NFB
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PROFICIO
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FROM THE CEO's DESK

Pre-amble: with our CEO, Mike Estment, taking on the challenge of climbing Aconcagua in Argentina, the highest mountain outside of Asia and one of the Seven Summits, the honor of writing this month's "From the Desk" falls to me - Paul Marais. What follows is an extended version of NFB Asset Management's recent December 2015 Newsletter.

With Nhlanhla Nene having been summarily removed in December 2015 as South Africa's Finance Minister, to be replaced with political-appointee, David van Rooyen, who himself was replaced just four days later by Pravin Gordhan, South Africa must have the dubious honour of the planet's shortest-lived Finance Minister. Gordhan was previously Finance Minister, replacing Trevor Manuel in 2009 and occupying the role for just over five years.

One could be forgiven for thinking then that December 2015 represented an unusually tumultuous time in the marketplace, to the extent that anything in the market is unusual, and that a return to the workplace in the New Year would be accompanied by calmer markets. Not so! Markets have, if anything, been even more tumultuous in the first few weeks of the year than they were at the back-end of last year.

China has had to suspend trading a number of times on their stock exchange as selling pressure forced their markets down enough during certain trading sessions to trigger automatic closures; a safety-value mechanism all markets have in order to introduce a period of inactivity in which calm might hopefully prevail.

Saudi Arabia – together with other members of OPEC (Organisation of Petroleum Exporting Countries) – in continuing to flood the market with oil to drive American shale producers out of the market, have found the global oil gorilla to be bigger and nastier than they first imagined, leading to speculation that they intend to publicly offer equity interests in their state-owned oil company in order to raise cash for their swiftly dwindling national coffers. Saudi Arabia, together with OPEC, may also have seriously underestimated the ability of US-based shale producers (frackers) to adapt to changing market prices for their end products. More recently, the effects of the lifting of sanctions against Iran will need to be factored into the global price of oil; it is not unreasonable, therefore, to expect the oil price to be under continued pressure.

And then there's the behaviour of the rand. A year ago the rand was below 12 to the US dollar. It now finds itself pushing 17 to the dollar. Whilst it may be a rumour that a trade based in, possibly, Japan, placed a sell ZAR/buy USD order at 17.99, it certainly isn't a rumour that the Barmy Army, currently touring the country and quite possibly enjoying the extra few days off in Johannesburg, gave up counting from 1 up to the current exchange rate against the pound at the Newlands Test Match between England and South Africa.

We are only able to maintain the somewhat irreverent tone adopted thus far because we believe that – whilst this is difficult to do at portfolio valuation time and desperately uncomfortable given that even if your exposures are low you are still exposed – these types of markets create opportunities. Though there is a fair argument that our President's unilateral actions in December have meaningfully contributed to the ongoing erosion of South African's wealth in foreign currency terms, the reverse is also true: foreign currency holdings have appreciated significantly in rand terms. For those portfolios where there are offshore assets NFB AM's Investment Committee are looking to repatriate these as both a profit-taking and risk-mitigation strategy.

In addition, there are a number of local assets that may not appear interesting enough to talk about over the dinner table or at cocktail parties, but are beginning to show signs of investment merit. Here, the Investment Committee is looking very closely at vanilla government bonds where the nominal yields have increased (as prices have fallen) to such a level that they are beginning to provide attractive real returns, i.e. a bond issued by the South African government with a reasonable maturity term (i.e. not too far away) and a large enough yield (say 10%) has a place in a portfolio where the benchmark is inflation given that the market anticipates inflation is going to be somewhere between 6.5% and 8.0%. ■

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ACTIVE VERSUS PASSIVE INVESTMENT MANAGEMENT

The active versus passive debate has been raging for a number of years now. We thought it would be instructive to explore these concepts further so that you might understand what role these investment strategies could potentially play in your investment portfolio. Firstly, however, it makes sense to set out what is meant by the terms 'active' and 'passive' as the investment management industry has habits, amongst many others, that are relevant here: the first being the inclination towards using jargon, and the second being the predilection towards assuming that everyone else cares about, and understands, these terms. Neither habit is particularly useful when engaging with potential investors.

ACTIVE MANAGEMENT

Active management is the process of selecting securities from a pre-defined universe of securities and allocating investments amongst these securities in order to achieve a pre-defined benchmark. Note the inclusion of the words “pre-defined”; that's an important element of the process. These universes could consist of nearly anything, but generally are grouped by asset classes: all the securities that make up the Top 40 of the JSE All Share Index by market capitalisation, for example. Benchmarks also vary widely and are the result of an agreement between the investor and the portfolio manager. In the Top 40 portfolio “above the benchmark” might be the broad JSE All Share Index; with the portfolio manager attempting to achieve this by selecting from only the Top 40 shares measured by market capitalisation. Importantly, all benchmarks should have a measurement period. The above example would probably come with a rolling five to seven year performance measurement period.

> “Active management is the process of selecting securities from a pre-defined universe of securities and allocating investments amongst these securities in order to achieve a pre-defined benchmark.”

The key distinction between active and passive investment strategies is that the manner in which the portfolio manager selects securities for inclusion is up to the manager, their team and/or their investment process and is generally disclosed to investors upfront. The manner chosen spans the range from gut feel right through to very sophisticated investment processes, which have varying degrees of quantitative work. Generally speaking, the process, the team and/or the manager involved in running the portfolio are expensive

> In the same way that an active managers' investment process and ability to achieve a certain benchmark within a prescribed set of opportunities must be assessed in determining their suitability for a particular investor, so too must the rules-based approach of a passive manager be assessed on the same criteria.

resources; the cost of which is borne by the investment portfolio itself.

PASSIVE MANAGEMENT

Passive management, too, is the process of selecting securities from a pre-defined universe and allocating amongst these securities in order to achieve a pre-defined benchmark, which also comes with a measurement period. The key difference, however, is that the manner in which the securities are selected is rules-based. As with active management, the choice of which set of rules to use is up to the provider of the passive product. As strategies for active managers can vary, so too can rules for passive managers. Rules might include matching the weightings of a selection of securities in a portfolio to the same weighting for the same securities in a publicly available benchmark, like the JSE All Share Index, or they might simply be to build a portfolio consisting of the ten securities with the best 1-year historical dividend yields. The resource requirement for a passively managed investment product is far lower than that for a similar active strategy and this allows passive strategies to have lower cost profiles relative to their actively managed counterparts. This doesn't, however, mean that all passive products are cheap or that all passive products that are similar have a similar fee.

It's easiest to compare active and passive management in the equity space, but both investment strategies can be deployed into any asset class (equities, bonds, property or cash, locally or globally or a combination of both) or even amongst asset classes. Increasingly, there exist passive asset allocation portfolios that have a fixed rebalancing schedule which are becoming increasingly popular with investors who are looking for a simple blend of a number of asset classes for their portfolios.

Further, like active managers that choose to specialise in certain market sectors (Japanese mid-capitalisation equity portfolios or South African long-term bond portfolios, for example) so too is there specialisation within the passive industry. For example, it is possible to obtain exposure to South African inflation-linked bonds through the RMB Inflation-X product.

This raises an additional characteristic of active versus passive management. The RMB product mentioned earlier is an Exchange Traded Fund (ETF); essentially a portfolio with multiple investors (a bit like a collective investment scheme (CIS)/unit trust) that is listed on a securities exchange (the JSE in this instance). The majority of passive products are in ETF or CIS form, but the majority of active management takes place through non-exchange traded products (unit trust funds or limited liability partnerships, for example). Though this is swiftly changing. The inward-listing of Astoria, a portfolio of equity securities amongst other items, on the Johannesburg Stock Exchange where the portfolio management is conducted by Anchor Capital, is a good example.

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Having worked through these key differentiators and characteristics of active versus passive management it is clear that not only is there a wealth of choice within each portfolio management strategy, but that the low-cost nature of passives shouldn't be the driving factor behind decision-making. In the same way that an active managers' investment process and ability to achieve a certain benchmark within a prescribed set of opportunities must be assessed in determining their suitability for a particular investor, so too must the rules-based approach of a passive manager be assessed on the same criteria. For example, if an active manager has an exposure to a security that subsequently falls in value and a passive manager has a similar exposure it won't matter whether the portfolio results were because of poor decision-making/the absence of a robust investment process or whether the rule being followed was poor; the investment outcome will be the same. The suitability of the portfolio for the client will be the over-riding, determining factor of whether the investment, and therefore the subsequent return, was appropriate or not.

There is also the presence of research indicating that the average active manager underperforms the benchmark by the extent of their fees and whilst this is empirically true for a given set of observations it, like most things in life, doesn't apply everywhere all of the time. Passives, therefore, shouldn't be selected simply because of a dim view on active managers. There are certain market sectors and certain market conditions when being exposed to a non-rules based portfolio can protect against losses, participate in gains or do both.

Should you have any queries with regards actively or passively managed portfolios, please do not hesitate to contact an NFB Private Wealth Manager at one of our NFB offices in Johannesburg, East London, Port Elizabeth, Stellenbosch or Cape Town. ■

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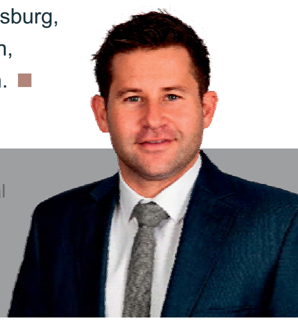

RETIREMENT REFORM

In the past, many have found it difficult to distinguish between all of the different kinds of retirement vehicles, due to the differing tax treatments, caps on contributions and maximum tax deductions of each. However, The Tax Laws Amendment Act 2015 has passed some new rules into law, which will harmonise the annuitisation requirements and tax treatment for all of the retirement vehicles as from 1 March 2016. This new piece of legislation will not only make it easier to come to grips with all of these complexities, but will also offer an opportunity for taxpayers to take advantage of a legal form of tax savings, by increasing contributions to retirement funds. The legislation will also assist in ensuring that the majority of retirement funds (pension, provident and retirement annuity funds) are annuitised and retirement funds aren't withdrawn and unnecessarily spent.

The new legislation allows a maximum tax deductible contribution to all retirement funds of 27.5% of the greater of remuneration and taxable income. This tax deductible contribution will be capped at R350 000 per annum. Those who have been contributing more than this amount towards their retirement savings each year, will have the option of contributing more than this and making use of the tax deduction of the amount contributed that is over R350 000 in later years. If any of these non-deductible contributions have not resulted in a tax deduction by the time the individual who made them retires, the contributions will not be taxed at retirement or withdrawal.

Only employees will now be able to claim tax deductions in respect to both employee and employer contributions, and if the employer makes the contribution, it must be included as a Fringe Benefit in the gross income of the employee to neutralise the effect.

> “The increased tax-deductibility of contributions to retirement funds is an incentive being offered by the government to encourage South Africans to take responsibility for their retirement savings.”

Up until this point, provident funds and provident preservation funds have not been subject to the retirement annuitisation regime that is applicable to pension funds and retirement annuities. However, as from 1 March 2016, this new legislation ensures that provident and provident preservation funds are subject to these same annuitisation rules. However, this is subject to the below provisos:

- If the total of the 'retirement interest' in the provident fund is less than R247 500, the rule of having to annuitise will not apply and the full amount will be able to be taken in cash.
- Balances in provident funds as at 29 February 2016 plus growth will always be available in cash (vested interest).
- The annuitisation requirement will not apply to members who are 55 years and older as at 1 March 2016, for as long as they remain members of that provident fund.

The increased tax-deductibility of contributions to retirement funds is an incentive being offered by the government to encourage South Africans to take responsibility for their retirement savings. This, along with the change in legislation of provident funds having to be annuitised will hopefully result in more South Africans not unnecessarily spending retirement funds, which in turn should result in more South Africans being financially independent by the time they reach retirement age.

Should you have any queries or would like assistance with your retirement planning, please do not hesitate to contact an NFB Private Wealth Manager at one of our NFB offices in Johannesburg, East London, Port Elizabeth, Stellenbosch or Cape Town. ■

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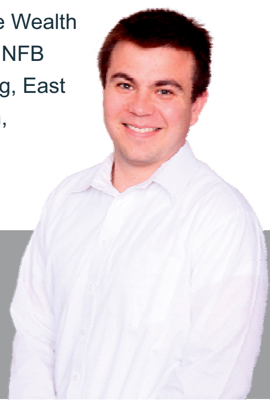

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