Vickers & Peters
LIFESTYLE AND ASSET PLANNING

"Around the Table with Vickers & Peters Financial Planning"

Issue 06 – April 2008 **Quarterly Publication** *Compiled by Graeme Holt*

Budget Highlights 2008/2009

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Retirement Funds

The new tax regime effective 1 October 2007 on lump sum benefits remains unchanged, as does the tax deduction limits on contributions to retirement funds – Please see the October issue 04 of Around the Table for further information.

Estate Duty and Donations Tax

- The first R100 000 of property donated in each tax year by a natural person remains exempt from donations tax as do donations between spouses.
- The rate of estate duty and donations tax remains unchanged at 20%.
- The estate duty abatement (exempt threshold) remains at R3.5 million.
- A new specific exemption from estate duty up to a specific threshold (yet unannounced) will apply to certain structures of life assurance payouts. Certain structures of pension benefits upon death are also under review.

  With this in mind life assurance will become an even more attractive way of providing for Estate liquidity.

Capital Gains Tax

- The annual capital gain exclusion will increase to R16 000 (previously R15 000).
- The capital gain exclusion on death remains unchanged at R120 000.00.
- The primary residence exclusion remains unchanged at R1.5 million.
- The maximum effective rate remains 10% for individuals, 14% for companies and 20% for Trusts – although correctly structured Trusts can result in the individual rate being applicable.

Transfer Duty

- The rates remain unchanged. Houses costing less than R500 000 will attract no duty. The 5% rate will apply between R500 000 and R1 million, and the 8% rate will apply thereafter. The flat rate for companies and trusts remains at 8%.

Companies and Close Corporation

- The rate of tax has been reduced to 28% (previously 29%) in respect of the next year of assessment – 01 April 2008 to 31 March 2009.
- Secondary tax on companies (STC) remains at 10%. This will be replaced with a final withholding dividend tax of 10% during 2009.
- The total rate of tax (normal tax + STC) where all profits are distributed is 34.55%

Individuals

- The interest exemption has increased to R19 000 (previously R18 000) for individuals under 65, and R27 500 (previously 26 000) for individuals over 65. R3 200 (previously R3 000) of the above exemption can be applied to foreign interest and dividend income.

Individuals income tax rate and bracket structure

2007/08		2008/09	
Taxable Income	**Rates of Tax**	**Taxable Income**	**Rates of Tax**
R0 - R112 500	18% of each R1	R0 - R122 000	18% of each R1
R112 501 - R180 000	R20 250 +25% of the amount above R112 500	R122 001 - R195 000	R21 960 +25% of the amount above R122 000
R180 0001 - R250 000	R37 125 +30% of the amount above R180 000	R195 0001 - R270 000	R40 210 +30% of the amount above R195 000
R250 001 - R350 000	R58 125 +35% of the amount above R250 000	R270 001 - R380 000	R62 710 +35% of the amount above R270 000
R350 001 - R450 000	R93 125 +38% of the amount above R350 000	R380 001 - R490 000	R101 210 +38% of the amount above R380 000
R450 001 - Above	R131 125 +40% of the amount above R450 000	R490 001 - Above	R143 010 +40% of the amount above R490 000

Rebates		Rebates	
Primary	**R7 740**	Primary	**R8 280**
Secondary (65 & over)	**R4 680**	Secondary (65 & over)	**R5 040**

Tax Thresholds		Tax Thresholds	
Below age 65	R43 000	Below age 65	R46 000
Age 65 & over	R69 000	Age 65 & over	R74 000

Taxpayers over 65 years continue to be exempt from the payment of provisional tax, provided their taxable income does not exceed R80 000 p/a and is derived solely from salary, interest, dividends and rental.

Medical expenses

The deductible portion for contributions made by members to their medical schemes has increased by 7.6% from R530 to R570 for each of the first two beneficiaries and by 7.8% from R320 to R345 for each additional beneficiary.

This translates into the following tax saving for a family of five:

2007/2008 tax year
R530 + R530 + R320 + R320 + R320 = R2020

2008/2009 tax year
R570 +R570 + R345 + R345 + R345 = R2175

The increased deduction will thus reduce the tax liability of the tax paying contributing member by R155 for the tax year.

Market Update – the last quarter

The aim of this quarter's Around the Table will be not to dwell on the macro-economic variables which have been so well publicized in recent months but rather revisit the importance of portfolio asset allocation and strategy.

However, because these macro economic variables have had such a direct impact on portfolio performance over the last 3 months it would be unjustifiable to ignore them completely. So before we attempt to illustrate the importance of asset allocation and strategy and link these two portfolio fundamentals with the performance of your portfolio I have bulleted below the macro economic themes grabbing the headlines over the last quarter.

- De-coupling of global markets – the US still a dominant factor in global markets.
- Global credit crunch – further right downs from banks, FED lead bailout?
- US recession – weak housing market, weak consumer, weak US$.
- Higher inflation numbers – high oil, fuel, energy and food prices.
- Resource lead rallies – high commodity prices.
- Weaker rand – slowing capital inflows, government imports.

What does emerge from all the noise as the two most notable factors for investors has been the commodity price surge and the currency movement (R/$ 6.81 on 01 Jan 2008 to R/$ 8.07 on 27 March 2008 – 18.5% movement). Both these factors have had a significant impact on recent market behaviour and portfolio performance.

From an asset allocation perspective we will take a closer look at the importance of diversifying offshore and from a strategy viewpoint illustrate why VPFP prefer general equity managers as apposed to theme or specialist equity managers.

Offshore asset allocation

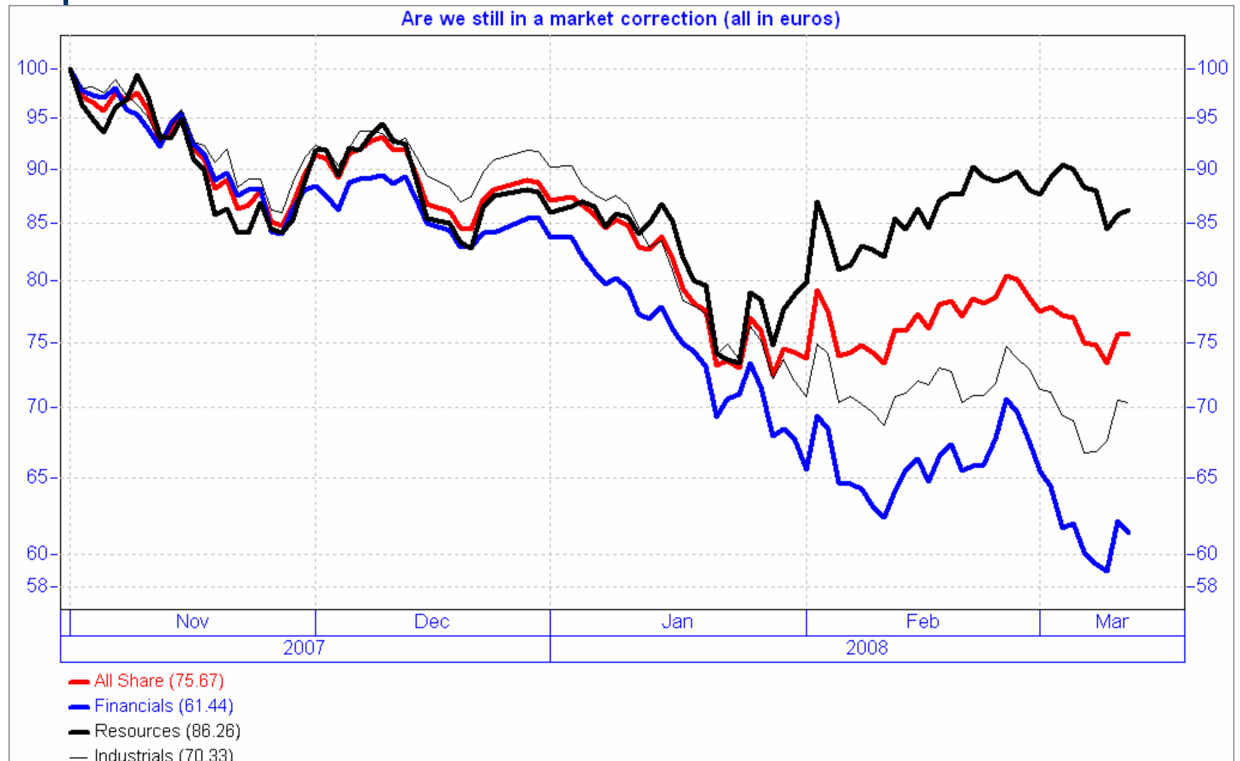
In previous issues of Around the Table we mentioned the vulnerability of the Rand to future weakness and the importance of holding a Rand hedge position by including offshore assets as part of the portfolios strategy to lower risk and volatility.

Although offshore assets have been out of favour since the Rands recovery in 2002 and the rampant local price movement in equities since 2003, it should never be totally discarded from an investment portfolio. Apart from the obvious benefit of providing a Rand hedge, it also provides exposure to developed market economies and quality companies with globally diversified source of earnings. With SA accounting for 1% of the MSCI All Companies World Index, it would suggest a myopic view to investing if offshore exposure was not considered. Interestingly, global emerging markets as a whole account for only 11.30% of the MSCI All Companies World Index – (source: MSCI Barra Global Capital Markets Yearbook 2007).

Sanlam recently produced a graph which sums up the current situation and provides a sobering example of the impact currency movements can have on performance. **Graph 1** below illustrates the performance in Euros of the ALSI (Red), Resources (Thick black), Financials (Blue) and Industrial indices. As can be seen all four indices have been in a downward trend since the end of October and despite the recovery from the lows in

January 2008, they have still not recovered to their October highs. Looking at Resources in isolation between the 31st October and 14 March, the Resource index is down roughly 14% in Euros and up around 13% in Rands i.e. a direct beneficiary of a weaker Rand!

Graph 1



Source: Sanlam

The recent Rand weakness is a timely reminder of the cost investors pay by not including offshore diversification. The optimal amount of offshore exposure would depend on the client's needs and objectives. Although current legislation only allows for 15% offshore exposure in Preservation Funds and Retirement Annuities, an alternative would be to invest in a voluntary product and attain the necessary offshore exposure either via Rand denominated offshore funds or through asset swap.

Equity strategy

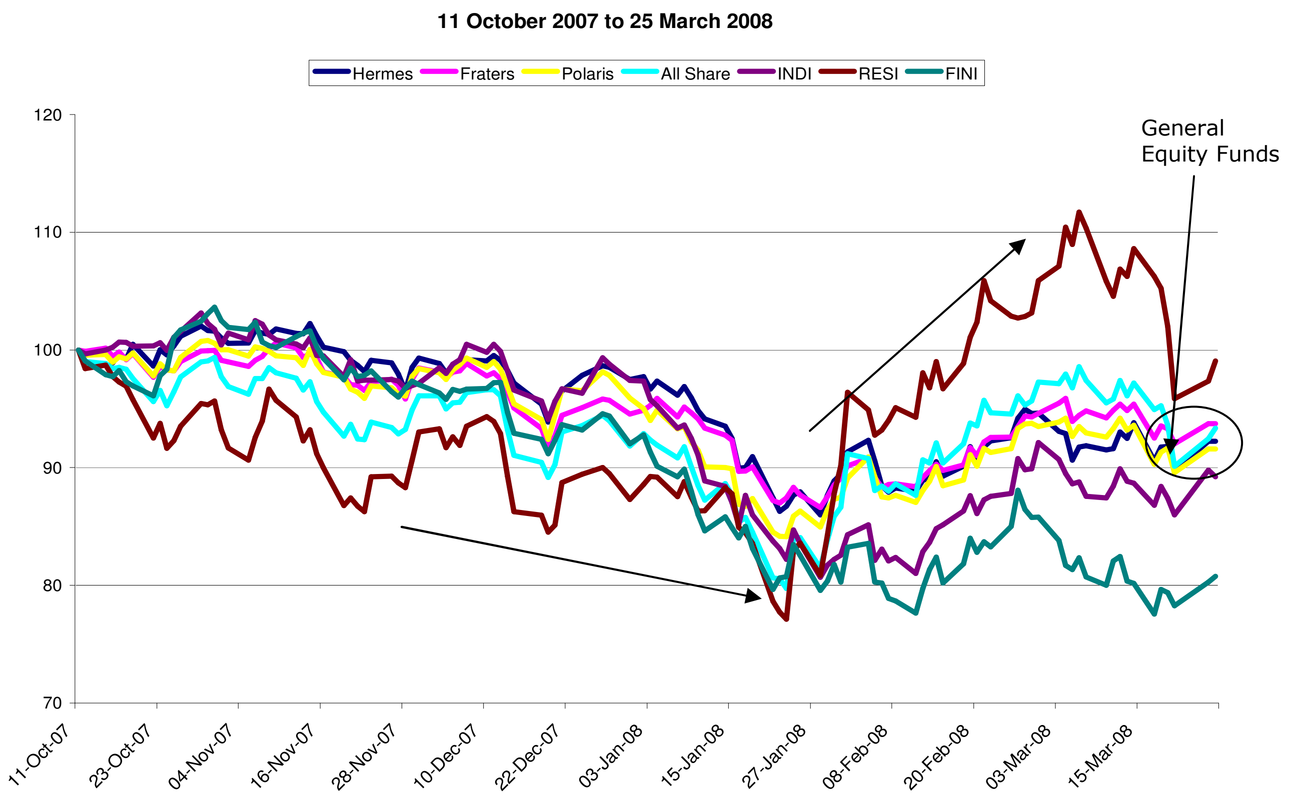
Clients should take comfort from the diversification that is attained through our general equity manager exposure. General equity managers are not restricted like many of the other fund managers to narrow investment mandates which could restrict them to selecting sector specific stocks (resources, industrials or financials), theme stocks (small caps or large caps) or stock classes (cyclical or defensive, growth or value). Typically, general equity managers would have access to the entire market and would rely on their stock picking ability for outperformance. The freedom to be able to rotate between sectors remains an attractive feature for investors.

The recent market behavior is a very good example of the benefits of a general equity manager. With resources up 40%, industrials 10% and financials flat since the January lows it clearly illustrates that fund managers that have had no exposure to commodity stocks would have barely participated in the upsurge.

Graph 2 below shows the performance of the ALSI, Resources, Financials and Industrial indices against the performance of our three houseview equity funds, namely, Hermes Equity, Fraters Earth Equity and the Nedbank Rainmaker Fund (Polaris) for the period 11

October 2007 to 25 March 2008. With Resources being the top performer and our equity managers keeping pace with the ALSI (Fraters Earth Equity has outperformed the ALSI, with all three general equity managers attaining better risk vs return characteristics), two important factors have emerged. Firstly, as mentioned above, if you had no exposure to commodity stocks the downside you would have experienced would have been far more severe if your exposure was restricted to financial or industrial stocks. Secondly, although Resources has outperformed one always needs to consider the cost of performance i.e. the amount of risk relative to return. As can be seen, the price movement of commodities has been far more volatile than all the other graphs, underperforming the market for the first three months (down 22%) and jumping 44% between its January lows and its March highs – not for the faint hearted!

Graph 2



Source: I-Net

The value proposition for any general equity fund investor is to be able to benefit from the independent skill of the manager which emerges with the ability to select any stock in the market based on fundamental research. We feel the risk vs return characteristics of our funds will become even more attractive over time as sector performance rotates and our managers are able to exploit opportunities and capture returns.

Although there are many challenges ahead and definite headwinds for equity investors, the market continues to offer good long term opportunities for those who are patient enough to follow a disciplined risk strategy in order to achieve their objectives.

Risk vs Volatility - Are your investments really that "risky"?

With the newspapers bombarding investors with gloomy tales of sub-prime losses, negative revisions in GDP projections, increasing interest rates and rampant inflation, we are frequently hearing that they feel that "they need to take less risk right now". That's fine, but do they **really** know what "risk" is?

Joe Public will tell you that a risky investment is one in which you can "lose money". He'll tell you that if you bought a share for R100 last year, and it is currently worth R80, he's "lost" R20. But has he? What happens if he holds onto that share and next year it is worth R120? Then he has not incurred a "loss", but has in fact made a "gain". What Joe thinks is "risk", is in fact "volatility".

It is the nature of equity investments that they are volatile and their values are going to fluctuate from time to time. It is also the nature of equity investments that, over time, they tend to go up. Sure, not all investments go up and we know that a small proportion of businesses will fail from time to time.

To decrease the probabilities of investing in a company which will fail (and in which you would be forced to realize your loss), it is thus advisable to diversify your investment into more than one stock. This you can do either by buying a basket of equities yourself, or by getting exposure to a unit trust which holds a range of stocks in it.

If we accept that you will only realize a loss if you sell your investment for a value less than you purchased it for, then it is also necessary to look at the time frame within which you are investing. If your investment horizon is long enough in that you can wait for the value of your investment to bounce back to above the level at which you bought it, you will never have to realize any loss. If, however, you are **obliged** for one reason or another to sell your investment before it regains its value, then the choice of waiting-out the recovery of your investment is taken away from you.

It is thus of great importance that you have an appreciation of the volatility of an investment you intend to undertake, as well as the "recovery time" therein. For example, in a diversified pure equity investment, due to the volatility of such investments the probabilities of negative returns over the short-term (let's say 1-3 years) are high. Consequently, if you are taking a sum of money which you will be required to realize during that time and investing it in equities, the probability of you having to realize a loss during that period is also high. On the other hand, if you have an investment horizon of five years or longer for your equity investment, the probability of realizing a loss over that time is very low.

Let us now look at where we are today. Yes, your investment may be "worth" less than it was four months ago. If you sell now, you will "realize" those losses. If, on the other hand, you do not have to sell now, but can wait for the value of your investment to return to and then exceed the value it was at last year, you will have successfully learned the difference between "volatility" and "risk".

To those of you out there who would like some help with identifying the correct investment(s) for your particular risk tolerance and time-frame, please speak to a financial advisor. You'll be glad you did.

We would like to thank Alphen Asset Management for their contribution to this edition of Around the Table.

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"Time is our most valuable asset, yet we tend to waste it, kill it, and spend it rather than invest it."

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