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Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – November 2016

A Note from Theo and Warren

The rand is a bit like a stretched elastic band at the moment. The pressure is on from an international perspective for the rand to strengthen; only domestic politics keep stretching it further and weakening it in the process. Any positive news like the scrapping of the case against Pravin Gordhan leads to an immediate strengthening.

Unfortunately if there is a significant increase in domestic political instability, it might cause the rand to snap. We hope that the series of court cases including the charges against Zuma and the Public Protector report on State Capture go positively.

The first of the ratings agencies will release their view on South Africa on 25 November, and the other two a few weeks later. We hope for good news on this front, but we are not optimistic unless we see further positive political news in the next few weeks.

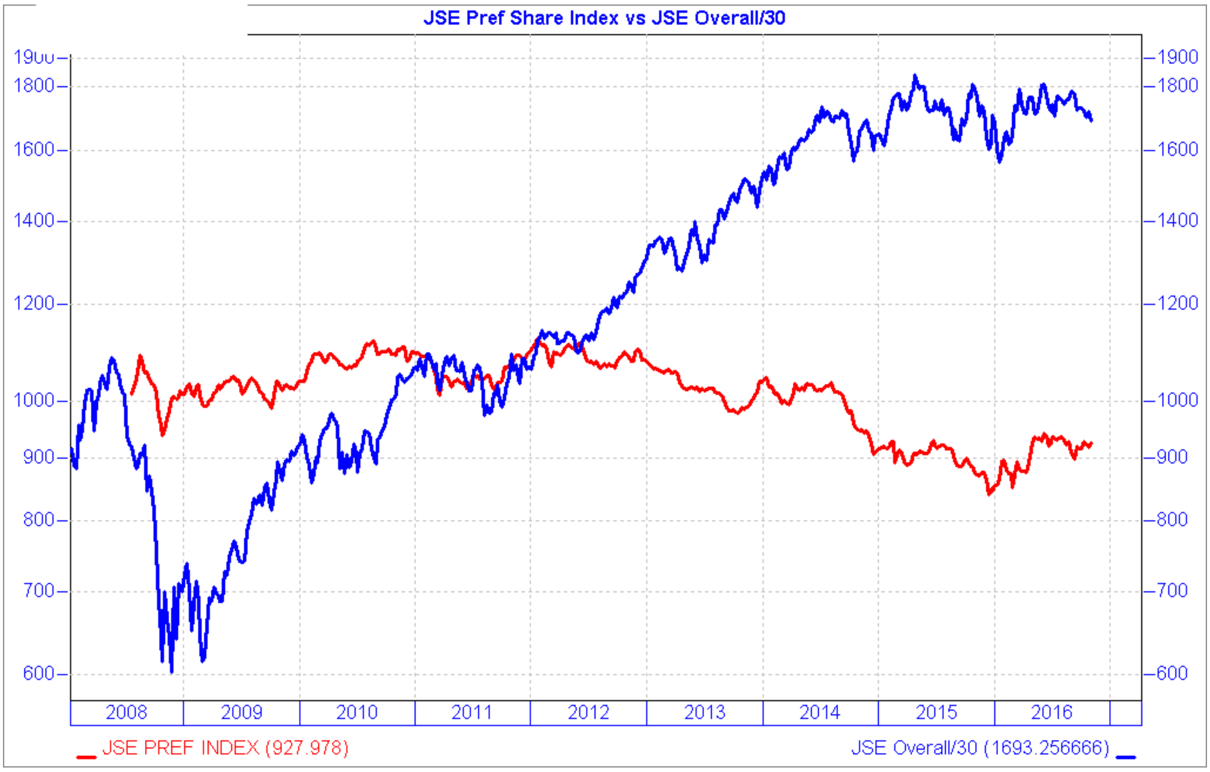
- Theo and Warren

Investing versus parking

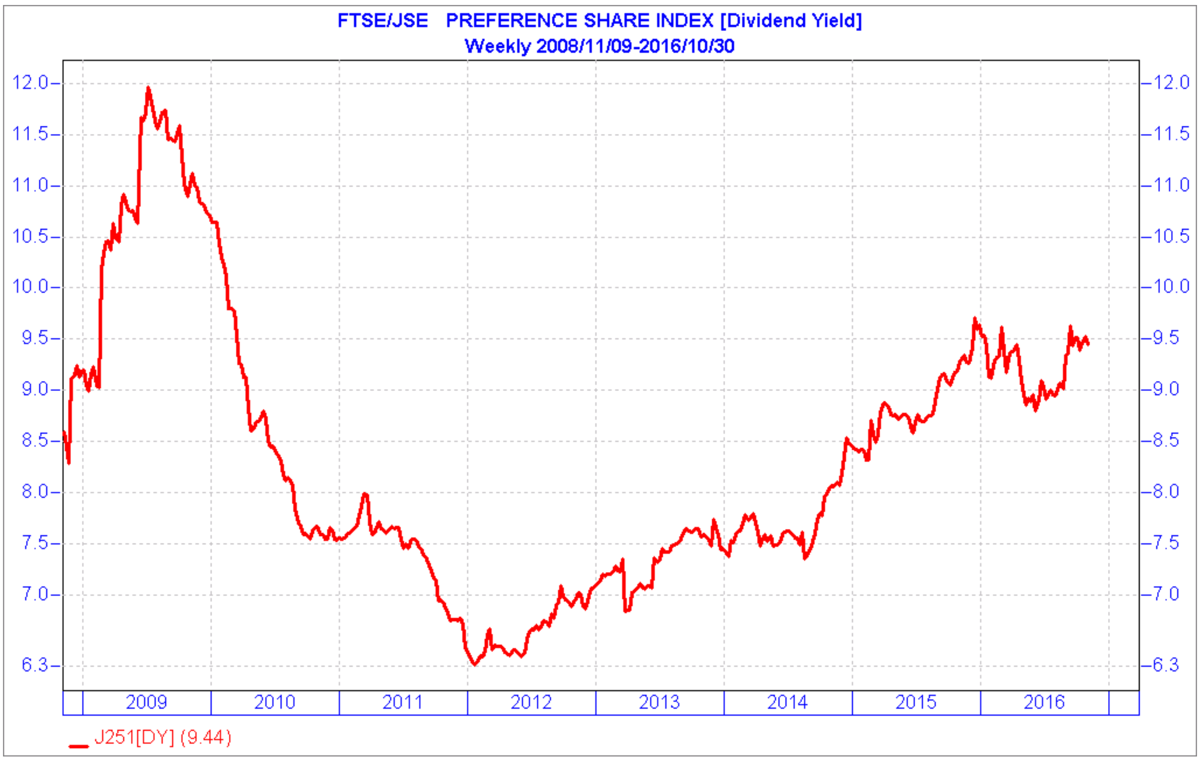
I've no doubt you've heard the mantra many times, but it bears repeating: "Cash – whether local or offshore – is not an investment – it's only ever a temporary parking zone." To which I might add the reminder that the best investments (by a long way) for the very long term, are shares and listed property.

However, we acknowledge that short-term visibility, or certainty, does come first at certain points or periods in life. Thus we would like to highlight an alternate asset class to consider for temporary/intermediate cash parking needs over one to three years: preference shares.

The graphic below shows the significantly lower volatility of preference shares (red) vs. shares (blue):



What is not illustrated in the graphic above, is the excellent yield offered by preference shares, as illustrated in the next graphic:



What is even more attractive is that preference shares are not taxed as interest bearing; they are classified as dividends, which makes them very attractive to high bracket taxpayers. The current dividend yield of 9.5% for preference shares from the big four banks is very attractive indeed, in our view.

Most of the backsliding we've seen since 2014 in the index of preference shares, has related to concerns about a possible downgrading in South Africa's national credit rating, as they relate to underlying banks. Markets are now pretty much regarding such an event as a fait accompli, so that's already discounted (as it is for shares, bonds and the SA Rand forex rates). Indeed, the possibility of "no-downgrade" may start featuring as a possible sweetener in South African assets.

Of course there are some risks we need to highlight: preference shares are part of the capital structure of banks, and as such they rank behind depositors and bond-holders in seniority. The yields do fluctuate as a function of prime interest rates, so the pay-out profile remains aligned with the interest rate cycle, and does not vary as widely as occurs with bonds.

Overall, the high yield is adequate risk-adjusted compensation for high bracket taxpayers to consider this alternate parking strategy instead of cash deposits.

- By Warwick Lucas, chief investment officer, Galileo Asset Managers

Five ZAR-friendly holiday destinations

When the rand is in free fall it can easily have an impact not only on your mood, but on your plans for international travel. Suddenly your dreams of exploring other corners of the world don't seem quite as attainable as they used to be.

But there are still a lot of destinations that won't empty out your piggy bank – here are five places you might not have considered:

1. **Budapest, Hungary** – Not everywhere in Europe is expensive. Prices for a beer or a cappuccino are pretty much what they are in South Africa. Budapest is home to magnificent architecture, including one of the largest synagogues in the world and boasts one of the oldest ever underground railway systems.

2. **Bucharest, Romania** – The "Paris of the East" will give you a whole new experience of Europe. Bucharest will delight with 17th and 18th century Byzantine churches tucked away on narrow streets, inexpensive street food and a fascinating 21st century art scene, plus the gorgeous Cișmigiu Gardens.

3. **Cambodia** – Cambodia is a beautiful blend of ancient and new. In Ankhor Wat, be moved by the unbelievably intricate stonework and other-worldly sculptures. Cambodia has been through so much turmoil, but its people are warm, and the untouched islands in the south are well worth a visit.

4. **Laos** – This quiet, verdant jewel of southeast Asia is a land of quiet temples, steep green hills and the lazy Mekong River. Laos's 4 000 islands are home to the rare Irrawaddy dolphin, and French-influenced Luang Prabang is an indochine dream.

5. **Maputo, Mozambique** – Maputo has undergone a revival, and is fantastic for those who like a festive, with-it kind of feel. The music scene is a draw, as are the young designers

and entrepreneurs. And it's really close for South Africans, so there are no long-haul flights to worry about – you can be on holiday in just a few hours.

The best ways to secure your financial freedom

In order to secure your financial freedom you need financial back-up. If you have a way to pay for any unexpected expense that comes your way, be it a repayment on a vehicle or the ability to pay cash for the excess when the geyser goes, having the money available helps to give you total peace of mind.

As with anything in life, you need a plan, and for financial security that plan starts with a budget.

Because we are creatures who crave instant gratification, drawing up a budget is something we generally resent. The easiest way to do your budget is to split your income in three, one third to cover all the daily expenses, one third to spend on something you enjoy, ie. holidays, and the balance towards savings.

Otherwise you can make use of goals-based budgeting. Calculate your net salary – this is the gross salary minus tax, medical aid deductions and retirement savings. Use 50% of the net salary for fixed expenses, 30% for variable expenses and 20% for saving towards goals. Make sure the 20% does not sit in your bank account, otherwise you may be tempted to use it.

Secondly, you should have an emergency fund. We usually recommend that you keep three to six months' worth of living expenses in this account. This helps you to manage expenses such as car tyres, some school event that you didn't plan on, or an insurance excess payment. We all know that these expenses happen from time to time and having the money available ensures that you do not derail your plans for holidays, retirement and the like.

Debt can obliterate any plans you have for financial freedom. The only debt that could be seen as "good" debt is where the asset which is bought with debt increases in value over time, for example, your home.

The other debt people always say you cannot get away from is when you buy a vehicle. But you should not feel the need to replace the vehicle as soon as it is paid off with one of a higher value. Most vehicles can last for much longer than five years without giving you any mechanical problems. Save the amount you would pay on a new vehicle and buy your replacement vehicles with cash. You will save an enormous amount on interest.

Store cards, credit cards and personal loans are also an absolute no-go if you want financial freedom.

Lastly, make your savings work for you. Once your emergency fund is set up, channel your savings to retirement funds, tax-free investments and then some discretionary savings.

There seems to be a lot of negativity around retirement savings, but this is the only investment that gives you free cash in the form of a tax rebate. Currently you can invest up to 27.5% of your income in a retirement fund and claim all the tax on these payments when you do your tax return. If you are in the maximum tax bracket that gives you 41% of your payments back in your pocket.

The best option is to re-invest this money, but it can go towards your holiday or any other big purchase you have in mind.

Other great investment vehicles are tax-free investments and unit trusts. Always make sure that your investment is transparent and that you know exactly what it is you are investing in and what the costs are.

Make sure that you put money away every month and that it actually beats inflation over time. It always helps to get some direction and if you are not sure where to start go and speak to two or three financial advisors. There are advisors who will do an hourly consultation and it might be all you need to put you on the path of financial security and freedom.

- By Yolande Botha, head of wealth, Galileo Capital