The Investor

In our 26th year of free service to the South African investing public!

The tragedy of the Genteel Poor

by Richard Cluver

Faced with the new reality of living costs creeping insidiously upwards as the inevitable consequence of the "Quantative Easing" exercises of the world's major central banks, I am increasingly being called upon to assist elderly folk to squeeze retirement incomes out of shrinking capital sums.

The problem would have shown up anyway because folk are living much longer today than ever before and the world is still stuck in the rut of an outmoded retirement planning model which was designed for an era when mankind normally expected to live only a few years after retirement. But the global financial crisis and Central Banks' efforts to rescue the major economies from catastrophic meltdown has unleashed a new wave of global inflation that will in coming years make life increasingly difficult for people forced to live on fixed incomes.

Advances in medicine over the past 50 years have offered us all much greater life expectancies which have in turn burdened us all with greater medical costs than many of us can afford. Meanwhile, longevity has for over a decade been increasingly burdening pension schemes. Fund managers were, in turn, obliged to seek ever-higher yields from investments which inevitably led to a climate of greater risk-taking which in turn set the scene for what became known as the "Sub-Prime Crisis", a derivative-fuelled investment bubble that eventually brought the world economy crashing down.

For centuries mankind accepted, to quote Psalm 90, that "The days of our years are three score years and ten": a score being the biblical measure for 20 and so a reasonable life expectancy was 60. Thus as recently as the 1970s the average South African corporate employee signed on to a pension plan that assumed he would retire at 55, giving him five "golden years" before he shuffled off. Of course a few of us lived longer, but enough of us conformed to the average and so annuity-based pension schemes became the basis of what was then considered to be sound retirement planning practice. The annuity system creates an income stream by assuming that interest and dividends derived from an accumulated capital sum can be supplemented by drawing down a portion of the capital each month.

Such schemes worked well when life expectancy beyond retirement was around ten years, but not when people are hoping to stretch pension benefits to last 30 or more years. Today, however, actuaries tell us a significant proportion of our youth can expect to live well beyond the age of 100. This being so, it is extremely dangerous to rely upon pension schemes which base their planning on annuity-based retirement, and even more so for individuals to do so.

I should add that until very recently, the annuity system was regarded as the conservative approach to retirement planning. In most of Europe, governments were happy to go the far more dangerous route of non-funded pensions. Here, instead of requiring their workers to contribute a portion of their earnings to the build-up of a capital sum to fund their future pensions, the State merely guaranteed such pensions and relied upon tax income to fund the system. That approach also worked reasonably well until people both started living much longer and having fewer children. Fewer young taxpayers entering the system meant a dwindling tax base which thus made it increasingly difficult for governments to meet their obligations. Not surprisingly then governments began borrowing on an ever-increasing scale which is why we today have countries like Greece, Spain, Portugal and Ireland floundering in insurmountable debt.

Never has it been more important than now for ordinary people to realise that they cannot rely upon their governments or their employers to plan their futures. It is incumbent upon us all to emphasise to young people just starting out in their careers the critical importance of building a solid retirement nest egg…..in addition to any pension plan that their employers might offer. My own fundamental rule of asset-building is to commit to saving a tenth of one's income from day one. And by day one I mean from the very beginning of one's money consciousness. I have repeatedly demonstrated that parents who start their children on the road to responsible money management by, from their earliest experiences combining regular pocket-money payments with savings incentives, usually reap the reward of seeing their offspring grow up as responsible self-sufficient citizens.

I have personally observed such children complete their education and enter the workplace with lump sums under their control sufficient to either fund the down-payment on a house or to finance the start of a business enterprise. Putting numbers on such examples as I have witnessed and, without detailing all the arithmetic, young people who have followed this route are today starting out with nest eggs worth R100 000 and more.

In stark contrast, there are retired folk who have been used to a comfortable lifestyle throughout their working days, now being forced to sell their homes in a depressed market in order to try and ease the bleak reality of an inadequate retirement income. Take the example of someone at the upper end of the middle-income group whose salary at retirement was R30 000 a month who had worked for the same company for the past 30 years; on the old defined benefit system of pension

planning, his pension would be calculated on 30/60 times his retirement salary. Thus upon retirement his monthly income before tax would fall to R15 000. However, he was able to commute a third of his pensionable amount. Calculate it out and you would see that he would have been able to draw out a lump sum of plus/minus R600 000 and his retirement income would have fallen to R10 000 a month.

All well and good if he had wisely re-invested the R600 000 in blue chip shares which would have guaranteed him a steadily-rising dividend income during the the years of his retirement. Too many folk, however, saw that lump sum as a retirement bonus to be spent on home improvements, a round-the-world holiday or a new car. Then there were compelling arguments to bail out children from debt, helping with the education of grandchildren, paying for a wedding etc. Suffice to say, most folk soon saw that “retirement bonus” spent. Meanwhile monetary inflation, even at the modest six percent or so average of recent years, meant that their pension buying power was being halved every 12 years.

So we have the classic case of the 72-years old pensioner who retired at age 60 and could just get by on a R10 000 a month then, is now being totally crippled by a monthly R4 000 municipal rates, water and electricity bill, A R1 500 medical aid bill and car running costs of at least R1 000 a month. About the only thing such folk are able to economise on is the grocery bill! This is the daily reality of a large proportion of South Africa’s “Genteel Poor”: folk who are having to swallow their pride and call on family and friends for help because in their twilight years they are no longer able to adequately feed themselves, let alone enjoy any of the things that they took for granted for most of their lives.

At the heart of their problems is the fact that they are living too long. But the real tragedy is that our society did not equip them or adequately advise them of their need to set aside savings in the good years in order to ensure a comfortable retirement.

Now our Genteel Poor pensioner might have ended his earning career on R30 000 a month. But the reality of inflation means that his grandchildren are starting work on a similar sum. So let us assume that these young people are able to save a tenth; that is R36 000 a year and, keeping it simple, elect to invest that money in the Satrix Divi which since 2009 has been growing in value at compound 16.8 percent, then it is easy to see how our young person could quickly build up a lump sum:

In the table below I have extrapolated what would happen to our young investor's money if he were saving a tenth of his income annually using the Satrixc Divi and, to keep it simple, he did not enjoy a single pay increase during his first decade of saving. As I have illustrated, in a decade our young investor would have amassed over R1-million in investment capital. Were he to continue this process for a total of 30 years, he would achieve a capital sum of R38-million: sufficient at this time to fund a very comfortable retirement.

SAVING A TENTH OF YOUR INCOME			
INCOME		360000	
INTEREST RATE		18.6	
YEAR	SUM SAVE	INTEREST	TOTAL
1	R36 000	R6 696	R42 696
2	R36 000	R14 637	R93 333
3	R36 000	R24 056	R153 389
4	R36 000	R35 226	R224 616
5	R36 000	R48 475	R309 090
6	R36 000	R64 187	R409 277
7	R36 000	R82 822	R528 099
8	R36 000	R104 922	R669 021
9	R36 000	R131 134	R836 155
10	R36 000	R162 221	R1 034 376

However, let us be more realistic and assume that our young investor enjoys a 10% annual pay increment and let us also assume that inflation runs at a constant rate of 6% during the next decade.

' SAVING A TENTH OF ANNUALLY INCREMENTED SALARY				
ASSUMED AV INFLATION RATE %				6
ASSUMED SAL INC RATE %				10
RETURN ON SAVINGS				18.6
YEAR	SALARY INCREMTD	REAL VAL OF SALARY	MONTHLY VALUE	YEAR END VALUE
1	360 000	338 400	30 000	35 580
2	396 000	351 936	33 000	81 336
3	435 600	366 013	36 300	139 516
4	479 160	380 654	39 930	212 823
5	527 076	395 880	43 923	304 501
6	579 784	411 715	48 315	418 440
7	637 762	428 184	53 147	559 302
8	701 538	445 311	58 462	732 668
9	771 692	463 124	64 308	945 213
10	848 861	481 649	70 738	1 204 918

Now we see that our young investor will have saved R1.2-million in ten years and, while his annual salary will have nearly trebled to R848 861, the erosive effect of inflation will have cut the buying power of that sum to R481 649. However, notwithstanding inflation, the buying power of his nest egg will have held up well. In fact, after 30 years he will have saved a total of R61.8-million: quite enough to provide him with a secure retirement income regardless of the impact of inflation.

However, good as it is, the Satrix is no match for a portfolio of blue chip shares which, as my graph below illustrates, have been growing at a compound annual average rate of 25.4 percent and on top of that have paid an average dividend yield of 3 percent over the same period.

Assuming then that our young investor was prepared to take a little trouble to isolate blue chip shares from the rest, guess where he would be in ten years time…and in 30?

' SAVING A TENTH OF ANNUALLY INCREMENTED SALARY				
ASSUMED AV INFLATION RATE %				6
ASSUMED SAL INC RATE %				10
RETURN ON SAVINGS				28.4
YEAR	SALARY INCREMTD	REAL VAL OF SALARY	MONTHLY VALUE	YEAR END VALUE
1	360 000	338 400	30 000	38 520
2	396 000	351 936	33 000	91 832
3	435 600	366 013	36 300	164 521
4	479 160	380 654	39 930	262 515
5	527 076	395 880	43 923	393 467
6	579 784	411 715	48 315	567 248
7	637 762	428 184	53 147	796 587
8	701 538	445 311	58 462	1 097 882
9	771 692	463 124	64 308	1 492 252
10	848 861	481 649	70 738	2 006 879

Yes, you read correctly. At the end of ten years our young investor would have accumulated a capital sum of R2-million and, were he to continue in that manner for a total of 30 years, his capital would have swelled to an amazing R375-million providing him with, by the most conservative dividend yield, a monthly R1-million; quite enough to retire to a mansion in the south of France.

ANCHOR CAPITAL

RICHARD CLUVER OFFSHORE MANAGED PORTFOLIO

The Parties

Richard Cluver is a legend of the SA private client investment world. Over many years his Sharefinder programme and regular publications have been guiding SA investors on the JSE and offshore markets. Richard is also the author of numerous investment books.

SAXO BANK

Saxobank is a Denmark-based bank, which focusses on providing trading platforms to investors all over the world. This portfolio is managed on the Saxobank platform and provides investors with 24-hour online access (PC, iPhone or iPad) to their segregated portfolios.

Anchor Capital is SA's fastest growing asset manager, and is the FSB-registered entity which will implement the Richard Cluver Offshore portfolio on the Saxobank platform. Anchor Capital has offices in Durban, Sandton, Irene and London.

The facts and figures

- **Fund manager: Richard Cluver and Anchor Capital**
- **Asset class: Offshore developed market long-only portfolio of equities, initially limited to those listed on the London Stock Exchange**
- **Minimum investment: R500,000**
- **Nature of product: Segregated portfolio with shares owned in the investor's name. These are held on the Saxobank platform, with a London domicile.**
- **Default currency: Pounds**
- **Risk profile: Medium**
- **Management fee: 1% per annum**
- **Investment horizon: 3-5 years**
- **Liquidity: Investors can sell their portfolio at any time**

Nature of the equity investment portfolio

This is an investment in offshore listed shares following a model portfolio compiled and regularly updated by Richard Cluver, in collaboration with Anchor Capital. The initial focus will be on London-listed equities.

The shares are purchased in an account in the investor's name on the Saxobank platform—in other words, the investor owns the shares directly. This is the ultimate protection in the volatile investment world, and there is complete transparency for the investor.

Richard's investment process has been developed and fine-tuned over decades. The approach is:

- Firstly, to apply a number of **fundamental filters**, which identify shares of sufficiently high quality which are trading at attractive valuations.
- Secondly, a **technical overlay** is applied which assists in timing the purchase of the shares and setting target prices for purchase.
- A portfolio is the constructed taking the overall mix and exposure into account. Shares are **patiently accumulated**, with acquisition target prices in mind.
- Shares will normally only be sold in the event of a deterioration in balance sheet fundamentals or unjustified valuations.

The objective of the portfolio is **capital growth over the long-term** and is appropriate for investors who wish to have a managed offshore equity component to their portfolio.

The risk profile is considered "medium", as equities are volatile by nature.

Contact: FJ Veldman (012-686 3481); Peter Armitage (011-783 4793); info@anchorcapital.co.za

Anchor Capital (Pty) Ltd, FSP number 39834. www.anchorcapital.co.za

The Ten Minute Millionaire

Tailoring a portfolio to your personal risk profile

by Richard Cluver

Let us start with the observation that there is never a one-size-fits-all share portfolio. We each have our own individual investment needs and ability to cope with risk.

Deciding what your personal requirements are requires that I remind readers of the process I described early on in this series which enables me to define and categorise investment grade shares. I define a Blue Chip as a share of a company that, among a series of qualities, has paid constantly-rising dividends over at least a decade. At the time of writing there were some 71 companies listed on the Johannesburg Stock Exchange that had delivered consistently-rising earnings over the past decade. In the table below, I have listed them all. I have, furthermore, grouped these shares in a descending series of seven rankings which, in a nutshell, represent ever-increasing risk as one moves down through the categories. I defined these as follows:

The Grand Old Favourites

This is the safest category of all for long-term investment. Within it are found the “big cap companies” with, in South Africa, a market capitalisation exceeding R10-billion, companies which have consistently delivered higher than average earnings, dividend and price growth rates over extended periods of time. This is a category which by definition includes shares in companies beloved of people seeking to set up widows and orphans trust funds. Collectively the group enjoys lower price volatility than long-dated Government bonds and I accordingly use their mean volatility rate as the benchmark against which the volatility of all investment grade shares is rated in order to, within the ShareFinder computer analysis system, create risk ratings for every listed company.

Mid-Cap Companies

These are companies with a market capitalisation greater than R1-billion that have also delivered consistently high earnings, dividend and price growth rates over extended periods of time. Like the Grand Old Favourites they normally enjoy both extremely low rates of price volatility and high dividend and share price growth rates.

Tightly-Held Mid-Cap Companies

This category enjoys all the attributes of the Mid-Cap Companies with one exception, that relatively small numbers of the shares are available to ordinary investors. This makes them comparatively hard to obtain and in theory renders them liable to severe price volatility. In practice, however, they are tightly-held precisely because they return such consistently high dividend, earnings and price growth rates that the voting blocks which control them are unlikely to sell

Blue Chips

These are the companies that remain when the above three categories have been stripped out of the list of companies that have consistently delivered rising dividends over at least the previous ten years. As a rule these are also extremely safe investments but they tend to deliver relatively lower total returns than the other three categories.

Medium-Term Market Leaders

Drawn from a list of companies whose primary fundamental quality is that they have paid constantly rising dividends for a minimum of five but less than ten years, these are a category which have in addition also experienced exponential rates of dividend growth. Usually this category of companies will provide the highest share price increases, making them the market darlings for a while. Few, however, have ever managed to maintain these very high growth rates for extended periods. The best of them subsequently end up in the Grand Old Favourites, Mid-Cap or Blue Chip categories if they are able to sustain their exponential dividend growth rates for at least ten years, but usually by this latter stage the dividend growth rate will have slowed to a more measured and sustainable rate. The majority, however, run out of steam and quite often fall from grace. It would accordingly be unwise to weight too many of these into a long-term growth portfolio.

Rising Stars

These are companies whose primary quality is that their dividends have remained unchanged or have risen for a minimum of five years. Here it is important to note that many of these might have been subject to a dividend *growth-rate* reversal in the latest year of reporting and this often precedes an actual dividend decline the following year. In such circumstances, such shares will normally experience a sharp share price reduction and will thus be dropped from this category, not to be restored until they have rehabilitated themselves by achieving a minimum of five years of steady or rising dividends.

Maverick Market Leaders

This is a category of companies with very few claims to fundamental quality, which for inexplicable reasons have shown exceptional price growth. I like to display them in descending order of compound annual average share price growth rate and those topping this list will, despite their uncertain credentials, have achieved very high rates of share price growth. Some might in time achieve the fundamentals that will elevate them to the above six quality categories. Here, it is worth keeping an eye on those companies in this category which have achieved exponential dividend and earnings growth rates. Often these are cyclic profit companies of good reputation which are enjoying one of their periodic phases of profit growth which will often be reflected by rapid speculative share price gains. Sometimes it will be a sign of improving fundamentals which might in time lead to such companies being elevated in status to one of the higher categories. Below I have listed the shares as they currently appear in the ShareFinder Quality List:

First

Grade	Name	5YrDiv	5YrGro	Risk
806.4	Averages:	36.28	18.41	7.43
638.9	Blue Chip Index Average:	21.85	22.19	2.55
1 014.2	Rising Star Index Average:	54.21	13.72	13.48
Grand Old Favourites				
907.7	Group Avg.	31.40	18.99	0.00
1 824.4	MTN GROUP LTD	53.17	10.36	-17.50
1 224.3	CAPITEC BANK HLDGS LTD	47.68	44.83	38.90
956.4	SABMILLER PLC	19.54	23.91	-11.14
768.4	BHP BILLITON PLC	25.48	5.64	-1.97
726.0	WILSON BAYLY HLM-OVC ORD	35.32	3.89	0.84
666.8	CLICKS GROUP LIMITED	29.19	31.18	11.57
187.4	GROWTHPOINT PROP LTD	9.41	13.10	-20.69
Mid-Cap Companies				
1 442.4	Group Avg.	27.57	27.43	6.48
2 352.6	CASHBUILD LTD	45.33	22.12	3.36
1 369.3	EOH HOLDINGS LIMITED	31.17	53.17	43.80
605.2	SYCOM PROPERTY FUND	6.22	7.02	-27.72
Tightly Held Mid-Cap Companies				
991.3	Group Avg.	41.37	18.74	52.27
991.3	ELB GROUP LTD ORD	41.37	18.74	52.27
Blue Chips				
453.2	Group Avg.	17.71	22.60	0.81
991.6	BRIMSTONE INVESTMNT CORP	19.02	37.24	20.08
708.0	COMPU CLEARING OUTS LTD	51.20	11.19	-7.79
681.3	COMPAGNIE FIN RICHEMONT	16.21	29.13	46.23
635.7	INVICTA HOLDINGS LTD	25.84	30.41	22.48
617.0	TRANSPACO LTD	27.51	24.71	12.10
611.5	MR PRICE GROUP LTD	26.10	41.88	33.46
596.1	FAMOUS BRANDS LTD	32.11	44.67	28.30
571.8	THE FOSCHINI GROUP LTD	14.18	19.35	21.51
557.9	WOOLWORTHS HOLDINGS LTD	18.17	40.90	26.83

Second

528.3	SHOPRITE HLDGS LTD ORD	27.68	30.75	0.49
528.1	TRUWORTHS INTERNATIONAL	24.33	22.28	15.22
479.3	SPUR CORPORATION LTD	20.12	40.31	14.66
465.9	MASSMART HOLDINGS LTD	12.69	15.13	-11.22
456.0	MMI HOLDINGS LIMITED	4.78	11.72	-21.85
359.8	KAGISO MEDIA LTD	9.63	18.30	-18.58
309.8	REUNERT ORD	6.08	3.93	2.99
308.7	STANDARD BANK GROUP LTD	8.43	5.08	-29.54
301.7	BOWLER METCALF LTD	17.99	16.02	-6.19
298.6	SANLAM LTD	11.24	21.37	-16.33
254.4	TIGER BRANDS LTD ORD	6.26	18.52	-25.56
253.7	NASPERS LTD -N-	18.81	33.52	19.14
245.0	DISTELL GROUP LTD	12.04	21.74	-16.22
231.9	Fountainhead Property Trust	9.44	4.90	-32.42
205.4	PREMIUM PROPERTIES LTD	11.49	9.30	-19.79
131.6	HYPROP INVESTMENTS LTD	11.27	12.63	-37.82
Medium-Term Market Leaders				
1 223.8	Group Avg.	19.71	19.58	19.13
2 964.9	AVI LTD	64.72	30.36	7.39
2 923.6	HOSKEN CONS INVEST LTD	13.00	17.51	-6.62
1 307.4	PINNACLE TECH HLDGS LTD	32.02	42.54	111.56
1 074.1	GOLD FIELDS LTD	9.98	-4.38	36.81
937.7	OCEANA GROUP LIMITED	27.33	37.43	5.94
764.6	NEDCOR LTD	13.70	12.08	-19.00
483.7	LEWIS GROUP LTD	12.30	8.54	-7.58
298.7	Mondi Limited	3.73	19.74	48.00
259.6	PUTCO PROPERTIES LTD	0.60	12.40	-4.31
Rising Stars				
919.9	Group Avg.	69.73	11.08	10.94
4 576.7	HOWDEN AFRICA HLDGS LTD	388.20	34.91	40.45
2 260.1	GRAND PARADE INVESTMENTS LI...	184.23	5.70	8.37
1 622.1	EXXARO RESOURCES LTD	130.26	9.44	27.77
1 546.3	PRIMESERV GROUP LIMITED	87.50	-15.58	47.79

Third

1 450.4	KUMBA IRON ORE LTD	117.44	13.05	36.54
1 257.8	COUNTRY BIRD HOLDINGS LIMITED	153.40	12.36	42.63
749.6	AFRICAN RAINBOW MINERALS	51.05	-6.32	49.17
718.6	VALUE GROUP LTD	37.53	21.45	-11.56
630.9	VUKILE PROPERTY FUND LTD	10.55	8.86	-29.31
543.3	Y3K GROUP LTD	32.32	16.51	52.97
528.9	DISCOVERY LTD	25.36	33.65	1.11
513.3	TRENCOR LTD	26.44	21.09	15.63
412.7	Marshalls Ltd	25.08	29.67	1.87
382.1	THE SPAR GROUP LTD	24.19	17.28	-24.81
315.4	NEDBANK LTD NONCUMPREF	13.46	-1.56	-60.44
277.2	JSE LTD	26.09	11.37	-16.30
236.3	EMIRA PROPERTY FUND	21.76	6.63	-37.50
172.7	AFGRI LTD	13.03	-1.88	7.25
118.1	ANGLOGOLD ASHANTI LTD	21.14	-10.57	35.87
85.0	AMALGAMATED ELEC CORP LD	5.56	15.43	31.27
Maverick Market Leaders				
349.4	Group Avg.	5.64	27.25	56.22
2 846.9	OMNIA HOLDINGS LTD	-6.18	17.62	22.11
1 371.6	DATATEC LTD	34.97	14.16	30.24
1 310.2	BRAIT SE	-14.51	17.50	34.54
1 188.3	NAMPAK LTD ORD	14.66	16.71	-20.70
1 092.1	PSG GROUP LIMITED	31.92	30.48	20.33
1 063.3	TREMATON CAPITAL INV LTD	9.72	23.17	22.37
1 046.8	ADAPTIT HOLDINGS LIMITED	-9.09	44.10	83.52
966.4	OLD MUTUAL PLC	77.31	16.76	28.54
848.9	ASSORE LTD	56.80	18.57	39.96
826.0	IMPERIAL HOLDINGS LTD	22.54	32.93	22.20
795.7	ASPEN PHARMACARE HLDGS	2.07	39.24	36.49
794.9	PAN AFRICAN RESOURCES PLC	11.55	20.10	42.48
791.6	VERIMARK HOLDINGS LTD	-0.46	14.55	121.54
781.2	METAIR INVESTMENTS ORD	51.99	40.24	83.22
638.1	FIRSTRAND LTD	10.25	14.90	-8.71
587.3	BIDVEST LTD ORD	13.35	18.37	-11.86

Matching these attributes to your needs

Now let us turn to the issue of portfolio construction and how the individual investor should define his own personal capacity for risk-taking? It is tempting here to seek to distinguish between those who have a stomach for the big gamble and those who are too cautious to ever do so, but this is dangerous ground. Though many nurture the romantic notion that such risk-taking can be equated with courage and manliness, it is in truth territory only for adrenaline junkies and there is nothing clever about it. It is a whole different matter to take a calculated risk, provided you know the extent of the risk and have made the necessary provision for it.

The Genteel Poor: People who cannot afford any risk at all!

To understand how much risk you can afford to take, let us start by defining its limits. Let us recognise that someone who is retired or nearing retirement and has just sufficient capital to provide for a living income from gilts or a fixed deposit can afford absolutely no risk whatsoever. All too often such folk have been obliged to cut their living standards in order to conform to the maximum return their retirement nest egg can give them. Usually, by definition, such people can be found deriving all their income from bank fixed deposits and are usually held to ransom by any decline in interest rate patterns.

Here it must be recognised that for such people, inflation, even at the relatively low levels South Africa was experiencing in the new milennium, can decimate the living standards of people on fixed incomes. If, for example, you are just scraping by on a sum of R5 000 a month, then at an inflation rate of 5% you will be really struggling ten years later when you will need R8 145 to provide the same amount of goods and services.

For such people, even though it would mean taking a cut in income to do so at that stage, it was essential that a portion of their capital be placed in the safest category of shares in order to counter the erosive effect of inflation. How to do this? Well let us assume that the R5 000 was being derived from a fixed deposit which at the time of writing was yielding 7%, this would imply our investor had a total capital sum of R857 143 which was yielding an annual income of R60 000. The risk here is not only the erosion of inflation but also the fact that interest rates tend to fluctuate. They halved in the decade to June 2012. So what would our pensioner do if they halved again?

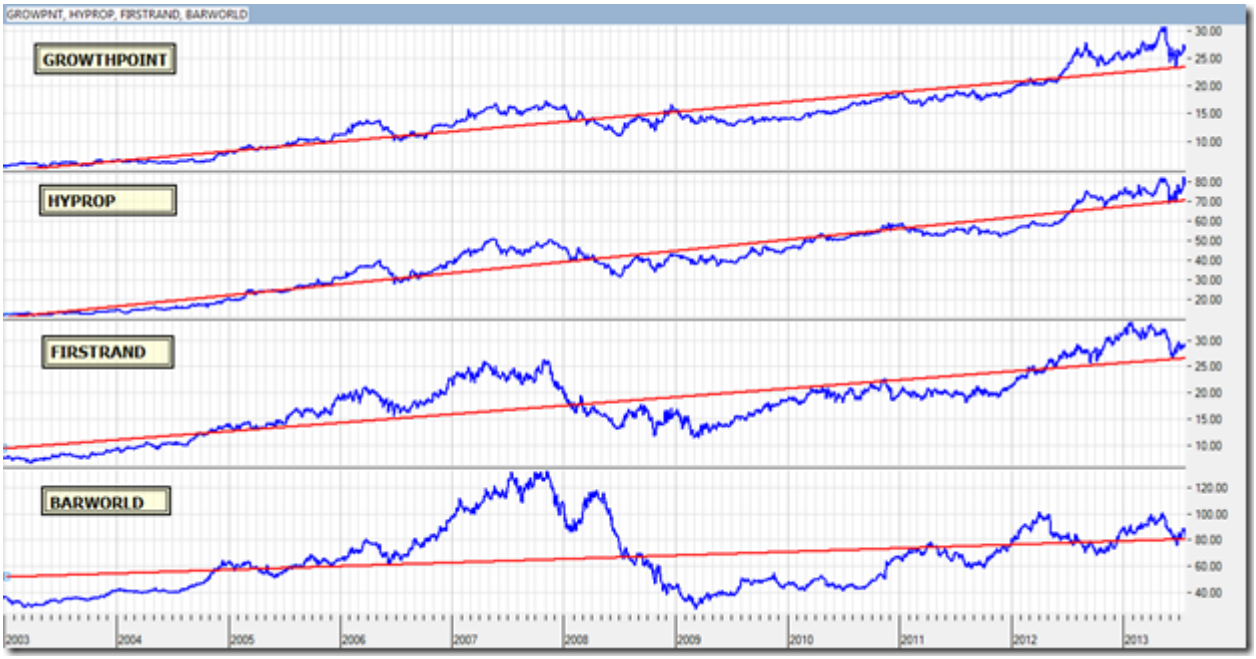
My solution would be to place R150 000 into each of four property unit trusts and the balance into two Grand Old Favourites as follows:

	Amount	**Div**	**5-year**	**Present**	**Income in**	**Income**
	Invested	**Yld%**	**Div. Gro**	**Income**	**10 Yrs time**	**Needed**
Premium Properties	150000	9.5	19.55	14 250	35 315	17103
Growthpoint	150000	7.7	16.9	11 550	55 046	17103
Hyprop	150000	6.8	8.76	10 200	23 621	17103
Putprop	150000	8.2	14.66	12 300	48 309	17103
Firstrand	107143	3.6	24.36	3 857	34 125	4050.0
Barworld	150000	4.1	22.27	6 150	45 928	6457.5
TOTAL	857143	6.65	17.75	58 307	242 344	68412

The result would be a slightly diminished annual income of R58 307 which would mean that in Year One our pensioner would need to get by on R4 859 month. The benefit that would accrue from such a sacrifice is the fact that in ten years time, in order to be able to buy what R3 775 bought in year one, our pensioner would require R5 701 and he would actually have R20 195.

Taking this approach would require three years of steadily-easing financial struggle for, assuming that the five-year compound average growth rates of these six investments remained unchanged, our pensioner would have R5 721 a month after one year, R6 737 a month after two years and R7 933 after three years. Importantly, the investments I have chosen had, at the time of writing, an aggregate Risk Rating of – 8.26 because the relative volatility of the property mutual sector is extremely low and the remaining two companies were Grand Old Favourites.

I should add one caveat to this portfolio approach. There are times when speculative fever has driven the share market well above its normal growth trend and in such cases it would be wise to remain in cash until such time as a regularly recurring cyclic decline had restored the market to normality. The red lines in the graph below represent their ten-year trends, highlighting the fact that at the time of writing both the Property Loan Stock sector and the Grand Old Favourites I had chosen for this portfolio were priced considerably above their long-term trend and for risk-averse investors it would have been wise to wait a while until such time as the market had downward corrected to a more average set of prices.



Comfortably Retired

One down the risk scale is the investor who has provided well for his retirement; whose children are off his hands, has a completely adequate pension, a fully-paid-for home, comprehensive medical aid and is not responsible for the financial support of anyone other than a wife and the odd family pet. If he has got this much of his retirement planning right, the chances are that he also has an adequate nest egg set aside for those rainy days that inevitably lie ahead.

For this happy individual, the only normal hazard is inflation which is likely to erode his pension faster than normal increments can compensate for it. Nevertheless he cannot afford to risk this nest egg because, in the event that he loses it, he will at his age have very few opportunities to earn money with which to replace it.

He cannot afford to risk his nest egg because it is probable that the increments that he receives from HIS pension, retirement annuities and a few share market or fixed deposits will very likely not keep up with inflation and the growing costs of medicare if he and his spouse should be blessed with a long retirement.

Accordingly, I would advocate that he invest in a portfolio consisting exclusively of Grand Old Favourites together with possibly just one Medium Term Leader as a portfolio sweetener.

Shares that qualified as Grand old Favourites at the time of writing were:

	Total Return %	Risk %
Standard Bank	19.85	-13.06
ABSA	24.42	14.15
Remgro	19.68	-9.26
Barworld	20.36	4.75
Woolies	34.5	3.58
AVERAGE	23.76	0.03

To this I would add Astrapak which at the time of writing enjoyed the highest Risk/Return ratio of 1.35. Its risk rating of 37.2 would increase the overall portfolio risk to 6.23% and the Total Return to 28.16%. In practice, he could probably afford to increase his aggregate risk to the region of 15% and accordingly grow his aggregate portfolio growth rate potential to around 40 percent, but I would always prefer to err on the conservative side.

High Net Worth

One further step down the risk ladder is the person of high net worth who, though of retirement age or beyond, has provided sufficient capital for his retirement phase, such that when all of it is invested in an ultra safe portfolio consisting of Grand Old Favourites, money market instruments, property and gilts, the net result is an income that will provide **more than twice** his normal living requirements. His only risks are imponderables; unforeseen rainy day items such as the possibility that an improvident Government might sometime in the future allow runaway inflation to decimate his investment capital. His is the fortunate position that I hope every one of my readers will attain for the fact that he can afford to invest in relatively low-dividend shares means that dividend growth will ensure that he should never face a serious financial crisis.

Such individuals can afford to put nearly 50% of their investment capital at reasonable risk in the medium-term leaders in return for some high growth provided the other half is providing the portfolio foundation stone through investments in Grand Old Favourites.

Though a little higher than I would prefer, his risk level would at the time of writing have been 37.14% against my own preferred level of 30%. Set against this, however, his aggregate Total Return would have been a massive 40.55% which would allow him some spectacular capital growth. Here again, though, I would apply the caveat that it might be unwise to go to quite such high levels of risk at times when the share market as a whole has climbed more than 20% above its long-term trend line.

Well-Planned middle age

Yet another step down is the middle-aged investor in secure employment who has 15 to 20 years of working life left before retirement, whose home is virtually paid for and whose children are nearly off his hands. Provided he has already learned the discipline of thrift, is putting aside at least 10% of his income towards his retirement nest egg and has learned the lessons of this series of articles, he can look forward to a life of steadily-growing ease, to the possibility of early retirement if a second career beckons, or to travel, or some self indulgent hobbies, charity work and the whole gamut of gratifying personal growth.

Precisely the same rules apply to the well-planned middle aged person as do to the high net worth individual. Here, in a worst case scenario that he risked and lost more than 50% of his savings by allowing for too high a risk element in his portfolio, he has ample time to recoup his losses from savings and portfolio growth during the rest of his working life. Thus, for him I would advocate the same mix of 50% Grand Old Favourites 50% Medium Term Market Leaders, again urging caution when the overall market index has climbed more than 20% above its long-term trend line.

Newly Married

Another step down is the successful young person, well set into a career, newly married with a young family to provide for, a home to pay for and the host of uncertainties ahead. His need is to ensure that his loved ones are taken care of in the event that anything happens to him. He needs good accident insurance, bond cover and perhaps some form of unemployment insurance if this can be obtained at an affordable cost. In addition he needs to ensure that he can also save a tenth of his income towards building that retirement nest egg that will provide him with future peace of mind and comfort.

This latter savings provision is often the toughest to meet because it needs to be balanced against a series of other demands tugging at the finances of the young parent. I have written extensively in my books How to Make a Million and Footsteps to Fortune about the strategies that such people might employ to meet this need, and so it is unnecessary to repeat them here. Suffice to say that if people at this stage in life do not make a priority of regular saving, they will never escape the insecurity that is life on a salary and they will very likely end their days dependent in their retirement years upon either their children or the State.

Here, though it is extremely difficult to set aside income towards creating the basis of an investment portfolio, the overwhelming need is to achieve capital growth. I would accordingly visualise a portfolio consisting of an anchorpiece of around 20% in the highest total return Grand Old Favourite.To this I would add bit by bit, in a one to one ratio; one Maverick and one Medium Term leader.

Just starting out

Finally. at the other end of the scale is the young graduate who has no dependents and the prospect of a lengthy and well-paid career ahead of him. He can afford to take on lashings of risk, gambling that high-growth but risky investments will pay off handsomely so that early on he can fulfil all the dreams of young people, of a comfortable home, a secure family life, travel and so on.

I would nevertheless advocate that while going for shares in the Maverick and Medium-term Leaders categories which offer compound annual returns of the order of 50% and more, he attempt to include at least one Grand Old Favourite in his portfolio and try to buy at least one more each year. Here his risk level could be in excess of 70%, but the gradual build-up of Grand Old Favourites in the portfolio will tend to steadily dilute the risk of his portfolio as a whole.

So there we have it; we have developed a risk/ return approach to investing on the stock exchange, noting that at opposite ends of the scale, investors who are just starting out, who have long working lives ahead of them can afford portfolios with a risk rating in the upper 70 percents while the Genteel Poor who have retired with very limited financial means should not allow themselves more than 5%.

In between these poles, as they progress through the various phases of life towards the ultimate goal of a prosperous retirement, they should be shedding risk, at a rough rule of thumb at approximately one to one and a half percentage points a year.

The table should thus look something like this:

1) Aged 20 to 30 years: Maximum risk 36% Potential portfolio growth 40% compound.

2) Aged 20 to 30 years but married: Maximum risk 30% Potential portfolio growth rate 35% compound

3) 30 to 40, married with children: Maximum risk 30% Potential portfolio growth rate 35% compound

4) 40 to 65, Married children off their hands Maximum risk 30% Potential portfolio growth rate 35%

5) High net worth people at any stage of life: Maximum risk 30% Potential portfolio growth rate 40%

6) Comfortably retired with invested capital capable of generating almost as much as their pensions when placed in money market investments: Maximum risk 15 to 20% Potential portfolio growth rate 30% compound

7) Genteel poor: Maximum risk 5% Potential portfolio growth rate 20%

Now these figures are intended only as rough guides based upon the risk return ratios that pertained in the market at the time of writing. As a general rule, if an investment is sound, the risk percentage will normally be about a third of the total return. However, at times in the future average risk percentages might either climb or fall with potential portfolios growth rates expanding and contracting in harmony with them as markets move through their normal boom and bust cycles. So these numbers should not be regarded as absolutes.

What is much more important is, having recognised the importance of developing an understanding of the amount of risk you can afford depending upon your age, earning potential, dependent responsibilities etc is to recognise the absolute relationship between risk and return. If someone points you at a high-return investment and claims there is little or no risk, take the claim with a big dose of salt.

It is an absolute fact that the higher the return the higher the risk. However, it is possible to some extent to lower risk without lowering the overall return by expanding the size of a portfolio.

At the level of the Grand Old Favourites, the very fact that these companies have been around for 20 or 30 or even 50 years and more, constantly delivering rising earnings speaks of management excellence that renders it improbable that a major profit reversal could occur such as to render the probability that an investment in such shares could be a total loss.

Similar arguments would normally apply to most shares that qualify for inclusion in the Royals and Blue chip categories; namely those that have experienced constantly-rising dividends for a minimum of ten years.

Rising US bond yields – what it means for equities

By Mathieu Leheilleix of Investec

The recent uptick in bond yields, triggered by ongoing speculation of an imminent QE tapering, have resulted in heightened volatility across all capital markets, exacerbating the year to date selloff in emerging market assets whilst adversely impacting developed market equities.

In light of this volatility, and in an attempt to deduce what impact this could have on equity markets, it is pertinent to consider the historical correlation between US bond yields and the performance of the S&P500 Index.We ran an exercise analysing the data points going back to January 1980, and made some interesting findings.

There has historically been a weak positive correlation between movements in the US 10 year bond yields and the S&P500 Index **(+ 0.18 correlation ratio** implying that a +1% move in one of the series would translate into a positive +0.18% move in the other variable).

However, we can observe a completely different level of correlation ratios based on the nominal level of the 10 year bond yield. We find that:
* Should we only review the periods since 1980 when the 10 year US bond yield was below 4.5%, **this correlation coefficient jumps to a more credible +0.5**;

* In contrast, should we only review the periods since 1980 when the 10 year US bond yield was exceeding 4.5%, this correlation coefficient **becomes slightly negative (-0.1 ratio).**

The rationale for such a discrepancy can be summarised as follows:
* Yields tend to rise from low levels when we experience periods of improved economic growth, characterised by a benign inflation environment and a reduced probability of deflation. In such instances, market participants will likely witness a rotation out of fixed income (with the exception of inflation linked securities) and into equities.

* In contrast, upside movements in bond yields from a more elevated base tend to result from hyperinflation risks. Such risks themselves threaten future economic growth whilst eroding the future value of future corporate earnings thereby acting as a negative underpin for stock prices.

Based on the above, we can assume that the prevailing market conditions reflect the former rather than the latter scenario. Therefore - whilst significant (+130bps from its all time lows) ? the recent rise in US bond yields should not present a threat for equity investors.

We have further reviewed the correlation between the movements in the 10 year US bond yield with the S&P500 when the 10 year bond yields remains below this 4.5% threshold and the difference between the 10 year and 30 year bond yields exceeds 1.25% (referring to a clear positively sloped yield curve).

In such an instance, the correlation in movements between the 10 year bond yield and the S&P500 Index jumps to **a firmer 0.6 ratio**. This stronger correlation relates to the fact that the shape of the yield curve (positively or negatively sloped) reflects the future expectations of economic growth. In this respect, a negatively slopped yield curve (whereby long term rates are lower than short term rates) generally precedes a recession whilst inversely, a positively slopped yield curve implies a period of future economic expansion.

Furthermore, from a corporate point of view, a steeper yield curve does provide some positive outcomes. For example, it leads to enhanced margins for the financial sector whilst companies holding huge cash stockpiles (as currently experienced) can enhance their investment portfolio returns. It also eases pension fund liabilities and their associated funding costs.

One could argue, of course, that the recent rise in bond yields is mostly attributable to enhanced probabilities of QE tapering rather than improving economic fundamentals. However, it is important to bear in mind that the Fed is only reviewing its accommodative policy because of the improvement observed in specific economic thresholds (i.e. the unemployment rate with its associated participation rate coupled with the inflation outlook). Furthermore, the end of QE1 and QE2 programmes did not result in rising bond yields because of the anemic growth forecasts at that time, prompting the Fed to initiate another round of QE.

Moreover, whilst the rise in bond yields could pose a threat to the US housing market recovery, one should remember that the uptick in housing starts started in June 2011 at a time when 30 year mortgage bond were approximately 4.3%. Mortgage rates currently remain marginally below this level but, more importantly, the labour market has materially improved over the period.

Based on the above factors, it is seems fair to assume that the recent rise in bond yields should not pose undue risks to equity investors. This is especially so for investors in developed market equities, which could remain supported by capital rotations out of developed market bonds (which has largely not occurred yet) and emerging market assets.

A Volatile Season

By Cees Bruggemans

South Africa may find itself in the crosshairs of various global trends currently playing out, with implications for the oil price, the Rand exchange rate, bond market yields (and equity prices), inflation and interest rates, and all this ultimately feeding back into its growth. In other words, pretty much all our metrics could be affected, with invariably downside potential, given the nature of the global unease playing out.

Egypt is experiencing a violent political transition, where democracy gained traction a year ago, only in recent weeks to be confronted by another coup originating in the old dispensation. Anti-coup demonstrations this past week have been violently suppressed, resulting in hundreds of deaths and giving the impression of killing off the possibilities for a political solution in a throwback to an earlier Algerian condition. This sudden increase in Egyptian instability in close proximity to the Persian Gulf oil patch has made some global importers of oil nervous, resulting in increased ordering and hoarding ahead of unforeseen escalation.

This has seen Brent oil rise towards $110 at at time when global supply and demand trends should have favoured a break towards below $100. So far the oil price reaction has been relatively minor, although when combined with the Rand weakness of recent times it implies upward pressure on our domestic petrol price feeding into higher inflation when this is least wanted. The big question for coming weeks and months is whether the Egyptian troubles will still severely escalate, in turn creating much greater upward potential for oil price increases and our inflation.

Meanhile over in India, disappointing growth and big fiscal and current account deficits have put downward pressure on the Indian Rupee in any case already weakened by global pressures on EM space. This has set in motion capital outflows, further weakening the Rupee. Matters came to a head this past week when the Indian government started fearing a surge in capital flight causing yet more financial instability potentially undermining growth. In a shock surprise decision not well received it reimposed capital controls on local companies and residents in an attempt to prevent more outflows and further Rupee weakness. But this action backfired, giving more momentum to the Rupee's fall. Instead of stabilizing conditions, this policy action may well invite more speculation against the Rupee, reminiscent of the 1998 Asian Contagion crisis and other historic EM currency crises. This is potentially not good news for SA with its own disappointing growth rate and large budget and current account deficits not needing another dose of unease focusing on its fundamentals and exposed currency.

The Indian troubles are not an isolated incident as many EM countries have experienced substantial currency sell offs this past year, including SA. But India appears to be taking these troubles to the next level, no longer only driven by global realignments, but now by internal actions as well. Something perhaps to watch carefully, given our own home brewed labour troubles and their potential impact on financial sentiment and flows still to come.

If these EM country specific problems were not enough, it is playing out on a much larger global canvas still anything but stable. It was no issue whatsoever when the BOE (Bank of England)

stopped buying bonds last year, or when the ECB (European Central Bank) started shrinking its balance sheet as banks started repaying some of their emergency borrowing.
But when some Fed governors started making noises earlier this year about the need to taper bond purchases, and eventually end such purchases entirely, unease started to creep into global bond markets.

When Fed chairman Bernanke made the intention formal in various speeches in late May and early June, markets went into shock as they extrapolated these intentions and then discounted them to the present. Bond investors started to bail, causing long yields to jump.
The Fed had thereafter to tread carefully, guiding markets about its slow intentions. This message was eventually mostly bought and markets calmed down during July-August. But that initial sell-off episode had only been the opening round of a much larger and long adjustment, with many still ahead as Fed bond buying tapering still has to start, eventually end, followed by rate tightening, all the way creating opportunity for new market tensions.

This past week saw renewed unease as growth or labour data were strong enough in the US, UK and Europe for markets to question the sincerity of central banks to keep to their low-for-long mantra. Bond investors in particular feel exposed and some now sense being in the wrong asset class with regard to likely trends these next five years as leading central bankers normalise their policy stances. This creates greater uncertainty and in the process more market turbulence spilling far and wide.

South Africa is not isolated from these strains as our bond yields rise and the Rand weakens anew. And all this before actual Fed tapering has even begun. Considering that we are likely to see more global bursts of such unease as central banks proceed and economies and markets adjust, along with any pressure from Egyptian and Indian events, against a domestic backdrop of vigorous politicking ahead of the 2014 election and possibly severe mining strike action shortly, and labour unsettledness in other sectors as well, we may expect a volatile season ahead with much pressure on our markets, economy and policymakers.

The potential is there for more Rand weakness above 10:$, higher inflation bias in excess of 6% and greater capital flow unease providing more twists to this outlook, forcing our domestic petrol price yet higher and further eroding household purchasing power and growth.

ShareFinder Mobile for R1 400

Its very affordable, quick to use and outstandingly reliable so it is no surprise that the new ShareFinder mobile has become one of the hottest sellers in South Africa because it takes all the guesswork and decision-making out of share market investment.

Designed as an ultra-easy-to-use share market investment system for people on the move, the ShareFinder Mobile combines many of the portfolio-building and monitoring features of the ShareFinder Professional at an extremely affordable price tag. There are:

- No daily data downloads to worry about
- No bills to pay for expensive data services
- No complicated charts to try and understand
- A portfolio-builder that tailors 10-share portfolios to your personal needs
- An alert system that tells you when to buy and sell

Conceived with the busy executive in mind; for the kind of person whose only spare time is waiting in airport lounges, the ShareFinder Mobile was designed to operate on a pocket computer. It will, however, function equally well on a standard desk-top computer. With just two or three clicks of a mouse it will tailor a blue chip share portfolio to your personal risk profile, generating portfolios which under practical testing throughout the 2003-2007 bull market have dramatically outstripped the performance of the top-performing unit trusts.

Unlike competing computer programmes which carry extremely costly price tags—sometimes as much as R25 000 — and which are linked to internet data services costing over R2 000 a year, the ShareFinder Mobile is offered as a subscription service costing just **R1 400 a year** and there are no additional costs whatsoever.

It offers you:

1) The tools to help you draw up an investment plan tailored to your personal needs.
2) A systematic portfolio builder that enables you to scientifically minimise risk and maximise capital and income growth rates.
3) A weekly overview of leading world markets accompanied by a graphic commentary of changing trends.
4) A personal portfolio analyser which will keep watch over your investments and suggest periodic changes.
5) An alert system which will signal you by e-mail if emergency action is called for. Shortly we hope to add a facility that will also send you a cell phone SMS so you will be alerted to the need for action wherever you are during the day.

The ShareFinder Mobile system operates from the RCIS servers where your portfolio is subjected to a daily automated analysis. At the end of each week Mobile subscribers receive an e-mailed update that will automatically update the programme.

Having been rigorously beta tested for many months during its final development stages, the ShareFinder Mobile is now ready for you. During the latest 2003-2007 bull market, its top-performing portfolio achieved a compound annual average growth rate of 87.4% . Simultaneously its income-growth portfolio, where dividend growth is more important than share price growth, also significantly outperformed both the Satrix 40 and the unit trust leading Sage Resources fund.

To order it, log onto www.rcis.co.za and go to the order form on the left-hand menu. Next scroll down through our list of products and services and click on the Mobile.

** If you want to use this software to its maximum advantage, it is highly recommended that you read Richard Cluver's books "The Philosophy of Wealth" ISBN No: 0958 3067 61 and "The Simple Secrets of Stock Exchange Success" ISBN No 9780 95830 6775 which can also be ordered from Richard Cluver Investment Services at a cost of R130 including postage.*

France: On the Edge of the Periphery

By John Mauldin

"The emotional side of me tends to imagine France, like the princess in the fairy stories or the Madonna in the frescoes, as dedicated to an exalted and exceptional destiny. Instinctively I have the feeling that Providence has created her either for complete successes or for exemplary misfortunes. Our country, as it is, surrounded by the others as they are, must aim high and hold itself straight, on pain of mortal danger. In short, to my mind, France cannot be France without greatness.

– Charles de Gaulle, from his memoirs

Recently there have been a spate of horrific train wrecks in the news. Almost inevitably we find out there was human error involved. Almost four years ago I began writing about the coming train wreck that was Europe and specifically Greece. It was clear from the numbers that Greece would have to default, and I thought at the time that Portugal would not be too far behind. Spain and Italy clearly needed massive restructuring. Part of the problem I highlighted was the significant imbalance between exports and imports in all of the above countries.

In the Eurozone there was no mechanism by which exchange rates could be used to balance the labour-cost differentials between the peripheral countries and those of the northern tier. And then there's France. I've been writing in this space for some time that France has the potential to become the next Greece. I've spent a good deal of time this past month reviewing the European situation, and I'm more convinced than ever that France is on its way to becoming the most significant economic train wreck in Europe within the next few years.

France: On the Edge of the Periphery

I think I need first to acknowledge that the market clearly doesn't agree with me. The market for French OATS (Obligations Assimilables du Trésor), their longer-term bonds, sees no risk. The following chart is a comparison of interest rates for much of the developed world, which I reproduce for those who are interested in comparative details. Notice that French rates are lower than those of the US, Canada, and the UK. Now I understand that interest rates are a function of monetary policy, inflation expectations, and the demand for money, which are all related to

economic growth, but still….

Bond Market Metrics

Country	Sovereign Rating[1]		JP Morgan GBI Index					5-Year CDS Premium (bp)
				Yield				
	Foreign Curr.	Local Curr.	YTD Return[2] (%)	Current (%)	Average[3] (%)	Diff. (bp)	Current Spread to US (bp)	
Australia	AAA	AAA	-14.6	3.8	5.1	-130	135	52
Austria	AA+	AA+	-0.9	2.0	3.4	-143	-49	29
Belgium	AA	AA	-1.6	2.4	3.6	-124	-10	64
Canada	AAA	AAA	-8.2	2.6	3.4	-85	11	n/a
Czech Republic	AA-	AA	-4.3	2.2	3.8	-153	-23	63
Denmark	AAA	AAA	-3.3	1.7	3.2	-157	-79	25
Finland	AAA	AAA	-2.5	1.9	3.3	-134	-51	22
France	AA+	AA+	-0.7	2.1	3.4	-128	-37	67
Germany	AAA	AAA	-1.9	1.6	3.1	-151	-85	26
Hong Kong	AAA	AAA	-10.8	2.2	1.7	44	-30	51
Hungary	BB	BB	0.9	6.1	7.6	-146	367	318
Ireland	BBB+	BBB+	8.5	3.8	4.9	-115	131	142
Italy	BBB	BBB	5.4	4.0	4.2	-29	150	235
Japan	AA-	AA-	-11.0	0.7	1.2	-51	-180	63
Korea	A+	AA-	-5.2	3.6	4.7	-109	110	83
Mexico	BBB	A-	0.0	6.0	6.6	-67	351	122
Netherlands	AAA	AAA	-2.4	2.0	3.3	-126	-42	46
New Zealand	AA	AA+	-7.6	4.5	5.4	-88	204	49
Poland	A-	A	-4.6	4.1	5.6	-147	167	83
Portugal	BB	BB	6.5	6.3	5.5	77	385	438
Singapore	AAA	AAA	-9.1	2.1	2.5	-38	-35	n/a
South Africa	BBB	A-	-18.2	7.7	8.3	-56	529	234
Spain	BBB-	BBB-	10.3	4.1	4.3	-11	169	227
Sweden	AAA	AAA	-4.5	2.2	3.2	-102	-28	20
UK	AAA	AAA	-8.6	2.4	3.7	-132	-4	36
US	AA+	AA+	-5.4	2.5	3.4	-96	-	22
World Index[4]			-5.4	2.0	2.6	-65	-48	
Ref: Emerging Markets			-1.6	6.9	7.1	-19	449	

Sources – Thomson Datastream, Capital Economics
Latest values are for 15th August 2013 unless noted.

1. S&P long-term ratings.
2. Total return indices.
3. 10-year arithmetic averages.
4. Developed markets only.

France's neighbors, Italy and Spain, have rates that are roughly double France's. But as we will see, the underlying economics are not that much different for the three countries, and you can make a good case that France's trajectory may be the worst.

"No: France Is Not Bankrupt" – Really?

We will start with a remarkable example of both hubris and economic ignorance published earlier this year in *Le Monde.* Under the headline "No: France Is Not Bankrupt," Bruno Moschetto, a professor of economics at the University of Paris, made the following case. He apparently wrote this with a straight face. If you are not alone, please try not to giggle out loud and annoy people around you. (Hat tip to my good friend Mike Shedlock.)

No, France is not bankrupt .... The claim is untrue economically and financially. France is not and will not bankrupt because it would then be in a state of insolvency.

A state cannot be bankrupt, in its own currency, to foreigners and residents, since the latter would be invited to meet its debt by an immediate increase in taxation.

In abstract, the state is its citizens, and the citizens are the guarantors of obligations of the state. In the final analysis, "The state is us." To be in a state of suspension of payments, a state would have to be indebted in a foreign currency, unable to deal with foreign currency liabilities in that currency….

Ultimately our leaders have all the financial and political means, through the levying of taxes, to be facing our deadlines in euros. And besides, our lenders regularly renew their confidence, and rates have never been lower.

Four things leap to mind as I read this. First, Professor, saying a country is not bankrupt because it would then be insolvent is kind of like saying your daughter cannot be pregnant because she would then have a baby. Just because something is unthinkable doesn't mean it can't happen.

Second, contrary to your apparent understanding and the understanding of your partners in the Eurozone, especially Germany, France does not have its own currency. The Greeks, Portuguese, Italians, and Spanish have all found out that they cannot print their own currencies, no matter how much they wish they could. You are all bound up in a misguided economic experiment called the euro. Deal with it. For all intents and purposes you are in fact indebted in a foreign currency. On your current path you will soon have to go to Germany and the rest of Europe asking for a special dispensation simply because you are France. If this development weren't so potentially tragic, with horrific economic implications for the entire world, it would be especially amusing theatre.

Third, I find the use of the term *invited* in the phrase "invited to meet its debt by an immediate increase in taxation" to be quite a wonderful French expression. Your tax rates are already among the highest in Europe. At a 75% top tax rate, your entrepreneurs and businesspeople are leaving the country in droves. That icon of economic enlightenment, tennis star Serena Williams, recently commented in *Rolling Stone* magazine that "75% doesn't seem legal." Gerard Depardieu and many others not quite so famous agree and have already left. You are going to collect less, not more, taxes from the rich with your remarkably ill-considered increase in the top tax rate. Just look across the channel to England and see how their raising their top rate merely to 50% worked out for them.

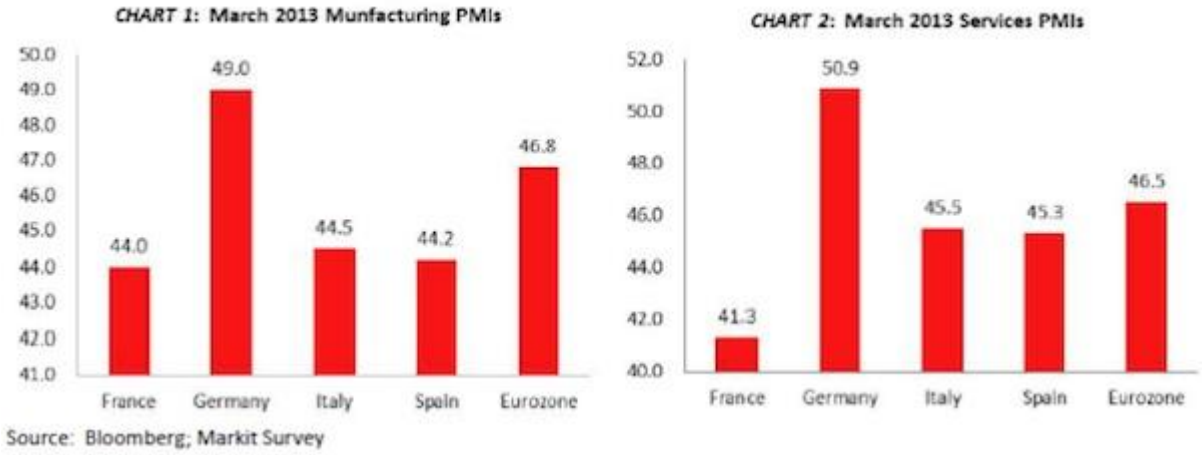
Fourth and finally, you clearly haven't done your homework on economic crises. The fact that your interest rates are low and that your loans routinely get rolled over simply says that you have not yet come to your own ***Bang!*** moment. Every country that falls into crisis is able to get financing at low rates right up until the moment it can't. It is all about investor confidence, and I readily admit that right now you have it. But through its policies the current government is doing everything it possibly can to destroy the confidence of the bond market as rapidly as it can. And France is particularly dependent upon non-French sources for the financing of its debt.

Let’s look at few facts, Prof. Moschetto:

1. Your country is in recession and has been for almost two years. Even the government is beginning to acknowledge that growth is and will be flat. Standard & Poor's thinks your growth rate may be as low as -1.5%. Jean-Michel Six of Standard & Poor's recently noted, "The current account deficit is growing month after month, and this means it is depending more and more on the rest of the world to finance its growth. In my view, France has got just one more year to sort itself out."

One of the ways to deal with a debt crisis is to grow your way out of it. You are not doing that. The number of new industrial plants created by foreigners fell 25% last year, and new job creation fell 53%. Ernst & Young said France's anti-market body language had become almost "repulsive" to outside investors, and a series of bitter labour disputes has not helped (source: *The Telegraph).* French industrial output is still falling, and both your manufacturing and service

PMIs are among the worst in Europe—far worse even than those of Italy and Spain, both of which are clearly in financial disarray. The following PMI chart is from March, but August was still in negative territory (chart courtesy of Josh Ayers of Paradarch Advisors).



1. Your debt growth is unsustainable. France is currently enjoying the lowest effective borrowing rates it has had for 30 years, allowing the interest you pay to fall even as the total debt rises. Both interest payments and interest as a percentage of GDP are at all-time lows.

Here is a summary analysis from just about the best research team around, at Bridgewater:

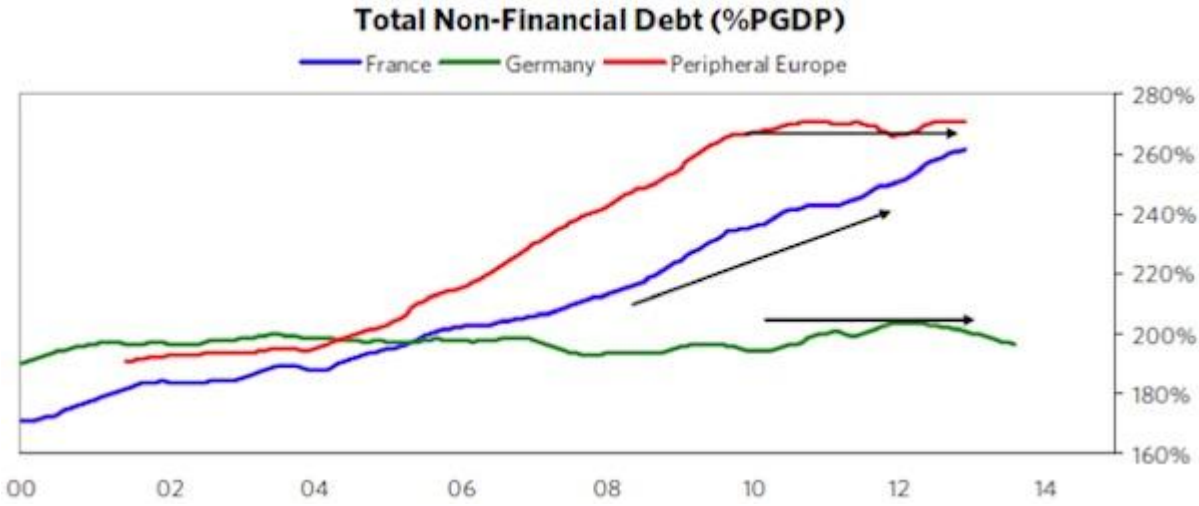
France is approaching the point in its debt expansion phase in which debt service costs will rise faster than incomes causing a squeeze. The below charts convey that in brief. They show France's debts rising relative to incomes while interest rates fell so that debt service expenses fell relatively despite the greater debts. When debt service expenses fall relative to income, that leaves more money for spending which is stimulative for the economy. Both the risk-free rate and credit spreads have fallen just about as far as possible. As a result, the net relief in debt service payments that has come from the interest rate decline will be removed. If interest rates rise, particularly if both the risk-free rate and the credit spreads rise, the debt service bill will have to increase more.

That means that either (a) debt service expenses will increase as a share of income, thus squeezing consumption and lowering economic growth (b) there will be an acceleration of indebtedness in order to pay for both the increased debt service requirements and increased consumption growth (which is a sure sign of an unsustainable bubble) or (c) incomes from some other sources have to rise. Since income growth is a function of productivity growth and competitiveness in global markets, and France is not doing much to improve productivity and competitiveness, we do not expect incomes to benefit from changes in these. That means that debt and debt service growth will either accelerate until the debt bubble pops or debt growth and economic growth will slow which will be painful. Since painful slower growth is not an option, it is more likely that debt and debt service growth will accelerate until the bubble pops. That will have important implications for the whole Eurozone.

France is getting close to the end of its ability to play games with its debt. Though France moved a lot of its debt to off-balance-sheet accounts for its social programs, the total debt is growing so much that the rating agencies will have to start taking notice.

1. The level of French debt is at post-war highs and is beginning to approach that of the peripheral countries. Note in the chart below from Bridgewater that in Germany total nonfinancial debt has been decreasing the past few years, the debt of peripheral Europe in

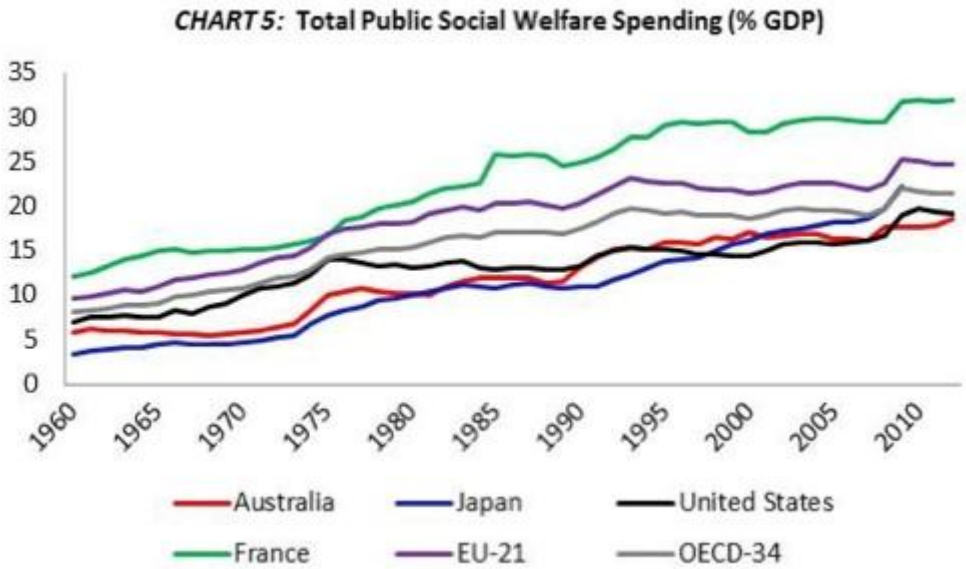
the aggregate has gone roughly flat, but France's debt is increasing dramatically. At the pace France is accumulating new debt, it will not be long before your financial situation looks quite similar to that of your peripheral neighbours.



1. Your fiscal deficit this year is likely to be well north of 4%, far above the level specified in your commitments to the Eurozone. The budget watchdog of France, the Cour des Comptes, is calling for much deeper budget cuts than Mr. Hollande is proposing. The unions and government employees, as well as much of Mr. Hollande's party, are in very vocal rebellion. France deeply needs labour reforms to make itself more competitive, but there is simply no political will or ability to do so.

Your social budget (entitlement spending) is currently 35% of your total GDP. From my friend and macro-maven Josh Ayers' colourful research letter, intriguingly called *Sex Drugs and Debt,* comes the following analysis:

Established in 1945, the French pay-as-you-go social welfare system is completely unfunded. The scheme (their word, not mine) has grown to preposterous proportions. As seen in Chart 5, French welfare spending now outstrips the rest of the world by a considerable margin.



How big is this contingent liability? Well, governments are kind of funny about medical transparency. While they covet the murky details of your entire proctologic history, they don't like disclosing their own information—especially unfunded, off-balance sheet social obligations. In

2009, the ECB commissioned a report from the Research Centre for Generational Contracts that sought to quantify the present value of both the government employer pension and social security schemes for each then-EU member. While their data terminates at YE2006, the report estimated that France had the largest total unfunded liability relative to GDP, at 362.2%, or EUR 6.5 trillion.

As countless failed US defined benefit pension schemes have proved, pay-go is just another word for pyramid scheme. The scheme stays solvent so long as the payers comfortably outnumber the beneficiaries. But everything goes jackfu [note from John: That's a technical economics term] when the percentage of payers begins to contract.

In France, the percentages of both payers and beneficiaries are now moving the wrong way. While the blue-haired beneficiary-intensive percentage of the total population has been consistently increasing over the last 25 years, the percentage of payers began declining. Is it any surprise then that the two major explosions in French fiscal deficits coincided with both the decline of the 30-49 year-old demographic in the mid-1990s and then later with the percentage acceleration of the 60+ demographic in the late 2000s?

1. France is in a profound economic funk, and this is not the stuff from which significant recoveries are made. Consumer confidence in your country, Professor, was at a 40-year low in June. A recent study by the Pew Foundation said French support for the European Project has crashed from 60% to 40% over the past year. Just 22% now think EU economic integration is positive.

The French unemployment level is at a 15-year high of 11.2% and has risen for 26 consecutive months. French youth unemployment stands at 25.7%. The IMF recently issued a report which suggests that the proposed economic reforms of Mr. Hollande do not go deep enough and will not cut unemployment from double-digit levels by the end of the decade.

France has seen a chronic erosion of labor competitiveness against Germany under monetary union due to higher wage deals. Pay has jumped 53pc in France and 35pc in Germany since 1999. French hourly wage costs are now 5pc higher at €36.40, even though German productivity is better. The IMF said the new twist is that France has begun to lose ground to Italy and Spain as they shake up their systems or cut wages. The chief worry is "a steady loss of market share, both globally and relative to peers." *(The Telegraph)*

1. Foreign holdings of French debt are 50% higher than those for Italy and four times higher than those for Spain. As investors became concerned about Spanish and Italian debt, they rotated into over $1 trillion of French government debt on the assumption that the French debt was safer. The simple fact is that France can't print its own currency, so it is therefore dependent upon the kindness of strangers. Bridgewater estimates that if France were judged solely on its fundamentals, its spread to Germany should be about 3.5% rather than the current 50 basis points. If that kind of differential were realized by the marketplace, France would have no hope, under the current regime, of getting its deficit under 3%, let alone below nominal GDP growth, which is the more important number.
1. Like the peripheral Eurozone countries, France has started to run a significant trade deficit. Without going into the math, in very general terms, you cannot reduce your debt and run a trade deficit the same time. That has been one of the key problems in Greece, Portugal, Spain, and Italy. Restructuring a trade deficit is painful in that it requires either a downward currency adjustment or a reduction in labour costs (or an increase in labour productivity). When currency devaluations are not possible, the adjustment is typically borne on the shoulders of workers in the form of reduced wages and layoffs. That of course means lower tax revenues and larger deficits, coming at a time when they are the most difficult to handle. France has simply become uncompetitive. New businesses are not being created, and existing businesses are leaving. Admittedly, Brussels has not been helping, with the imposition of a slew of new mandates that are increasing costs relative to the rest of the

world. Google "French chicken crisis" and "French egg protests" to see why exports are down. French poultry exports have fallen from €1.2 billion to less than €200 million in about 10 years.

1. French government spending is already at 56% of GDP, and debt-to-GDP is over 90%. At what point will the market begin to worry about a debt trap? How much more can you tax? And do you really want to raise taxes with the economy as weak as it is? You can't print money without the agreement of Germany and the rest of the European Union. Cutting spending by 4 to 5% over the next few years will result in a far more serious recession than what you've been experiencing. (Just ask Greece or Spain.)

When I look at your options in France, Professor, I see nothing but bad choices. Perhaps you can talk Germany into writing a check to cover your deficits, but I for one wouldn't hold my breath. Ask Cyprus how that went. The only way you're going to get the rest of Europe to write checks is to agree to give up your budgetary sovereignty. (And they in turn will have to give up theirs in a massive fiscal experiment—more on that below.) Given the mood of the French public as expressed in the polls, how likely is it that France will agree to such terms? But then, if you don't want to deal with enforced austerity, what choice do you have? Foreign creditors are not going to continue to extend loans to France simply because it is France.

I say all this with a heavy heart, because I really do love France. I love the French countryside and the history and the art and Paris. My numerous experiences in France have always been pleasant and have created many enjoyable memories. But the reality is what it is. You've run up debts, and now payment is due.

So What Is the Catalyst for a French Crisis?

So why does France enjoy such low interest rates? The simplistic answer is that the market simply doesn't see the risk. But then again it didn't see the risk in Greece or Italy or Spain prior to their crises, either. I think the catalyst could come during the latter part of this year or in the first half of 2014. There are two events that might serve. First, something has to be done very soon about Portugal. The Portuguese are going to need another infusion of capital. Their economy is upside down; their debt relative to GDP is still growing faster than income; and the simple fact is that they need to default on part of their debt. Call it debt forgiveness or apply whatever euphemism you want, it will be default. Otherwise, Portugal will slowly suffocate under the massive interest payments required to service its debt.

The problem is that any haircut on the debt would put Portuguese banks (which are the largest holder of Portuguese debt) into insolvency. The only guarantor of Portuguese banks under the current structure is the Portuguese government, which means that in order to take a haircut on the debt it already owes to creditors, the government would have to borrow more money to give to the banks. They would be taking two steps backward for every step forward.

After Cyprus, it is now apparent that the EU and the ECB are perfectly willing to see large depositors and subordinated bondholders of banks take rather large haircuts rather than assume a mutual liability. If the same principles are applied to Portuguese banks as were applied to those of Cyprus, it would make a bad financial situation in Portugal even more desperate. And yet if the ECB bails out Portuguese banks under some legal fiction, Cyprus would have a real justification for possible lawsuits. There are simply no good or easy solutions for Portugal without someone incurring a great deal of pain. But a Portuguese banking crisis would mean a run on Italian and Spanish banks. It is really that simple.

Everyone was told, and the market obviously believes, that Greece was "one-off" and that no other country would need to take a haircut on its debt. If Portugal does, then the contagion factor that Europe was worried about with Greece will really come into play. If Germany and the other core countries allow Portugal to default in some manner, what does that say about their

willingness to fund even larger sums for Italy and Spain? What will France do? Will it support further austerity for Portugal, or will the French argue for generalized European taxpayer support of Portugal (thereby implying that France should be able to access the same funding at some point in the future)?

Portugal has plunged itself into what can only be called severe austerity and is suffering economically for it. How much more can the Portuguese be asked to endure? The answer could be, quite a lot more, unless Germany and others want to write a rather large check. Italy, Spain, and France will be watching

If private investors in Portuguese banks are forced to take losses, that will make Italian and Spanish bank depositors nervous. Anyone paying attention to French fundamentals will begin to question the current low interest-rate regime there as well.

And then there are the European bank stress tests that are scheduled for early 2014. These have been postponed so that the ECB can do its own analysis, but the time for them is fast approaching. Regulators want to have a uniform methodology across the Eurozone for calculating bad loans, which will keep banks from using "local practices" to hide bad debts. Further, it is not yet clear how the new bank stress tests will treat sovereign debt. Heretofore, sovereign debt in Europe has been considered risk-free, and banks have levered up as much as 40 to 1 on sovereign debt. Portuguese banks, for instance, don't have to reserve against the purchase of Portuguese debt, and neither do Italian or Spanish banks when they purchase their own country's debt. Any modest restructuring of national debt will result in massive bank insolvencies, not just in the peripheral countries but throughout Europe.

There is some talk of beginning to require reserves against sovereign debt, but this would mean that banks would have to raise significant amounts of capital in order to bring their required Tier 1 ratios into compliance. Good luck raising the tens of billions of euros that would be required in the present market environment.

The bank stress tests that were administered a few years ago were a joke, and everybody knows it. It was all wink, wink and nod, nod and figure out how to finesse the obvious. In order to sustain any credibility, the next round of stress tests will have to be far more serious. How the new regulatory regime of the ECB deals with sovereign debt will to a great extent tell the world how serious they are about stress testing. After Greece, and after looking at the ongoing problems of Portugal and Spain (and especially Spanish banks), who can say with a straight face that there is absolutely no risk in sovereign debt? But if there is some risk, then there must be reserves against it.

France Cannot Be France Without Greatness

These two events—dealing with Portugal and undertaking the European bank stress tests—will focus the attention of the markets back on the fundamentals of European debt and the euro. It is quite possible that the French fiscal deficit will be over 5% in 2014. In a speech last week, Hollande talked about how France will have full employment, a third industrial revolution, and affordable housing within 10 years. Social justice will be achieved, and climate change will be dealt with. There was a lot of happy talk about how wonderful the future will be but not many details on how to get there.

At some point the market will no longer be content with happy talk: it will demand action. That action is going to be difficult to produce, given the internal politics of France. The decisions France makes, along with those of Germany, will determine the future of the euro experiment.

And the situation is not as simple as asking whether France will get its fiscal house in order or whether Germany will write a check.

Indulge me for a moment as I offer a very speculative but interesting scenario. German exporters would like to see a weaker euro, but Germany does not want to allow the European Central Bank to print money. However, German leaders recognize that at some point, if the Eurozone is to maintain a currency union, it must also have a fiscal union. A breakup of the Eurozone would be disastrously expensive for everyone but especially for Germany. There will be a live-or-die effort by all parties to maintain the euro. If Germany and the other fiscally sound members of the European Union can persuade the peripheral countries to adopt rules that require fiscal restraint in return for mutualisation of debt, then that would allow the ECB to monetize deficits in the interim—and thus potentially weaken the euro.

This scenario would require members of the Eurozone to give up a great deal of their fiscal autonomy to Brussels. This will become the central question with regard to the existence of the euro within a few years. In an odd sort of way, the Eurozone is going to enter into its own internal currency war as the peripheral nations continue to have debt problems.

The situation will be exacerbated by the fiscal crisis that will soon engulf France. It will come precisely at the moment when Germany will be asked to allow the ECB to accommodate the French bond market, as it has done for Italy and Spain, and when France will in turn be asked to enter into a period of austerity, as both Italy and Spain have done (very painfully). It is at that moment that the ultimate survival of the euro will be decided.

While I do think the euro will survive, I have to admit that I'm not strongly convinced of it. The euro has never been a truly economic currency; it was created as a political statement, and is a political currency. The problem for Europe is that a currency union ultimately requires a fiscal union. Just as the various states within the United States have to balance their budgets, that is what might be required of countries that are part of a European fiscal union. Given that most of Europe has entitlement-spending problems just as severe (or worse!) than those of the US, there will not be a European fiscal union without a great deal of political contention.

Will Germany be willing to pick up the tab for the rest of Europe, given the serious fiscal constraint that will impose on its own budget? Will France be willing to give up control of its budget process to Brussels? These are the questions on which the future of the euro hinges.

Charles de Gaulle said that "France cannot be France without greatness." The current path that France is on will not take it to renewed greatness but rather to insolvency and turmoil. Is France destined to be grouped with its Mediterranean peripheral cousins, or to be seen as part of the solid North Atlantic core? The world is far better off with a great France, but France can achieve greatness only by its own actions.