Sterling Times

April 2021 Edition

In this edition

MERCHANT WEST

STERLING PRIVATE WEALTH

Introductory message from our managing director

By Graydon Morris, Managing Director, Sterling Private Wealth

Dear valued clients and friends.

We have now come to the end of an eventful first quarter of 2021. The beach lockdowns and frustration of December seem to be a lifetime ago. The Budget of February came and went with little of tremendous significance. It does seem that hopefully financial emigration and related issues will be simplified over time. This is positive for sentiment and simplicity. It is a long time coming.

The oft touted increases to general taxes and CGT, again, did not materialise. In fact, the Corporate Tax rate reduced from 28% to 27%.

Markets have continued with the rotation from growth to value over the past few months, and many of our underlying managers have seen the benefits of this reflation trade. There is a global fear (and some evidence) of increasing inflation, and this will need to be monitored. Local and global cash rates remain at all-time lows and this poses several challenges for investors

We recently presented a client Webinar, where John Biccard and Cy Jacobs, two of our country's most revered fund managers, debated the growth versus value argument. It was well received, mediated by our very own talented and highly informed Joanne Baynham.

The "risk on" trade currently at play has been very positive for the Rand, presently trading around R 14,50/US$. We again note, that, whilst we are long term bearish on the Rand, it is not a straight-line one-way bet, and that those that incite fear and panic often do so for self-serving purposes. A balanced, diversified and considered approach is required.

Our wealth management and support team remain committed, and passionate, about providing first class service and cutting-edge advice to our valued clients. It has been a roller coaster 12 months for us all, and we hope that things will "normalise" to some extent over the next year.

Our team is stable and is growing steadily. We thank all our clients for their incredible support, loyalty, and friendship. It makes what we do so rewarding, interacting with diverse, interesting, and dynamic people. Next year will be our 20th year. I pinch myself, as it has all passed by in a flash. What a wonderful journey to date, we look forward to many more successful years.

We have included a few diverse pieces in this edition, including the importance of preserving what we have, economic and market outlooks, estate planning issues, and money anxiety thoughts. We hope you enjoy the read.

Graydon Morris

Managing Director

Get Rich versus Stay Rich

Paraphrased Article of Blair duQuesnay, CFA®, CFP®. She is an investment advisor at Ritholtz Wealth Management, LLC, in New York City

We don't help people get rich; we help them stay rich. Our job as a wealth manager is to help clients hold on to their wealth and to preserve and grow it to keep pace with inflation. Our number one priority is to ensure that money is there to meet their goals, when they are ready to spend it.

There are a lot of ways to get rich. The most reliable way is to spend less than you earn and invest the rest. Repeat consistently for four to five decades, and you are likely to secure a decent retirement. One of our favourite things about being an advisor is hearing the variety of ways people accumulated wealth. We have seen and heard it all. Share options is a common route, as is building a successful, privately-owned business. Then there are high earning professions such as medicine and law. In some cases, we work with the second or third generation of a family.

A common theme among wealthy individuals is the realization that money earned easily can be lost just as quickly. There is a healthy fear of making a mistake they will regret. Morgan Housel put this perfectly in his book, The Psychology of Money:

> *There are a million ways to get wealthy, and plenty of books on how to do so. But there's only one way to stay wealthy: some combination of frugality and paranoia.*

The truth of the matter is that many South Africans have made fortunes in recent years. The bullish market, until 2015 particularly, has made multi -millionaires out of employees and investors in many companies. Some of them will not be able to hold on to it.

Few things compare to the high of making millions off a concentrated bet, whether that bet is on a single stock, building a business, or working for a successful start-up. I imagine the brain responds to this high in the same way it does to addiction. The temptation to chase the next high is all-encompassing. We talk to investors all the time who cannot stop chasing that high.

Getting rich and staying rich are two very different skills. Getting rich is exciting, even thrilling, and often includes lots of risk taking. Staying rich is boring, bordering on mundane. That is because the only way to protect wealth with any degree of certainty is to diversify. Diversification means that parts of the portfolio will always be lagging the rest of the market.

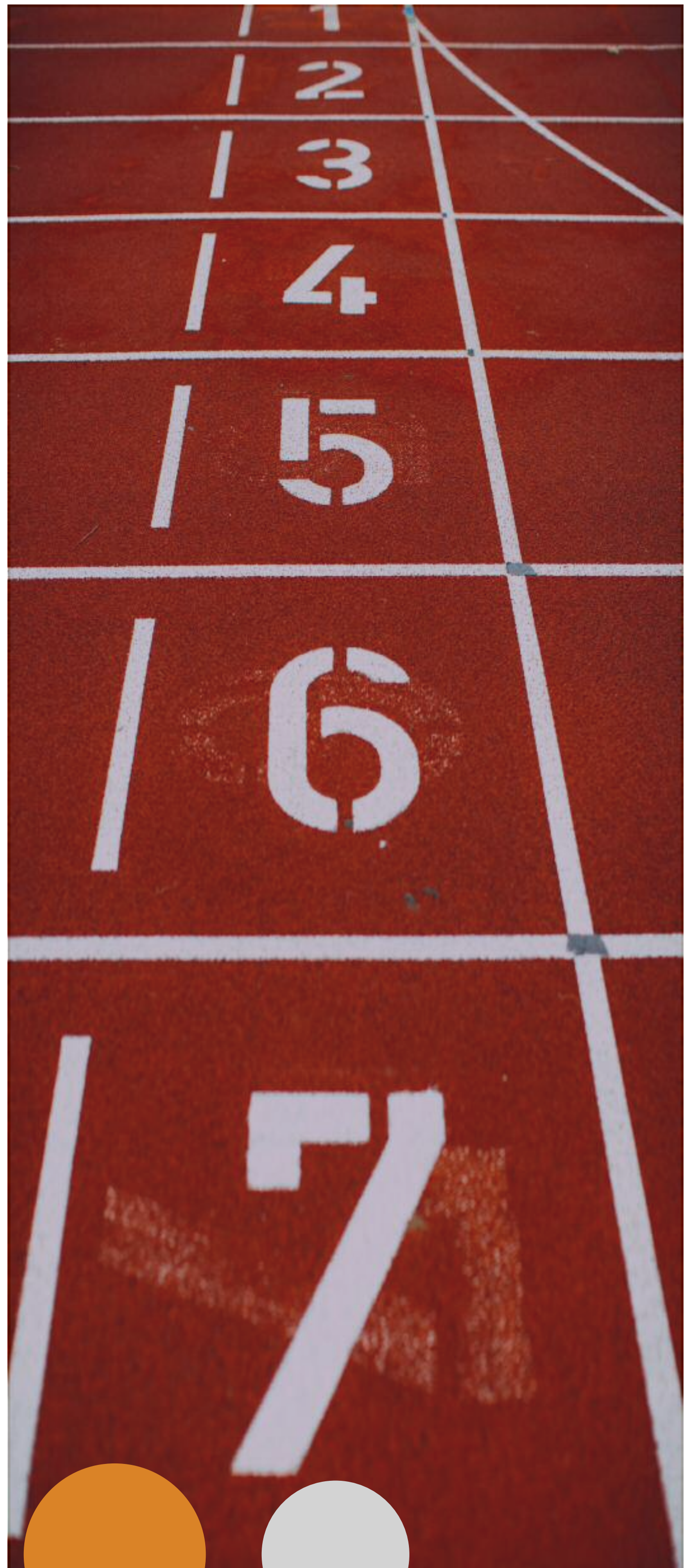
There are trade-offs to every investment and risk management decision. Equity has historically outpaced inflation yet is prone to periodic declines of 30-50%. Bonds provide more stability, but interest rates globally are painfully low. Cash yields zero internationally today, and no real return in SA, but nothing beats access to immediate liquidity when it is needed most.

Looking further down the investment landscape, value stocks have outperformed over the long run, but has experienced a decade of underperformance until the last few months. Growth stocks are the clear winners today (the last 10 years, except from November), but can retreat at lightning speed when sentiment turns. In hindsight, we all wish we put everything in the S&P and the NASDAQ 100 ten years ago and let it ride. Taking a position in a sector, style, country, region or fad means you may outperform for a while, but trends do not last forever. Investing styles come in and out of favour. Even Warren Buffett, arguably the greatest investor of all time, has experienced long periods of underperformance. He is currently in the middle of one.

Then there are the bright and shiny objects that surface in times of euphoria. Today we have Bitcoin, meme stocks, Tesla, ARKK, SPACs, and NFTs. It is hard not to be distracted watching others take victory laps with their winnings on these trades. We have a rule of thumb for this type of investment – If you can set this cash on a table, light it on fire, and watch it burn without risking your financial plan, then go for it. Gamble a little if you enjoy it. If you win, awesome. But you do not need shiny objects to stay rich, and the chances of you getting rich this way are less than winning the lottery.

There is a reason that people hire advisors and have hired advisors since the beginning of this human experiment we call money. They hire advisors who will look at their wealth a step removed from the emotions tied to those dollars. Staying rich is not embedded in human nature. It requires a ruthless lack of emotion about that which we hold most dear, our money.

We simply were not programmed to take a pot of money, place it at risk to daily fluctuations in value (some severe), while waiting for an outcome, decades into the future.



A GAVEKAL Market and Economic Outlook

The speculation in GameStop, SPACs, cryptos and even silver are clear cases of 'greater fool' or Ponzi trades, in which relatively small numbers of early investors make vast profits at the expense of much larger numbers of late entrants who end up losing their shirts.

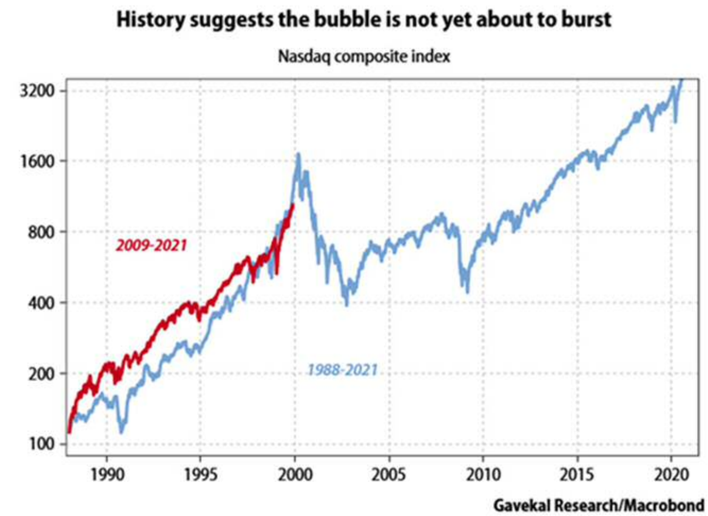
But does this obvious speculative behaviour, along with the recent VIX breakout above 30, mark the beginning of the end of the 12-year bull market that started in March 2009, as some believe? Or is this latest bout of market madness merely the end of the beginning, as Winston Churchill said after the battle of El Alamein, in a new post-Covid and post-Trump bull market that began less than 12 months ago?

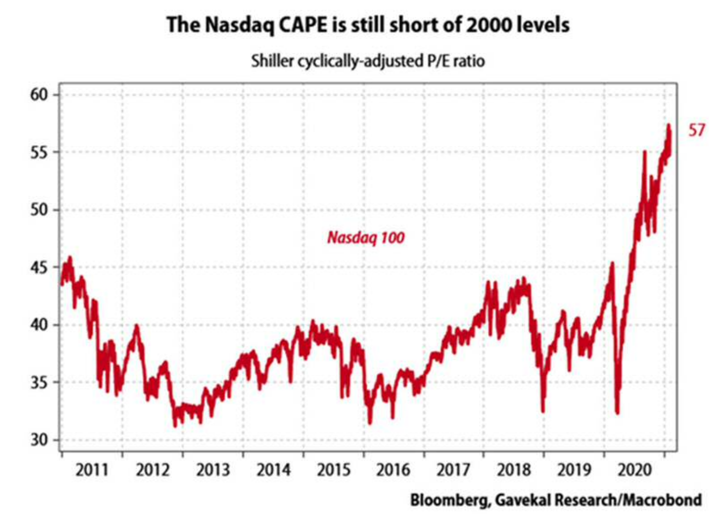
In my capacity as the Gavekal's perma-bull, my bias is towards the latter interpretation, even though I agree with the widespread view that many equity valuations are unsustainably high. I believe that the speculation on Nasdaq today is very similar to the 1998-2000 dot-com bubble, and I expect this bubble to burst in the coming months, causing big losses for some investors.

But I see no contradiction between expecting the Nasdaq bubble to burst at some point this year and remaining fully invested in global equities. In recent Gavekal webinars and client calls I have suggested six reasons why it is no contradiction. What follows is a brief summary:

1. Lessons from the dot-com bubble

Assuming the Nasdaq speculation today is roughly comparable to the 1998-2000 dot-com bubble, that experience suggests that valuations, momentum and speculative behaviour may have to get considerably wilder before the bubble bursts. The experience of 1999-2000 suggests that the current bubble could have another six months to go and that the prices of bubble assets could rise by another 50% or more before the inevitable crash happens.





Or maybe, things could get even wilder. The cyclically-adjusted price-to-earnings ratio, or CAPE, for the Nasdaq 100 today stands at a dizzying 57. This may sound wildly excessive, but according to calculations by our friend Gerard Minack, the CAPE for Nasdaq was at a similar level at the end of 1998 —at which point the dot-com bubble was still to expand by another 140% over the following 15 months

2. Macroeconomic conditions

The macroeconomic conditions today are much more likely to make unprecedented equity valuations sustainable than in the 2000 dot-com bubble, or in the 1989 Japan bubble, or in the credit bubble of 2005-08.

Interest rates are near zero and guaranteed to stay there for at least the next two years, whereas in the previous bubbles monetary policy was being tightened. Even more importantly, the global economy is only starting to emerge from a very deep recession and is therefore in the very early stages of a cyclical upswing.

When the 2000 bubble burst, by contrast, the world economy had just experienced its longest expansion in history and a recession was arguably overdue. Similarly, the economic cycle was long in the tooth when Japan's bubble burst in 1990 and, to a lesser extent, in the US in 2008.

3. The Keynesian policy shift

Looking beyond cyclical conditions, there is a solid possibility that medium-term economic growth will be stronger all over the world than at any time since the 1960s. The reason has nothing to do with the currently fashionable 'roaring Twenties' meme about a temporary burst of pent-up demand after Covid. Rather it is because maximising employment has replaced minimising inflation as the top priority of governments and central banks.

Admittedly, this 'Keynesian golden age' hypothesis has not been seriously considered by other economic analysts or policymakers. But the same could have been said in the early 1980s about the crazy notion that inflation might be permanently eliminated in the coming decade and that interest rates might one day fall below 3%.

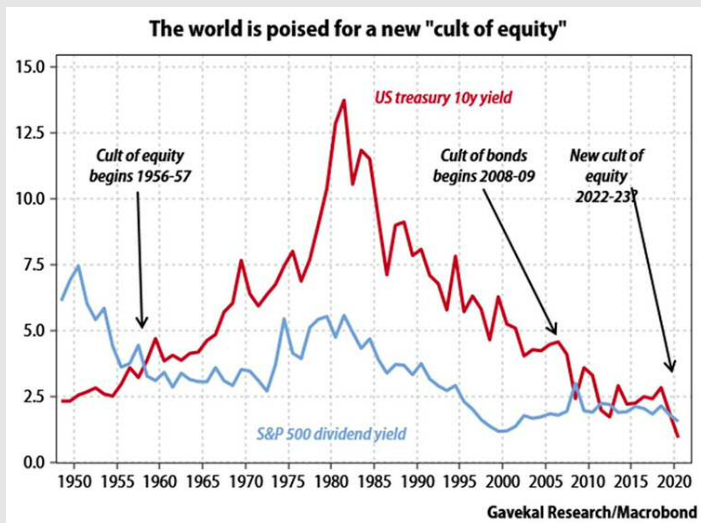
4. A new 'cult of equity'

The bubble in equities is only a ripple on the surface of a much bigger bubble in government bonds. But while it is obvious that investors will lose money by owning $17tn of negative-yielding government bonds, the bond bubble is not going to burst this year – not with central banks everywhere committed to ZIRP at the short end of the yield curve, and to yield curve control at the long end, so that governments can fund their deficits at minimal cost.

That doesn't mean bond yields will remain as low as they are today, but it does suggest that the Federal Reserve, for example, will try to keep US 10-year yields below 1.5%, so that the pre-Covid trading range of 1.5% to 3% is not re-established until the US economy has recovered fully.

By 2022, bonds may move back into their pre-Covid trading ranges, but even then, central banks will try to ensure that yields rise slowly and in an orderly manner. In other words, the bond bubble will deflate in a slow leak, not an explosion.

As a result, there will be a strong incentive for investors to shift capital from bonds into equities and other real-value assets, in a pattern similar to the 'cult of equity' that began in the mid-1950s.

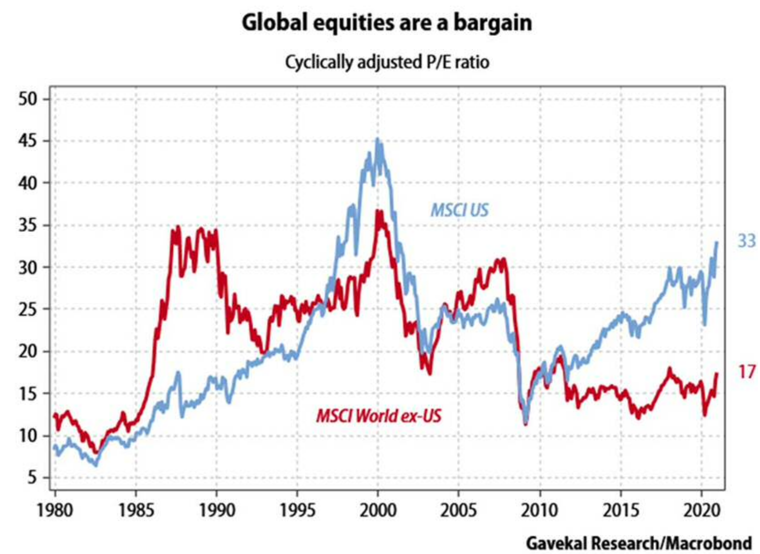


Governments will doubtless try to contain their funding costs by fighting the capital flight from bonds into equities. Central banks may continue with quantitative easing and regulators will continue to require liability-driven investment in 'risk-free' assets.

But, over time, investors and savers will find ways around such rules, as they did after 1956, when George Ross Goobey, one of London's leading pension managers, announced to his astonished colleagues that he had switched the entire Imperial Tobacco pension fund out of bonds into equities, semi-officially inaugurating the cult of equity.

5. The rest of the world

While valuations are historically expensive for US equities, especially for the 'growth stocks' seen as invulnerable to economic or public health conditions, this is not generally true of equities outside the US. A Shiller-type CAPE for non-US markets is lower today than at almost any time since the early 1980s.



Outside the US, share prices are not much higher today than they were 10 or even 20 years ago. Long-term equity returns in the US are almost universally expected to plunge to very low levels in the years ahead because of mean reversion and to reflect very low interest rates. But outside the US, this mean reversion has already happened, as has the adjustment to very low risk-free returns.

In fact, mean reversion in Europe, Japan and the UK would suggest higher equity returns in the decade ahead, as opposed to the lower returns implied by the over-shooting of US equities. Therefore, the rotation from US to non-US markets that started late last year is likely to gain momentum, especially after the Nasdaq bubble bursts. The same should be true of the rotation from growth to value.

6. A predictive bubble

A final reason for long-term optimism about equities, despite the crazy speculative behaviour evident in US markets, is the distinction between 'extrapolative bubbles' and 'predictive bubbles'.

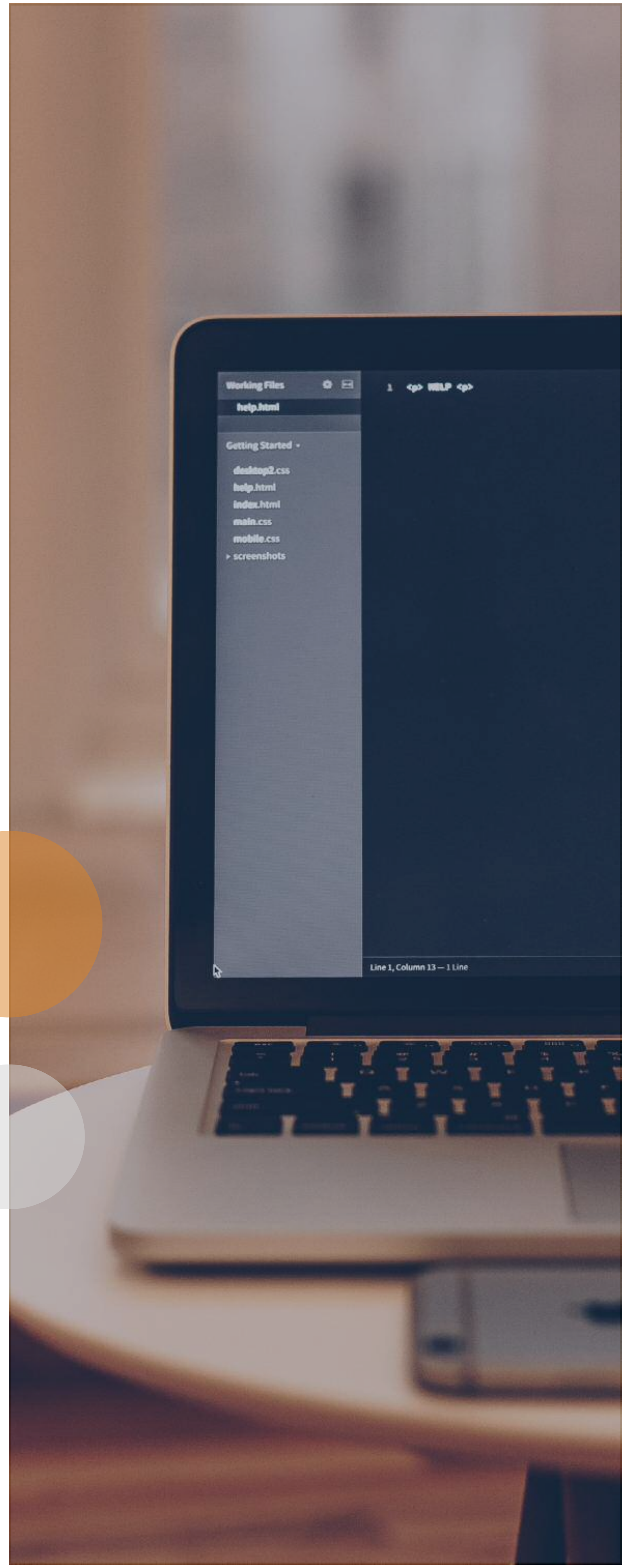
The valuations of legacy social media and Big Tech may be mindlessly extrapolating the exponential growth of these companies over the past 10 or 15 years into the indefinite future. This extrapolative bubble is very similar to the mindless extrapolation of Japan's post-war growth rates in the late 1980s or of the 'nifty fifty' growth stocks like Xerox and ITT in the late 1960s, and it will probably end the same way.

By contrast, the momentum in other apparently bubbly assets – clean energy, electric vehicles, China and in some other emerging markets – is not powered by extrapolating past performance. Many of these assets are driven by expectations and predictions – or in some cases by blind hope – about uncertain regime changes that may happen in the future, as opposed to what is already known about the present and past.

These long-term structural transformations can create 'predictive bubbles', which is how I would describe what happened in Nasdaq 20 years ago. While the 2000 technology crash wiped out silly businesses like Pets.com and also crushed some companies with genuine technological leadership such as Lucent, Nortel and Sun, investors who kept the faith in IT and social networking through the 2000-03 bear market eventually made up for their losses with huge gains in Amazon, Apple, Google and Microsoft.

Something similar will probably happen this time with clean energy and transport. The losses likely in over-hyped companies such as Tesla should be compensated by gains elsewhere in a diversified portfolio of new energy and electrification stocks, maybe even including some legacy auto, energy, utility and chemical stocks that manage to reinvent themselves for the post-carbon era.

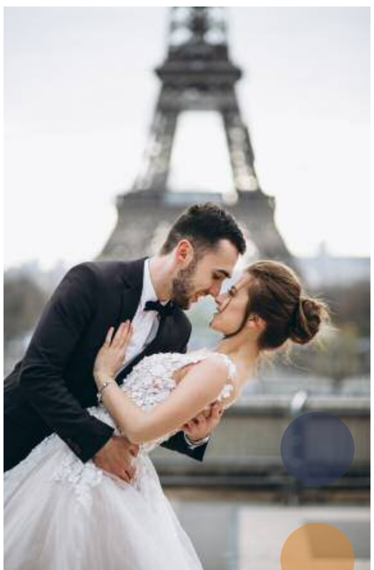
I suspect that the same will be true of investment in China and many emerging markets, as US sanctions force Chinese and Asian companies to develop their own technologies, and financial mechanisms that can withstand foreign pressures, that are fully competitive with the Western world. But I will leave that part of the story to my colleagues in Beijing and Hong Kong.



Estate Planning and the Accrual System

by Fidelis Vox

When a couple gets married and enters into an ante nuptial contract the accrual system is automatically included in terms of the Matrimonial Property Act No. 88 of 1984. The accrual system should be expressly excluded in the ante nuptial contract, if the intention is that it should not be applicable to the marriage.



At the dissolution of the marriage, by way of divorce or death of one or both of the spouses, the spouse or estate which shows the smaller accrual acquires a claim against the other spouse or estate for an amount equal to half the difference between the accrual of the respective estates of the spouses

This could become problematic in the case of the spouse with the smaller accrual dying first and that estate having an accrual claim against the surviving spouse. One way to overcome this issue is for the spouse with the smaller accrual to bequeath an amount equal to the accrual claim to the surviving spouse in his/her Will..

The application of the accrual system can also mean that bequests to beneficiaries in a Will do not end up in their hands, as the accrual claim has to be settled first. An option is for the bequests to the surviving spouse with the accrual claim, to specifically include the accrual claim, or for bequests to him/her to be subject to him/her renouncing the accrual claim. Careful planning needs to be done in such a case, as donations tax may be levied if the inheritance received by the spouse with the accrual claim is less in value than what the accrual claim would have been.

When an ante nuptial contract is entered into, the spouses may specify in the contract which assets are to be excluded from the accrual system- this has to be done and signed before the date of marriage. There are, however, certain assets which are excluded from the accrual system in terms of the Matrimonial Property Act No. 88 of 1984. These include an inheritance, a legacy or a donation which accrues to a spouse during the subsistence of his/her marriage, as well as any other asset which was acquired by virtue of the possession of or former possession of such inheritance, legacy or donation.

Other exclusions from the accrual calculation are donations between spouses, any amount which accrued to a spouse by way of damages other than for patrimonial loss, the proceeds of a ceded policy on the life of a deceased spouse, the proceeds of a policy on the life of a deceased spouse payable to a nominated beneficiary, and lump sum benefits payable to a nominated beneficiary on the death of a member from a pension or retirement fund or group life insurance.

Estate planning for heirs who are physically or mentally incapacitated

When your loved ones are no longer able to manage their own finances, a general or special power of attorney will not entitle you to continue to manage their finances on their behalf. The reality is that, under South African law, if your loved one is no longer able to make his/her own decisions, the general or special power of attorney will fall away.

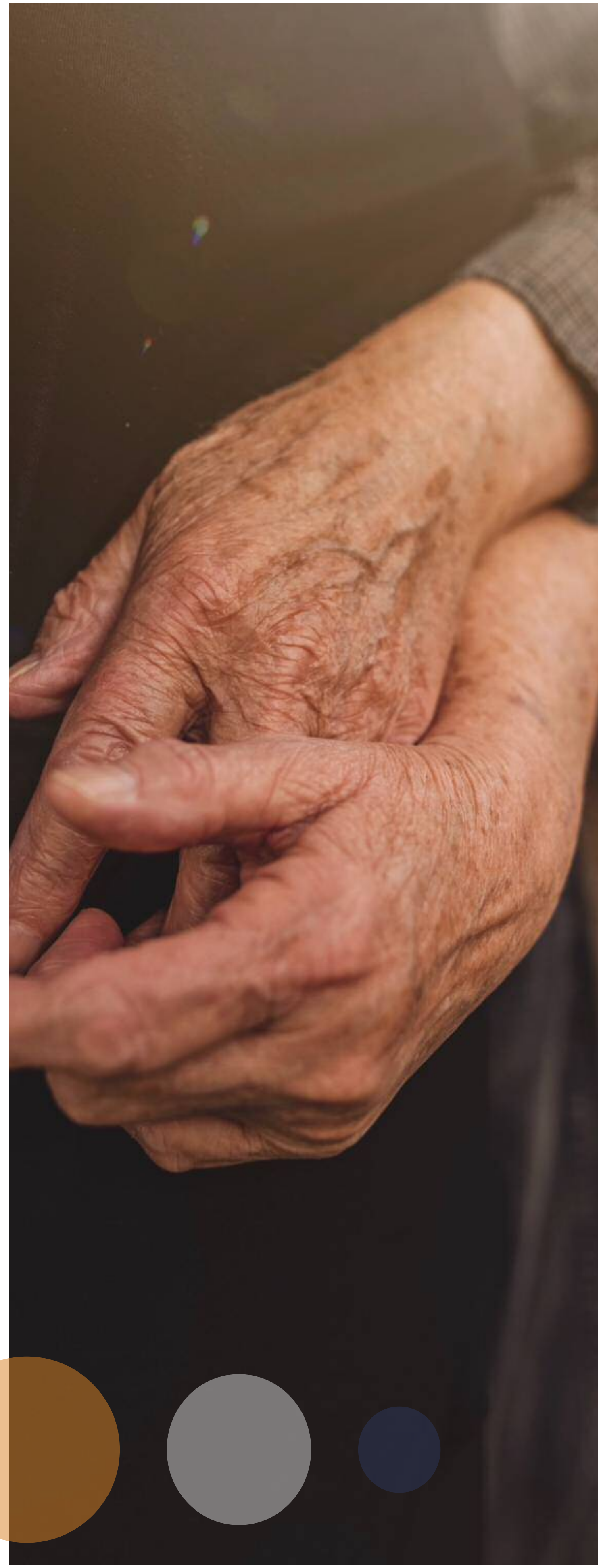
Unlike some other jurisdictions, South African law does not provide for what is known as an 'enduring power of attorney' which continues after the individual who granted it has become incapable of acting legally. Under our law, you can never have more rights on someone else's behalf than the person who granted the rights to you, so if your loved one is no longer of sound mind and they cannot act from a legal point of view, their power of attorney to you will become void and will fall away.

This clearly leaves those looking after a loved one who has lost mental capacity in a predicament, if funds need to be accessed to provide for the individual's personal care.

Alternative solutions:

One potential solution is to apply for the incapacitated individual to be placed under curatorship or administration. The process of applying for curatorship in terms of Rule 57 of the High Court Rules is usually cumbersome and long, and it can be very costly.

An incapacitated person can be looked after from a financial point of view by the trustees of a trust when he/she is a beneficiary of that trust. The trustees remain legally capable to act on that person's behalf in terms of the trust deed, even if that person cannot do so himself/herself any more. This may prove to be practically the best solution in these circumstances. A trust of which an incapacitated person is the only beneficiary of while he/she is alive, may be registered as a special trust to enjoy lower rates of taxes than most other trusts.



MESSAGE FROM CARL RICHARDS

I remember having a conversation once with a woman named Julie. She was 57, retirement was right around the corner, and despite doing "all the right things," she was worried.

Even when she was doing all she could, she often felt like it would never be enough.

If you can relate to Julie, I want you to know: You. Are. Not. Alone.

I have travelled all over the world talking to people about personal finance, and if I had to use one word to describe people's feelings about money, it would be "anxious."

If you, like Julie, find yourself struggling to feel fine despite doing all the right things, may I gently suggest two things to consider:

1. There is no spreadsheet that can guarantee you will be fine.

I know people in the finance industry love to talk about retirement projections as if they can tell you what the future holds, and there is definitely value in having a plan. But the value is not that it gives you certainty. Just like any plan, financial ones are just guessing about the future. They can tell us the general direction we are headed, but they lack precision when it comes to our exact destination.

2. More money does not solve feelings of financial insecurity.

I have met with people who have more money than they could ever spend, and they're absolutely convinced that tomorrow will be the day it all disappears. In fact, in my experience, there is very little correlation between net worth and a personal sense of financial security. To be clear, I am not talking about actual security. I am talking about one's sense of security. Those are two different things.

The truth, as I have written before, is that uncertainty equals reality. As Julie told me, one major medical emergency, not to mention a million other things, can throw a wrench in the whole plan.

And while that is true, it doesn't mean we should live our lives petrified with fear. Living with uncertainty becomes easier once we accept that the magic certainty button does not exist. It is not real, so don't bother looking or hoping for it. It's worth giving a nod here to the Serenity Prayer by the American theologian Reinhold Niebuhr:

> *"God, grant me the serenity to accept the things I cannot change, courage to change the things I can, and wisdom to know the difference."*

Here is a process I've found to be helpful:

1- Make a list of all the things that matter that you do control. Saving something for your retirement, evaluating the way you invest, spending less, finding side hustles to make a bit more, etc.

2- Look at that list and put a big, fat checkmark next to everything you have addressed to the best of your ability.

3- Whatever you did not check off, take some time and effort to work on it.

4- Any time you start to feel fear or discomfort creep up again, just go back to that list, take a deep breath, and remind yourself that you have done everything you can.

5- Repeat this mantra: "Let go of the rest. Let go of the rest. Let go of the rest."

If you can do that—specifically if you can make it all the way to step 5—you have got a touchstone for what can help you feel just a little more comfortable in an uncertain world.