eating into the capital deployed before the manager has had an opportunity to realise returns. The annualised returns dispersion is large and ranges from 15-25% in some strategies to 40% plus in others. This is a factor of manager skill, the underlying investment and the calculation methodology. Ensure you understand what assumptions are used to arrive at your anticipated IRR, that these are applied consistently and that you are not being intentionally misled.

For those ultra-sophisticated investors, who would have invested in this asset class regardless of the tax incentive and have the capital available to do so, it is a good, tax-efficient opportunity to enter an industry that is already on your radar, and hopefully you share the spirit intended by the legislation of being a part of stimulating economic growth of SMEs. In that case, ensure you are committing your capital to a credible VCC, with investment acumen, domain expertise, sufficient resources, stable teams, low key person risk, a solid investment thesis and strategy deployment that is reflected in their track record.

Check on SARS's website for registered companies, ensure you are issued your certificate of investment and understand the provisions on death and emigration, as well as the natural limits of your contribution (such as limits affecting your allowable retirement contributions if you're using the deduction against taxable income as opposed to capital gains). You can make use of independent Section 12J fund allocators but ensure that they are not tied brokers dressed up as independent advisors. They can assist you in narrowing down the universe to a handful of potentially suitable funds.

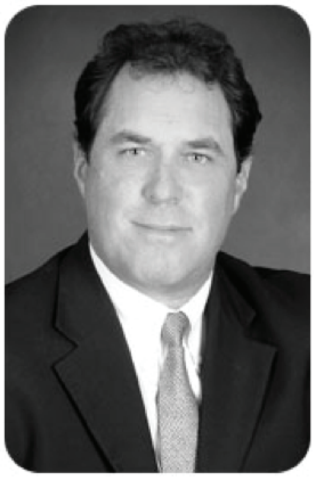
And for the rest of us?

Firstly, those that do not understand it or can't stomach it – allocate nothing. If you're in the process of building (not preserving) for retirement and you're more inherently aggressive, you shouldn't be putting more than approximately 5% of your Net Asset Value into these types of alternative asset classes and even then, it's clear you need to do some serious due diligence.

Chat to an independent financial adviser before making impactful financial decisions, they have an overview of an array of professionals in the industry with a wide spectrum of skillsets who will be able to assist or point you in the right direction.

Unpacking the Budget 2019

By Joubert Strydom, Director, Sterling Private Wealth



Eskom has been granted a R69bn bailout package – however there is widespread concern around exactly how this bailout will be used – and what, if any, measures will be put in place to ensure that the funds do not go to waste into what has become known as the "black hole of funding".

While Eskom and general cost-cutting was the primary focus of Tito Mboweni's budget speech, there were also some interesting points raised from a financial planning perspective. The budget is a first indication of some of the tax proposals that Treasury intends on introducing.

Lack of incentives to save is disappointing

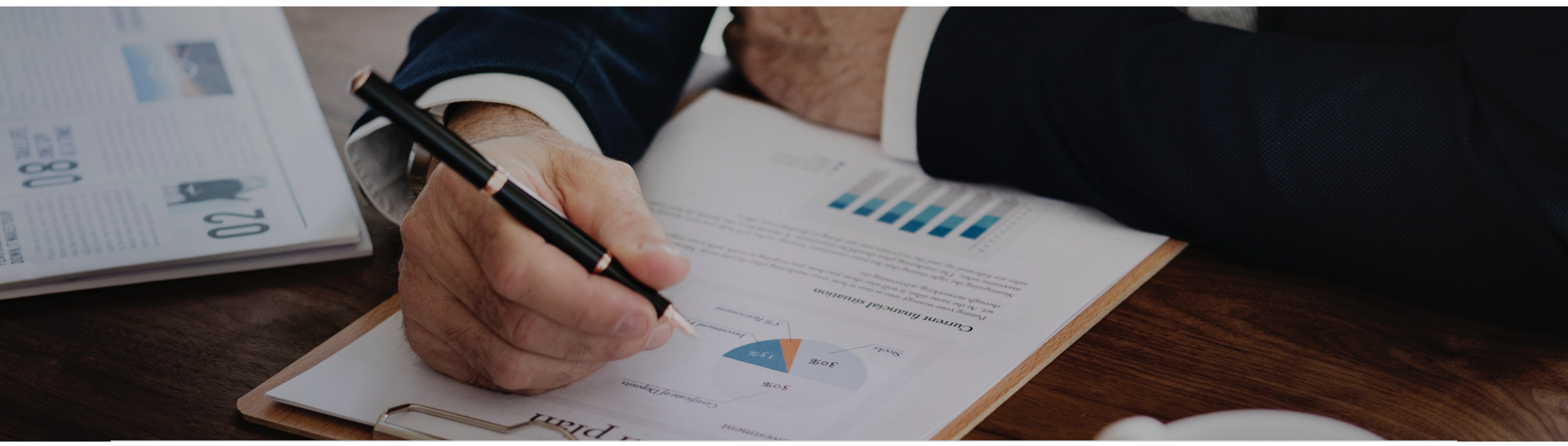
Disappointingly, this budget has not highlighted any significant attempts to further encourage savings. There is no mention of any increases to the limits on tax-free investments or incentives to promote retirement fund savings, which seems mismatched to the president's approach to growth and savings.

No further introduction of wealth taxes

Another interesting observation is the absence of any notable attempts to further introduce what is often referred to as wealth taxes (example: transfer duty, estate duty, CGT, donations tax, etc.).

Tax brackets not adjusted for inflation

South Africans should be aware that even though there wasn't any movement in the tax brackets – the table certainly has not been adjusted for inflation. This could catch people off guard from a personal finance point of view if they assume that their position is unchanged.



Many South Africans will receive inflationary-linked salary increases. This will result in a higher effective rate of tax, which in turn means more tax payable. Some people could end up in a higher tax bracket without any tax relief.

Some key changes to taxation of annuities from provident funds, foreign employment and spousal pensions

Refining the foreign employment income tax exemption for South African residents: From 1 March 2020, South Africa residents who spend more than 183 days in employment outside the country, will be taxed on foreign employment income of more than R1 million. This is an important point for any South Africans working abroad to keep in mind when planning their finances in the medium to long term.

Reviewing the tax treatment of surviving spouse pensions: Treasury has recognised the hardships caused for surviving spouses who are often liable for tax on income in their personal capacity as well as any spousal pension received. Often this can push the surviving spouse into a new tax bracket, which they have not accounted for. To address this, Treasury is aiming to introduce a flat rate on spousal income, which should make the system fairer. However, the exact mechanisms through which this will be achieved is yet to be clarified, so we will watch developments closely here.

Exemption relating to annuities from a provident or provident preservation fund: It has been proposed that non-deductible provident fund contributions can be used against income received. Currently, any non-deductible contributions for members of retirement funds are tax-exempt against any lump sum or income derived from the retirement fund, so this proposal is aimed at extending the exemption to members of provident funds as well. We welcome this development for members of provident funds who choose to take an income.

Change in approach to taxation of collective investment schemes

Taxation for collective investment schemes: The previously suggested taxation of collective investment schemes has been re-evaluated and will be re-considered. Following feedback from industry, based on last year's proposals, Treasury has acknowledged industry's concerns that introducing the taxation for collective investment schemes as previously proposed would cause more hardship than benefits. After reviewing the comments, government has proposed that they will need to work with industry. This is an encouraging development for the financial industry, indicating that the taxation will be introduced in a constructive and collaborative way.
We usually see the first draft of the taxation amendment bill towards the middle of the year and, after vigorous consultation with industry, we see these proposals come to life towards the end of the year/beginning of the next year in the Taxation Laws Amendment Act. As always, we will update our investors accordingly.

The Top 10 Words at Retirement

By Russell Gibson, Director, Sterling Private Wealth

How do you imagine your retirement? What words come to mind? In a 2018 US study, researchers asked these same questions to get a feel for how participants imagined their life in retirement.

We are aware that there are numerous South Africans currently in retirement, but significantly more will be entering retirement in the coming years and decades. We also know that for many soon-to-be-retirees, they have not saved nearly enough. In fact, very few of our countrymen have saved sufficiently to meet their obligations. Our country has one of the lowest saving rates in the world.

The US study's responses were surprisingly consistent. Of the 990 adults who were interviewed, only 27 words were needed to make up half of collected data. More surprisingly, the ten most frequent words respondents used to describe retirement, accounted for almost one-third of all responses. Yes, just ten words. What you'll find in the ten words below is that most of them are not related to money or investing. What research has found is that much of retirement happiness has little to do with financial wealth. There are many tried and true non-financial factors that contribute to retirement happiness.

Here are the ten most popular words used to describe retirement, and what you can think about and plan for as you approach retirement:

1. Relax. This doesn't surprise us. When we've had a bad day of work and we're driving home, what do we wish for? We just want to relax. Relaxation is often the quintessential word we equate to retirement.

While de-stressing and relaxing is positive and often needed, what I've seen in my retirement planning experience is that a little can go a long way. Too much "relaxing" becomes counterproductive and can lead to boredom and malaise.

Before you enter retirement, imagine both how you will relax but also how you can remain active and engaged. What hobbies do you have? Can you start a hobby that will give you purpose and meaning? One of my clients worked seven days a week for several decades. After he sold his company and retired, he needed a new passion. For him, it was training for and completing Ironman Triathlons! Not exactly what most people would consider to be relaxing, but for him it was the perfect fit. Enjoy your time off but find your new passion.

2. Happy. We all want to be happy, of course. It's nice to see that even though many South Africans are underfunded for retirement, they still envision a happy retirement. Money doesn't buy happiness – we've heard that all too often – but I would argue that without a baseline of income, it's hard to be happy.

If you haven't saved enough and you are still a few years away from your desired retirement age, this is your window and now is the time to save as much as you can. Happiness, at least how many of my clients define it, is having peace of mind and financial security. It can also help with the third most popular word…

3. Travel. Of course, "travel" was going to make the list! Travel and retirement go together like peanut butter and jelly. If you are like most retirees and want to travel more when you retire, there a few things to consider.

If you are going to be away from your home for longer periods, consider renting it out to earn money to partially offset the cost of your travel. You could also consider doing a "house swap" with someone in an area you want to visit. You also need to consider your health. If you envision gallivanting all over the world, you'll want to feel good and have energy. This means thinking about your health now, before you retire. I've had clients get into the best shape of their lives as they approach retirement because they wanted to feel vibrant and ready to tackle the next phase of their life.

4. Retirement. Not much to say about this response…

5. Family. Having more time to do the things that matter most to you is the hallmark of retirement. Most pre-retirees envision using some of this newfound time with their family. What issues should you be aware of as you approach retirement?

Based on my work with retirees over the last two decades, I've found that family can be an immense source of joy – family trips, spending time with grandchildren, and just being more available.

However, unexpected family responsibilities can also increase expenses. If you have children or grandchildren that can't afford to join you on a family vacation, will you pay their way? After a layoff, will you invite your children to move back home? These are real examples I've seen with my clients. Without proper planning, these are the kind of events that can financially derail a retirement plan. Its human nature to want to assist family, but sometimes helping can hurt. Run the numbers yourself or work with your retirement financial advisor to see just how much help you can provide without it impacting your own security.

6. Fun. Who doesn't hope to have a little fun in retirement? You've worked hard for three or four decades so why not have some fun? But sometimes when I ask pre-retirees what they will do to have fun, I get a blank stare. What does it mean to you to have fun? Fun doesn't just happen. You need to create an environment for fun to exist. Be as specific as you can and try to determine what fun looks like so you can pepper in activities in retirement that make you happy.

7. Success. I suspect that success here is some combination of financial and personal success. Just like "fun" from above, success doesn't just happen. Here is a question I like to use: "Imagine you are three years into your retirement, and you tell me your retirement has been a success. What had to have happened over those three years for you to say that to me?"

It's easy for time to slip by and for you to wake up and have a decade of your retirement gone. What makes a retirement successful, is forethought and strategy. We all define success, and certainly retirement success, differently. The onus is on you to discover what retirement success means to you. I've found that those who get clear on this before retirement have a much better transition into this phase of their lives.

8. Freedom.

When your boss demands a project be completed over the weekend or when you are stuck in traffic on the way home from the office, the promise of freedom must ring loud. Retirement freedom can be an amazing outcome – it can give you the time and space to do the things you really want to do and that give you meaning.

Freedom can also create tension, uncertainty and boredom. Why? Before retirement, we have a schedule and a purpose to our day – we get up at the same time, get ready, drive to the office, have people and/or projects for which we are responsible, and have co-workers with whom we interact. Once you retire, the predictability and purpose of the day disappears.

Once retired, it is up to you to create a new schedule and vision for how you will use this new time and freedom. Don't feel like you need to have your day blocked out from morning until night, and don't feel like you need to have all the answers before you retire. Sometimes it takes a few months into retirement to get a feel for it. However, it won't hurt to start thinking about how you will use your new freedom.

9. Money.

You can't talk about retirement planning unless you talk about money. One of the biggest fears of pre-retirees is not knowing if they have enough money to retire comfortably. The only way to effectively determine if you have enough to retire is to do the analysis – either by yourself or with a retirement financial advisor.

There are so many variables to consider that it makes sense to work with someone who has experienced hundreds of retirements (i.e. working with clients who have retired) and has seen what works and what doesn't, than trying to go it alone. Either way, make sure your portfolio is invested appropriately for a retirement of three or more decades; ensure that you are taking out a safe amount of income each month, and that you are considering all the various expenses and inflation in your calculations. Once you go through this process, you'll feel more confident about retiring or you may discover that you need to work an extra year or two. Either way, you are better off knowing this now, than after you leave the workforce.

10. Fulfilled.

This single word sums up everything we desire from retirement and life. We want to feel fulfilled. Many clients transition smoothly into retirement and feel fulfilled while others struggle. Think about what you enjoy about your pre-retirement life – maybe it's the camaraderie of your co-workers, the consistent schedule, the feeling of responsibility or purpose – and think of ways you can incorporate these factors into your retirement. This might include volunteering or sitting on the board of a non-profit. Maybe it's starting a new business or writing the novel you've always thought about. Fulfilment looks different for everyone. What does it look like for you?