Galileo Quarterly Newsletter

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GENERAL NEWS & INFORMATION

RESIDENTIAL PROPERTY: YOU DON'T HAVE TO OWN IT…EVER

We South Africans have a fixation on property. We are all told from a young age that we have to own property when we grow up. So when we start work we duly find a home and a mortgage and embark on our lifelong property adventure. As we grow older, we require more space and therefore a bigger house and mortgage. This carries on until we retire and decide to look for a smaller home – hopefully this time without the need for a mortgage. Many of us never stop to think whether this is the right way to manage our lives – we do it because that is the way things are done. Perhaps it is time we considered our alternatives.

The table below (Table A) shows the growth of residential property against the share market (equities), cash, listed properties, government bonds, inflation and mortgage (interest) rates. The growth is calculated annually and is calculated over very long periods of time. The reason we look at long term growth is that we can eliminate the distorting effect of short term bubbles or crashes and therefore we get a proper perspective on these investments.

Table A: South African asset classes - performance over the long term

Asset class	Indicator	3 years	5 years	LT – average after inflation
Equities	All Share Index	37.7%	22.7%	7.8%
Residential Property	ABSA House Price Index	23.4%	21.34%	2.4%
Listed Property	SA Listed Property†	31.2%	21.7%	5.7%
Bonds	All Bond Index	10.4%	13.0%	2.0%
Cash	STeFI Call	7.0%	9.0%	1.0%
Inflation	CPIX	4.5%	5.7%	N/A
Mortgage interest rates	ABSA	11.0%	12.74%	14.2%

Compiled by Galileo Capital
Data source: I-Net, Nedgroup Investments and ABSA

From the table we see that the best performing investment (asset class) is the share market. Over the long term it will beat inflation by 7.8% per year whilst residential property is the third best performing investment as it beats inflation by 2.4% per year. It is also important to look at the costs of your investment, in this instance one of the major costs would be a mortgage or home loan. The average mortgage interest rate over the last 40 years was 14.2% per annum. This means that investors in residential property actually paid more in interest than they gained in growth (12.2% before inflation) on the value of the property making residential property a very poor investment.

Unfortunately, mortgage interest is not the only cost of owning a home. There are the initial costs of buying the home including transfer duties, bond registration and legal fees. These costs may be as much as 2.5% - 8% of the value of your home. In addition, you will need to pay an estate agent 3% - 7% to sell your home when it is time to change. There are also the maintenance costs of owing your home - this could average as much as 1.5% of the value of your home per year. This may seem like a lot but this would include: painting (every 5 - 8 years), gardening and plumbing.

Whilst most people would view a residential property as a low risk investment, there are significant risks to consider. These include concentration and liquidity risks. Concentration risk means having too much of your capital exposed to one investment (having too many eggs in one basket) and liquidity risk means the ability to sell an investment quickly. Suburbs often go through cycles that reduce the prices of the properties usually resulting from crime or urban decay e.g. Hillbrow, Sea Point. If this happens, you may struggle to get a reasonable price for a property (bearing in mind that rentals will also decline) or you may struggle to find a serious potential buyer. This will cause a further depreciation in the price as you will need to drop the price further to get a buyer. You will not have this problem with a more liquid investment such as shares or listed properties.

Another factor to consider is the value of the capital that you have tied up in your home that effectively does not “work” for you. An example of this would be a retired person who does not have sufficient income to survive. If the person lives in a R1 million home that is paid off and has an additional R1 million in free capital then he or she could the home and use the R1m to provide additional income and eliminate the cost of home ownership. The person could rent a home for R7 000 a month and still have an additional R3 000 to R4 000 in disposable income that will be created from the savings on municipal rates and maintenance. If the R1 million is properly invested the capital should grow by more than the inflation rate and therefore the capital can be used to further supplement the retiree’s income. By comparison the rent should only increase with inflation.

In summary, it may make more financial sense to invest your money in growth assets and only rent a home. However, financial considerations are only one of the factors that influence your lifestyle decisions, if you are in a sound financial position, you may derive more benefit from the emotional security of property ownership. Conversely, if you are retired and do not have sufficient retirement capital it may be worth your while to do some calculations to see if you should keep your home or sell it.

ECONOMIC IMPACT OF THE INCREASED CRIME RATE

The updated crime statistics for the 12-month period Apr 2006 to Mar 2007 confirmed what we already knew, the crime rate in South Africa is escalating. As investors it is important for us to understand the potential economic impact of the increased crime rates in addition to the social impact. Firstly, it is worth examining what types of crimes have increased - the murder rate is up 6% whilst robbery at residential premises is up 25.4% and robbery at businesses is up 52.5%. These crimes are not random in nature, they are more likely the work of organized criminals. This means that these types of crimes cannot be attributed to the usual causes such as poverty and high unemployment.

This is disturbing as it means that we are becoming more vulnerable to organized crime, which can only be managed by effective policing and may be the clearest sign yet that our police are becoming less effective over time. It is widely acknowledged that is very difficult to prevent random crimes that result from poverty through effective policing – the best method of preventing this type of crime would be economic upliftment.

On a positive note it is conspicuous that the increased crime levels have not corresponded with a slowdown in foreign investment into the country. Foreign investment is critical for us to maintain our Balance of Payments. Continued foreign investment is also critical for maintaining our levels of economic growth, which is critical for creating increased formal employment. Should organized crime continue to increase at current rates, we could see a negative impact on local and international investment in the country. Naturally the cost of doing business has increased as companies spend more on security. This reduces margins and is equivalent to a non-productive tax which is harmful to the economy.

There has been a noticeable increase in the number of people emigrating from the country. According to Econometrix, it is still a fact that the majority of professionals in South

Africa are White and according to the population statistics released on 03 July 2007, the White population declined by 13, 200 for the year to end July. As the majority of emigrants are qualified professionals, the loss of skills are detrimental to our economic prospects especially at a time when we are actively recruiting skilled immigrants.

GALILEO CAPITAL NEWS

GALILEO CAPITAL UNDER NOW UNDER ONE ROOF

We are very happy to announce that we are settled in our new offices in Hyde Park. This means that our insurance broking and consulting divisions are now in the same offices as our stock broking, wealth management and structured finance divisions. Please feel free to come have coffee and enjoy our new home with us.

GALILEO CAPITAL PROTECTOR

In August 2006 we launched the first Protector product. This is a guaranteed product that allows investors to invest in the stock exchange with a capital guarantee. It is designed for investors who have a short time frame (three years) and want to invest in equities. Since inception the first investors have had excellent growth of 35.22% over 10 months which equates to 42.26% per annum. Investors who have been invested since October have achieved a return of 24.53% which equates to 36.79% per annum. This is an excellent return when you consider that investors have a capital guarantee. This product will not suite everyone as the time frame is short and investors with a longer investment horizon have better alternatives. If you have a three year view and want an equity investment with a guarantee then this is a great investment for you.

FIXED FEE INVESTMENT PLANNING SERVICE

As you may already know, we provide Wealth Management and Financial Planning services at Galileo Capital. We have two primary groups of clients, High Net Worth individuals who need their existing wealth managed and individuals who are interested in having an Investment Plan developed for them. In this Newsletter we will focus on our Investment Plan, which is a holistic plan where we outline our client’s their current financial position and indicate what they should do to achieve their financial objectives. We charge clients a fixed fee of R1,500 plus VAT for this Plan.

Our Plan provides our clients with a very good understanding of their current financial position and what they need to do to ensure that they are able to achieve their goals. We usually indicate how much extra they will need to save and what capital they require at retirement. In addition, we provide recommendations as to what investments should be used to achieve these objectives. The responsibility for implementing the Plan remains with our clients and we earn no fees from the investments we recommend. The people that find this service valuable are: younger individuals, people who manage their own affairs and individuals who already have an advisor and would like an objective second opinion.

AGRIXCHANGE

We mentioned in our last newsletter that we had developed a new funding product for Wine Farmers who deliver their grapes to cooperative cellars. We are happy to report that we have provided funding for our first clients and have seen tremendous interest from the broader market. As this is a very innovative new offering, we expect to be fully subscribed in the next few months particularly as the problems at the Land Bank continue.

STAFF NEWS

Deon Schoeman

Deon is one of our founding Directors and is in charge of our Structured Finance and Consulting divisions. Deon is an avid fly fisherman although his wife Farinda seems to have his match on the river. They are the very proud parents of four daughters with eldest (twins) recently celebrating their 21st birthday.