# CREDONEWS

Issue 18 | Autumn 2014

KEEP
CALM
AND
CARRY
ON

KEEP
CALM
AND
READ
CREDONEWS

# Now is the time…

*"To all seasons there is a time. A time to be born and a time to die. A time to prosper and a time to lose."* Ecc 3:1

**The 11th of November is a time to remember.** Therefore the front cover features the 888,246 red ceramic poppies (one for every British and empire soldier who died in the war to end all wars) which form a moat around the Tower of London to mark 100 years since the Great War broke out in 1914.

The theme *"Keep Calm and Carry On"* - originally a poster created in 1939 to encourage stoicism in the British public in the event of an invasion from Germany - is still relevant today when we consider the current state of the world and its financial markets.

And so on the 11th day of the 11th month I have left it to the 11th hour to write an introduction to this newsletter. It starts with a history lesson by Credo's Chief Investment Officer, Deon Gouws who writes of the October curse when 9 of the 16 worst days in stock market history occurred in the 10th month of the calendar year. The October effect was once again evident when markets reacted negatively to news of the Ebola crisis, deflation in Europe and other "bad news" stories.

Ed Fincham, our new investment analyst gives us a maths' lesson on fractals - objects that display self-similarity on all scales - and how this can be used to measure the stability of the market and predict a correction. While Ben Newton, a new investment manager, considers whether the bond bubble has burst.

There is always uncertainty in life and in financial markets. One can analyse and interpret this uncertainty in a multitude of ways, the only certainty however is that the uncertainty will persist.

In the current environment, Joelle Anamootoo suggests investors should have a preference for US and Japanese equity investments within a balanced portfolio. Stephen Davis recommends that UK investors consider using an offshore bond wrapper as a tax efficient means to plan for the future.

Ever the intellectual thinker, research analyst Ainsley To reminds investors that the fundamental purpose of our investment portfolios is to cash them in at some point in the future and spend on the things in life that matter, be it a home, an education or whatever other goal you may have set.

Over the past 15 years many people have passed through Credo, all have had an influence on our journey to where we are today and over the past year many new young faces have joined our team, all brilliant and well educated with so much potential for the future. In this issue we introduce the five new staff members who have joined us since our previous newsletter.

Deon is addressing all the young people when he advises them to keep calm and embrace as much risk as possible because they can afford to do so (see page 9).

*They have the advantage of time. While some of us have the advantage of experience.*

Just as the Great War of 1914 did not end all wars, this October will not be the last bad October. People will continue to react to bad news as they have always done. By selling and running. And others will look and wonder why they missed the opportunity to buy.

*"In this world, the optimists have it, not because they are always right, but because they are positive. Even when wrong, they are positive, and that is the way of achievement, correction, improvement, and success. Educated, eyes-open optimism pays; pessimism can only offer the empty consolation of being right."* Aswath Damodaran

Alan Noik - *MD* | @AlanNoik_Credo

# Is this the greatest motivational poster ever?

The instruction to *"Keep Calm and Carry On"* has become undeniably one of the most recognisable slogans in British history. The simple 5 word phrase is the very model of British restraint and keeping a stiff upper lip particularly in times of crisis.

The popular poster was originally a product of commercial advertising in wartime Britain. It was produced by the Government's Ministry of Information on the eve of war in 1939, along with 2 other motivational posters, *'Freedom is in Peril'* and *'Your Courage, Your Cheerfulness, Your Resolution Will Bring Us Victory'*. Simple reassuring instructions topped with the seal of King George VI's crown, 2.5 million copies were printed and were to be distributed if there was an imminent threat of a German invasion. Thankfully they were never used and were almost all pulped. 60 years later a Northumbrian bookseller, Stuart Manley, bought a box of dusty old books at an auction and discovered the soon-to-be-famous posters.

Though they didn't initially know what the poster was, Mr Manley and his wife liked it so much they framed it and hung it in their bookshop. They weren't the only ones who found its stark, simple reassurance engaging. In fact they had so many enquiries about it from customers that in the end they decided to have some copies printed.

The bookshop has gone on to sell tens of thousands of the poster, not to mention mugs, T-shirts and tea towels. This sage message seems even more popular during our troubled peacetime and during the uncertainty faced by many during the economic downturn triggered in 2008. The poster is not ideological but appeals to personal neuroses and thus the advice is quite Zen-like. The phrase reassures us that there is no need for overreaction and to stoically continue about our everyday business, safe in the knowledge that our strength is our ability to stay calm, be patient and weather the storm. The other option, *"Now Panic and Freak Out!"* just doesn't exist in the British psyche.

# Climbing a wall of worry

Early in the morning of Wednesday the 1st of October 2014, I posted a tweet quoting Oscar Wilde, stating that October is a peculiarly dangerous month to invest in stocks… others being July, January, September, April, November, May, March, June, December, August and February.

Of course Wilde was saying that there is no such thing as an "easy" market, which is why at Credo we do not believe that it is possible to successfully time one's entry point on a sustainable basis. Therefore, we would normally invest into the equity market on behalf of clients in a few tranches over a number of months.

We also do not try to forecast the market, certainly not over the short term (and one could hardly have more of a short term focus than the following month!). So why then quote Oscar Wilde, suggesting that we "anticipated" the much increased volatility experienced during October this year (or certainly over the first couple of weeks of the month)?

In short, the reason simply lies with historic precedent, as a disproportionate number of sizeable market drawdowns have indeed occurred during the month of October, with no less than 9 of the worst 16 days in stock market history having been played out during the 10th month of the calendar year (as measured by movements in the benchmark S&P 500 index, as a proxy for world equity markets).

It could be argued that a meaningful proportion of investors will be mindful of October's legacy, leading to a situation where their behavioural response ultimately results in a self-fulfilling prophecy. Accordingly, any hint of bad news (economic or otherwise) runs the risk of over-reaction (thus leading to higher volatility and potentially lower asset prices).

And so it seemed again this year. In the first half of October, the S&P 500 shed 5.5% of its value, reaching a level as low as 2% above the first day of 2014 (which was also the low point of the calendar year to date).

One only has to look at some of the news flow in mid-October in order to understand the apparent pessimism that prevailed (in addition to the possible "October effect"). Issues commanding newspaper inches (or internet bytes, as the case may be) included the growing threat of a global Ebola outbreak, signs of deflation in the Eurozone, disappointing growth in emerging market economies, the impending termination of quantitative easing in the US as well as political risks around the world (notably the Middle East).

Which one of these matters most and is there any one factor that can explain the recent volatility better than the rest? Given the multitude of moving parts and the many participants that make up global markets, the truth is that no-one really knows the answer to these questions… even though many commentators will try to explain gyrations with reference to specific data points, something that Nassim Taleb famously refers to as the "narrative fallacy". ▸▸

Deon Gouws - *CIO* | @DeonGouws_Credo

*"It could be argued that a meaningful proportion of investors will be mindful of October's legacy, leading to a situation where their behavioural response ultimately results in a self-fulfilling prophecy."*

This is also why our investment philosophy at Credo is to identify matters of strategic importance when considering investments, rather than focus on daily news-flow in financial markets (much of which can essentially be written off as "noise"). As Benjamin Graham said more than 50 years ago: "The market is fond of making mountains out of molehills & exaggerating ordinary vicissitudes into major setbacks."

Despite this, one also has to recognise that not all news flow can be casually written off as noise. Against this background, allow me to comment briefly about two of the news headlines in October, namely the threat of Ebola and deflation in the Eurozone.

While we recognise that Ebola may yet evolve into much more of a human tragedy than we have seen to date, we do not believe this is a reason to sell shares or reduce exposure to other financial assets. Quite the contrary: with the benefit of hindsight, we now know that some of the more recent pandemics (SARS in 2002/03, Avian Flu in 2004/05 and Swine Flu in 2009) all proved to be excellent buying opportunities.

Deflation in Europe, on the other hand, presents a much greater risk to financial markets, in our view. The main economies in that region have still not quite recovered from the 2008 financial crisis and a number of structural challenges remain.

On the bright side, the threat of deflation does however also mean that interest rates in most of the developed world are likely to stay lower for even longer, which on balance could yet provide a fillip to financial markets for some time to come.

Looking back, there has hardly been a time in history when financial market participants did not have a long list of issues to worry about, yet the long term performance of risk assets has always been strong (even if it came with some blips along the way). Perhaps Warren Buffett summed it up best in October 2008 when he said: "In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts, the Depression, a dozen or so recessions and financial panics, oil shocks, a flu epidemic and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

Yes, worries always abound… yet somehow the market typically seems to manage climbing that wall of worry. In the past, this has consistently led to strong returns from risk assets over time (providing that one is able to ignore short term volatility and focus on longer term outcomes). We see no reason why this would change - as long as one builds a carefully considered portfolio of investments, acquired at reasonable valuations. This is exactly what we at Credo try to do for our clients on a continuous basis.

Put differently: we would suggest, that investors keep calm, carry on... and keep climbing that wall of worry.

# KEEP CLIMBING THAT WALL OF WORRY

# KEEP CALM AND LIVE A LONG LIFE

# ...but don't outlive your money

At the start of my career in the late 80's, my newly qualified colleagues and I were sitting in an audience at the accounting firm where I did my articles when a number of business heads paraded across the stage, telling us what went on within each of their divisions. I'll never forget the following introduction given by the head of Personal Financial Planning: "In 40 years' time, when you're all scheduled to retire, 11% of you will be dead…and those are the lucky ones!".

The bottom-line of that presentation was of course that financial freedom will always remain an elusive ideal for most, even those with professional qualifications. Reasons for this are clearly plentiful, not least the fact that people are "disposed to increase their consumption as their income increases…" (in the immortal words of John Maynard Keynes).

Nearly 27 years later, I realise how fortunate I've been as far as the timing of my career has been concerned. Jobs were plentiful when I started out: no young CA battled to find work. Inflation was falling around the world whilst asset prices rose at an unprecedented pace. Best of all, a new world order was starting, with the Berlin Wall about to fall and South Africa making the transition to a full democratic state soon thereafter.

Fast forward to the present time and things could not be more different. I will not comment on world politics and all the tension experienced across the globe… that is clearly well beyond the scope of this article. But from an economic point of view, 2014 is by all accounts a much more difficult time to find one's first job (and indeed to start building an investment portfolio from scratch) than it was a quarter of a century ago.

Any person taking the first steps on their chosen career path today is likely to be a millennial - generally defined as someone born between 1980 and the early 2000's (also referred to as Generation Y). The members of English-Irish pop boy band, One Direction, are clearly all Millennials. So is Luis Suarez. As well as Kevin Pietersen and Julius Malema… just.

Here is the reality: unless you're a pop star or a world class sportsperson (or run your own political party), jobs are nigh impossible to come by these

*"In 40 years' time, when you're all scheduled to retire, 11% of you will be dead… and those are the lucky ones!"*

days. In Europe, for example, youth unemployment (under 25's looking for a job) exceeds 25%; in Spain and Greece the number is rapidly approaching 60%. This also explains phenomena such as a recent finding by EU social research agency, Eurofound, namely that the number of continental Europeans aged 18-29 still living with their parents rose to 48% from 44% between 2007 and 2011.

If you cannot even find a job, you clearly will have no money to invest or start a pension plan. But let's say that you've been the lucky beneficiary of a windfall, perhaps a generous grandparent leaving something to you in their will… what to do with the money? Can anyone blame you if you refuse to invest your little nest egg into the stock market?

Let's be honest, if you're the typical 25 year old millennial today, you were just about to start your teenager years when the Dotcom bubble burst in March 2000. Seven years later (as you were finishing high school) it was the much celebrated global financial crisis. As a result of these events (representing practically all of your living memory), you know nobody who has actually made any money out of equities.

Worse still, now that you've completed your degree (and possibly even earned a professional qualification), everyone will tell you that the stock market is overvalued (in terms of the Shiller CAPE ratio, for example, shares were on average only more expensive on two occasion in the last 140 years). Accordingly, it's probably fair to ask: why on earth would any member of Generation Y even contemplate buying a portfolio of stocks?

This scepticism is also borne out by the numbers. In a recent survey by US investment manager, MFS, it was found that the average equity allocation of those millennials who were in fact lucky enough to have pension plans in the first place, had fallen from 32.7% in June 2011 to a level as low as 30.5% at the beginning of 2014. An even more disturbing statistic from the same study was that 46% of millennials said that they would never be comfortable investing in the stock market (up from 40% in the same survey two and a half years earlier).

Elevated stock markets are of course not the only complicating factor facing Generation Y investors

these days. For many, their first step onto the property ladder will be even more difficult, with prices in many parts of the world considered to be in bubble territory and affordability levels at all-time lows.

Against this background, who can blame any millennial for counting the pennies and being totally risk averse today?

Unfortunately this all adds up to behaviour which is more than likely to add up to some serious opportunity cost in the longer term. With medical progress ensuring that life expectancy continues to increase, many (if not most) millennials are likely to live well past the age of 100, meaning that on average they should realistically all have an investment horizon of 75 years plus… based on which they should keep calm and embrace as much risk as possible, because they can afford to do so. In support of this, one really only needs to focus on the work of Jeremy Siegel and his seminal book, "Stocks for the Long Run", in terms of which equities comfortably outperform all other asset classes over the long term (and I would suggest that 75 years is indeed a pretty long term perspective!).

Millennials who take this advice certainly have enough time to ride out any market storms and forget recent volatility. To illustrate this last point: have a look at any longer term share graph and look at the effect of the famous 1987 crash (yes, I know most millennials were not even born then…). Today, it really amounts to a blip, at most.

According to a famous quote (the origins of which are unfortunately not quite certain), old age is not so bad when you consider the alternative. This is indeed the case, but nobody wants to grow old in poverty either…

Regardless whether you are Luis Suarez, Kevin Pietersen, Julius Malema, a member of One Direction - or just the average millennial, for that matter - you should therefore relinquish prejudices, embrace risk and implement a well-diversified investment plan focused on the longer term. If you don't, you might just be unlucky enough to outlive your money. ■

Joelle Anamootoo - *Investment Strategist*

# Keep calm, the party is not over

For the past six years the market has become accustomed to the Federal Reserve's bond buying programme - Quantitative Easing (QE) - and many market participants have been nervous about what the end of the US Fed QE would mean for asset prices and, by extension, for US and global economic growth.

Our view is that there should not be much cause for concern as long as the macro momentum remains on track. Indeed, had the Fed not been confident in the US economy's ability to grow "on its own", they would have continued QE for longer. The US economy has become more robust in the last couple of years with more attractive dynamics than China or the Eurozone. Consumer spending is growing, helped by an acceleration in household credit growth. Continuous improvement in the labour market, along with very low interest rates, should encourage this trend to persist. Besides, the recent drop in the oil price which translates into lower gasoline prices at the pump in the US should also help consumer spending as it is effectively a tax cut. Moreover, the corporate sector is likely to step up capital expenditure in response to stronger demand and reduced political uncertainty and the economy is no longer subject to the fiscal drag which kept a lid on GDP growth in 2011 and 2012.

One more reason why the end of QE in the US may not necessarily represent the end of the good times for risky assets is that there is plenty of liquidity in global financial markets. In fact the European Central Bank (ECB) and Bank of Japan are increasing the pace at which they are injecting liquidity in the market with recently announced QE programmes. Many central banks, including the ECB, around the world have been cutting interest rates in the last six months. While market participants have been expecting the Fed to increase interest rates from mid-2015 they have recently revised this expectation for later in the year. The recent downtrend in the oil price and the reluctance of wage inflation to rise are likely to limit upward pressures on US inflation. Hence, we expect that the Fed will not be under much pressure to raise interest rates quickly and aggressively.

Outside the US, the economic landscape looks less rosy. The Eurozone is flirting with deflation, largely due to falling energy prices and the strong domestic currency up until mid-year. While energy-led inflation or deflation is usually viewed as transitory, the risk for the Eurozone is two-fold. First, persistently low inflation could potentially trigger a deflationary spiral. If inflation expectations are anchored at a lower level, wage inflation would come under pressure, limiting consumer spending growth and causing further declines in the inflation rate. Second, against a backdrop of weak growth and exhausted policy measures- with interest rates barely above zero and tight fiscal rules in place - a potential recession in the Eurozone would likely push up unemployment, reducing wage inflation hence reinforcing the deflationary trend.

The other risk to the global economic outlook is China. We are not worried by the steady deceleration in China' GDP growth since the end of 2009 which we view as part of the economy's "normal" coming of age and the transition from a fixed asset investing-led to consumer spending-led economic growth model. This

was also observed in South Korea as the economy faced this transition. Rather, our concern with China is the slowing property market and the possible implications that falling property prices could have on the domestic economy, with consumer spending having become increasingly dependent on property investment in some regions (in a number of economies within China's supply chain, mostly emerging markets) as well as on the domestic banking system.

While we bear these risks in mind, we expect global GDP growth to continue to expand in 2015 led by the US economy and we continue to allocate a larger proportion of a multi-asset portfolio to risky assets. Of those, we prefer Equities over emerging market bonds or corporate high yield bonds which are relatively more expensive. The ongoing US dollar appreciation makes EM debt less attractive and the property slowdown in China represents a risk to the broader EM space. Within equities, we have a relative preference for US and Japan where we see more potential for earnings growth to improve further.

Ainsley To - *Research Analyst* | @AinsleyTo_Credo

# Investment existentialism

## Are you living to invest or investing to live?

When US Congress passed the Federal Reserve Act in 1913, the real economy was at the centre of the financial system. If the money supply was too low, the idea would be that a central bank could be a lender of last resort to banks who needed funding to satisfy deposit withdrawals and loan demand. The Fed would print just enough money to grease the wheels of the real economy and only the excess money supply over what was needed would flow into asset price inflation. Today asset prices have become the centre of the system - central banks will do whatever it takes to stop asset prices from falling, regardless of the real economy. Falling asset prices characterise deflation, an environment in which a credit based economy cannot function by design (collateral values are contingent, but the debt that they are backing is fixed). Some might even say the Fed's dual mandate is now the S&P 500 and house prices; focused on short term movements as opposed to long term price stability and full employment.

As we highlighted in a previous CredoNews article *"Open Mouth Operations"*, it's very easy to get caught up in all the *"ifs"* and *"buts"* of central bank rhetoric. However, it's important to remember that despite the fact the international monetary system has collapsed three times in the last 100 years (1933, 1944, 1971), if you had invested $10,000 in equities in 1914 you would still have ~$180,000 today in inflation adjusted terms (that's without even reinvesting the dividends along the way).

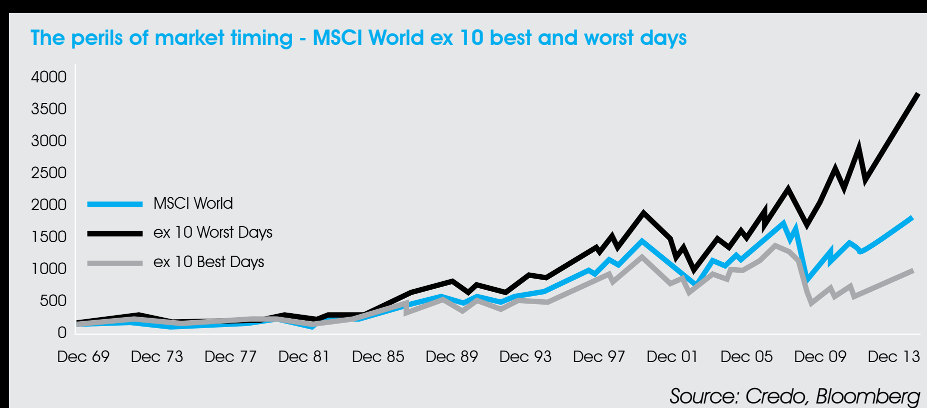
Forward guidance is just one of many fads the financial media has exaggerated, to increase short term portfolio turnover - they strive for investment to be a spectator sport where our savings are no longer where we store our future consumption, but speculation for speculation's sake. And because we are evolved to survive predators on the savannah (and not to invest in financial markets), the first stop for any new information in our brains is a part of the temporal lobe called the Amygdala, which automatically puts preferential emphasis on negative news that might threaten our survival.

So as a reminder of the bigger picture of what really matters to investors, it is worth having a recap on why we invest in financial markets in the first place…

### If you don't know where you're going, you have no hope of getting there

Every investor wants maximum return for minimal risk or maximum excess return over an index. However, in the same way that *"Hope"* is not an investment strategy, *"More"* is not an achievable investment objective. Whilst it can affect our emotional state, focusing on market movements is by definition backward looking. The past fluctuations in the value of your portfolio tell you very little about whether your savings will meet your future consumption needs.

An investment objective should be based on a defined wealth target and risk should be defined as the likelihood of falling short of that wealth target. Why is this distinction between maximising returns and minimising the chance of shortfall important? "Maximisers" will always be chasing optimums, trying to reach for more than might be sensible at a given point in time. There is substantial academic and anecdotal evidence that market timing is a mug's game and one of my favourites is illustrated below: the returns on the MSCI World index since 1970 without both the 10 worst days and the 10 best days in its history.




| 10 Best days in MSCI World since 1970 | |
|---|---|
| 13/10/2008 | 9.5% |
| 21/10/1987 | 8.4% |
| 28/10/2008 | 7.0% |
| 24/11/2008 | 6.9% |
| 19/09/2008 | 5.7% |
| 08/12/2008 | 5.5% |
| 29/05/1970 | 5.3% |
| 10/03/2009 | 5.3% |
| 23/03/2009 | 5.1% |
| 06/01/1972 | 4.9% |

If you're aiming to maximise returns you need to ask yourself if you have reasonable confidence you can distinguish every morning whether today will be a good or a bad day for the market. Because by aiming to be in and out of the market to miss the 10 worst days (the black line) you could very easily miss the best days and end up with half of the return you could have got from a buy and hold strategy. The fact that 5 of the 10 best days for the MSCI World occurred in the fourth quarter of 2008 when many commentators were suggesting the world was coming to an end suggests most market timers' results are probably best represented by the grey line. Instead of speculating over which days are likely to be good or bad, a more productive question to start with is whether or not the blue line would be sufficient for you to meet your wealth target. As Benjamin Graham wrote on market timing, ***"In market analysis there are no margins of safety; you are either right or wrong and, if you are wrong, you lose money"***.

## Hurry up and wait

Like the Federal Reserve, some investors have increasingly become too obsessed with asset prices. Remember the fundamental purpose of our investment portfolios is to cash them in at some point in the future and spend on the things that will really matter.

Start by abandoning your obsession with maximums and optimums. A definition of optimal is only valid for your best guess of the future i.e. maximum returns and lower risk cannot exist in an ex ante sense without a crystal ball. Besides, you can't retire on a Sharpe Ratio and you can't eat relative outperformance. Determine your investment objective, make a plan to minimize your chances of not reaching it, stress test your plan with conservative assumptions and stick to that plan.

The Fed will always be dovish or hawkish, government debt will always be a house of cards, there will always be geopolitical risk, valuations will always be too high or too low; and all of this will do precious little harm to your long term investments UNLESS you let your emotions affect your actions. Don't be the *"ass"* in asset allocation by benchmarking yourself against Nostradamus.

Ed Fincham - *Investment Analyst*

# Fractals

## Insights into market stability

Benoit Mandelbrot, the father of fractal geometry once said "my life seemed to be a series of events and accidents. Yet when I look back I see a pattern"; a fitting epithet for both the man and his child. A fractal object is one that displays self-similarity on all scales. In mathematical terms this means that many fractals are endowed with an infinite degree of complexity.

At first glance one may wonder what relation this seemingly arcane geometry bears to financial markets, governed not by the parameters of an equation but the duumvirate of supply and demand. The answer can be found in a brief excursion to the natural world, where examples of fractals abound; for instance, the internal anatomy of our lungs. From the primary bronchi, through inumerable bronchioles, terminating in the alveoli, the lungs exhibit a repetitive, recursive structure. This self-similarity is a key fractal property. Moreover, these structures have not originated by chance; rather, they have evolved to optimise the functional purpose of the object, in this case, to maximise the available surface area for the absorption of oxygen in the lungs.

Financial markets also exhibit this property. Figures I, II and III show 10 consecutive points for the S&P 500 Index ending on 31st October 2014. The graphs show the preceding 10 weeks, 10 months and 10 years. Yet ask yourself this: without axis labels, could you identify which was which?

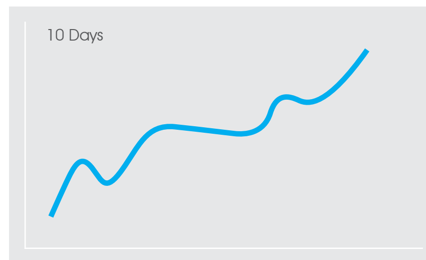



*Figure I*

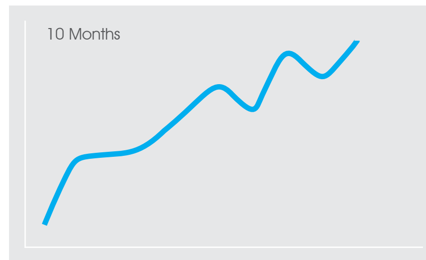



*Figure II*

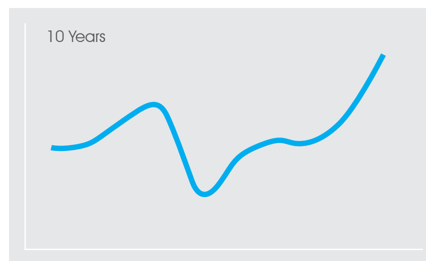



*Figure III*

So if financial markets can be described as self-similar, what is their purpose? The answer to this is to optimise liquidity and balance the forces of supply and demand. Fractals come to the fore when we start to think about what constitutes supply and demand. The word fractal owes its origin to the Latin 'fract-' for broken and this is the key intuition: fractal structures are optimised when investors who, on aggregate make up financial markets, are "broken". In other words, when investment horizons differ. This is reflective of reality: compare the trading practices of a high frequency trader with a pension fund. Their investment horizons differ from microseconds to decades. For instance, take a sharp one-day sell-off: short-term traders might interpret this as a sell signal, whereas long-term investors may interpret the same sell-off as a buying opportunity. This balancing of supply and demand provides the market with ample liquidity while also dampening violent price movements.

When investors have such divergent horizons then markets have a rich fractal dimension. Troubles arise, however, when this broken structure becomes "whole" and one view dominates. This is deeply intuitive: violent corrections occur when all investors want in or out of a market all at once and liquidity evaporates. Ironically, the less fractured the market becomes, the more unstable it becomes

*"...in the troubled waters of today's markets, where volatility is once again causing whirlpools, this fractal insight provides solace to the worried investor."*

and the liquidity precipice draws nearer. This all makes sense from a fundamental point of view. The benefit of fractals, however, is that they enable us to measure this degree of fragmentation,or fractal dimension.

What do we actually mean by fractal dimensions and how they can be measured? Put in the simplest of terms, the fractal dimension is a ratio indicating how detail in a pattern changes when it is measured at different scales. To borrow from Mandelbrot's seminal paper *"How Long Is The Coast Of Britain?"* the coastline of this sceptred isle depends on the length of the ruler used to measure it. Consider two rulers, one of which is normal and the other is shrunk by a scaling factor of 3. In the case of a straight line, the smaller ruler will measure the scaled length as exactly 3 times that of the normal ruler and so the fractal dimension would be one. This changes when the shape measured becomes more complex. In the case of the British coastline, the smaller ruler captures complexities - the innumerable bays and coves - that the larger ruler cannot and so counts more than 3 times more lengths; a scaled length of 5.75 times more.

Normal Ruler
12 Lengths

Shrunk Ruler
69 Lengths

Extending this principle, the fractal dimension of any shape or time series can be measured (after all, a financial time series is essentially a broken line). In the case of markets, we need only substitute the long and short ruler for a long and short investment horizon, say 1 day and 1 year. However, unlike the coastline, financial markets are dynamic systems. When investors' horizons converge to a uniform level, the delicate balance of liquidity collapses. With this loss of complexity, the fractal dimension falls towards the tipping point.

Looking back at the events and accidents of markets throughout history, a pattern emerges. Across asset classes and geographies, the precipice of instability is consistently reached when the fractal dimension approaches 1.25. Though this aspirant to the title of universal constant does not come without caveats. While fractal dimensions may provide a useful barometer of stability, they provide no indication of scale, scope, or direction of future corrections. Accordingly, an investor must recognise the limitations of this novel method. Nevertheless, in the troubled waters of today's markets, where volatility is once again causing whirlpools, this fractal insight provides solace to the worried investor. Consider the S&P 500, whose fractal dimension sits comfortably above the 1.25 level at 1.60. Paradoxically, for markets, the house divided against itself stands firmest.

Stephen Davis - *Director*

# An old story with a new life

## Keep calm - It's a wrap!

Tax avoidance under the present government is akin to evasion and with the pension lifetime allowance having been reduced to £1.25m from April 2014, there are few legal tax shelters available to UK tax residents. The £15,000 ISA allowance is useful but takes many years to become a valuable benefit.

For those concerned with tax leakage or the tax cost of switching investments, the answer may well be to use an offshore bond wrapper. These wrappers are not a tax scheme and have been around for over 40 years. Initially used primarily for "with-profit" policies, they became less interesting post 2008 due to changes to Capital Gains Tax, but subsequent increases in tax rates in 2010 means they are of value to many UK tax payers.

The wrappers are provided by Life Insurance companies, enabling the investor to withdraw 5% per year for 20 years. The 5% does not have to be withdrawn, in which case this "allowance" effectively rolls up. The withdrawal is a return of capital and not immediately taxed. On exiting the wrapper, which may be in over 20 years' time, the gain (after adding back the amounts withdrawn) is liable to Income Tax on a "top-slicing" basis. If your other income is low in the year of exit, the resulting Income Tax charge may be surprisingly low. In addition, if you emigrate and then exit the wrapper, no tax charge may arise.

So what are the downsides? The wrapper has to invest in funds, which includes trackers. You cannot invest in individual equities or corporate bonds. Charges were previously deemed excessive, with many wrap providers charging 1% per annum with a tie-in of 8 years. Today, typically you should be paying no more than a one-off fee of 0.5% for an initial investment of £750,000 and 0.8% for £250,000 with no tie-in.

A number of examples of who may be interested in using an offshore wrapper:

### Example 1

A divorced person or widow(er), no longer in full time employment, with a capital sum of £1m which is required to provide "income" to top up existing pension arrangements.

The 5% allowance will enable £50,000 to be available to supplement the pension. No tax immediately arises on the £50,000 and is a solution for the coming 20 years.

### Example 2

Having recently sold a business or downsized their home, a couple have sufficient income for their immediate needs but are concerned in circa 10 years' time, their pension fund may be insufficient to provide the income they will require. In addition, they are concerned any income and gains on the monies invested will add to their current tax liability.

The offshore wrapper will enable the investment income and gains to roll up without any immediate tax liability. The 5% allowance will be deferred and taken as and when required.

### Example 3

A retired couple previously gifted various monies to their children. They are mindful of future Inheritance Tax liabilities but are concerned as to what their income requirement might be in future years.

The couple lend £1m to a Bare Trust, which opens an offshore wrapper. In future years, the 5% allowance can be used to effectively repay the loan and provide additional "tax free income" to the couple. The investment growth in the wrapper will belong to the beneficiaries of the Bare Trust. No Inheritance Tax arises on the structure.

Everyone's circumstances are different, so it is imperative you take appropriate advice when considering whether an offshore wrapper might be appropriate for you.

# Bond bubble jitters

Since 2012 there have been stories in the press concerning the impending bond crisis. Although there have been periods of volatility the 'bubble' has not yet burst. Despite the recent equity sell off, corporate bond prices have remained resilient.

## So what is really going on and where do we see the risks?

As global interest rates are at historically low levels, there is a concern that rising interest rates, together with liquidity issues will create a double shock to bond prices. UK government bonds are traditionally classed as a low risk investment, the 2 year and 5 year gilts provide a prospective total return of only 0.65% and 1.51% per annum respectively. Therefore investors are currently losing money on an inflation adjusted basis with the potential of a significant amount of volatility along the journey. If the bubble was to burst, government securities that have been purchased as part of the quantitative easing could be the first to react with a sharp fall in prices.

Participants have naturally been expecting rates to rise, although paradoxically throughout 2014 the interest rate expectations for the next 10 years have continually dragged lower. In the UK, market consensus is currently fluctuating between an August or November 2015 rate rise, while only earlier this year it was expected to be before the upcoming general election in May 2015. When the moment arrives and rates do start to rise they are likely to be in small increments, allowing markets to adjust, on the way to long term average interest rates.

## On this basis our Fixed Income strategy is as follows:

1. **Corporate over Government**
   We don't advise holding government bonds as we are not comfortable with their total return profile. Corporate debt enables us to generate a higher yield with a lower correlation to central bank rates.

2. **Buy & Hold**
   The buy and hold strategy offers certainty of the total return over the duration of the bonds, provided the company remains solvent, irrespective of any short market movement. Additionally it minimizes trading costs, enhancing portfolio returns.

3. **Shorter Duration**
   We prefer shorter duration to minimize the effects of any interest rate rise and any ensuing volatility. These bonds enable us to rebase our expectations of returns on maturity, benefiting from any future increase in rates.

4. **Middle of the road**
   Predominately we hold bonds that are credit rated in the region of BBB, as we look to efficiently navigate between higher rated bonds that trade in a similar manner to government debt and companies with a lower rating have higher risk due to the underlying company fundamentals.

5. **Financial sector**
   We prefer the financials and insurance sector, which remain widely under-owned. In these markets, regulatory pressure continues to reduce risk, benefiting bond holders; although we remain selective as there are significant differences between issuers.

We have recently seen some volatility return to the markets with the most significant moves in US treasuries since March 2009. We remain cognisant of both the risks of the companies' financial strength as well as potential interest rate rises. The bubble may burst, however we should continue to achieve our target returns albeit with some ups and downs along the way. A portfolio of our preferred and widely held bonds has remained relatively stable in the recent period, leading to strong performance of portfolios despite the current economic climate for fixed income securities.

# KEEP CALM AND BALANCED

Christelle Coetzee - *MyCredo Specialist*

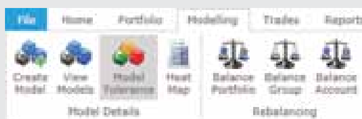


# MYCREDO

## Models the way…

**Credo is proud to introduce MyCredo's new Portfolio Modelling and Heat Mapping functionality.**

### Modelling




For our Financial Intermediary clients, a model with pre-defined security weightings can be created per portfolio, based on individual criteria such as risk profile and investment strategy.

**Re-Balancing**

Re-balancing can be done per portfolio, group or account. Re-balancing allows automatic trade generation, subject to approval.

### Heat Mapping

In order to manage your client portfolios more efficiently, the modelling tool can immediately warn you of any adverse portfolio deviations from the assigned model through the Heat Map function. Allowable deviations for each model can be setup using the Model tolerance functionality.

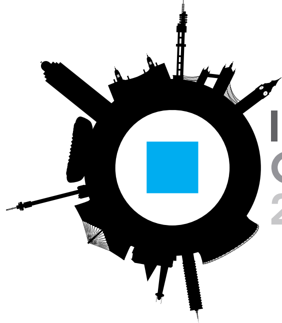
The weightings of the selected securities are chosen when creating the model and the deviation parameters can be set according to portfolio requirements. When securities fluctuate outside of these parameters, the Heat Map will highlight these deviations, affording you the opportunity to balance the portfolio back within the Model Tolerance.

The Heat Map can be viewed by various criteria such as Sector, Security type or even Issue Country.

**Credo is committed to continuous innovation and exceeding our clients' support expectations.**

Contact your Relationship Manager to arrange access to Portfolio Modelling today.

Sara Ettlinger
*Communications Officer*




Pretoria
Monday
**26 January 2015**
2pm to 5pm
The Irene Country Lodge

Johannesburg
Tuesday
**27 January 2015**
9am to 12pm
The Wanderers Club

Durban
Wednesday
**28 January 2015**
9am to 12pm
Sibaya

Port Elizabeth
Thursday
**29 January 2015**
9am to 12pm
Radisson Blu Hotel

Cape Town
Friday
**30 January 2015**
9am to 12pm
Cape Town International
Convention Centre

If you are interested in attending and have not yet received the "save-the-date" notification, please contact Christelle Coetzee at
ccoetzee@credogroup.com

# Keep calm...

## In golf as in life it is the follow through that makes the difference

No less than 65 people attended an international investment seminar at the St Francis Links Golf Club, South Africa on Wednesday 29 October 2014.

The program was co-hosted by Richard Arderne, who heads up Pam Golding in the area, as well as Gavin Harvey, CEO and owner of the 120 year old Port Elizabeth based financial services firm PW Harvey.

The keynote address at this event was delivered by Deon Gouws, Credo's Chief Investment Officer.

*Richard Arderne, SJ Du Preez, Gavin Harvey and Deon Gouws*

*Gavin Harvey, SJ Du Preez, Norman Dyer and Richard Arderne*

# ...and call Credo

## Introducing a few new faces to the Credo Team, who are always calm and ready to take your call

### Benjamin Newton

Investment Manager. Ben holds an MSc in Finance from Imperial College and is a CFA Charterholder. Prior to joining Credo, Ben spent four years working at Barclays Wealth & Investments managing private client portfolios as a Discretionary Portfolio Manager. During his time at Barclays, Ben also worked with relationship managers and was seconded to the Investment Product Office in Absa, Johannesburg. He is an avid sports fan, enjoys keeping fit and playing football and golf.

### Kathryn Linde

Relationship Manager. Kathryn is a South African and holds a Master of Commerce in Financial Markets degree from Rhodes University, South Africa. Prior to joining Credo, Kathryn worked as an Analyst in the Wealth Management division for Jefferies International Limited. She enjoys reading, travelling and keeping fit.

### Christelle Coetzee

MyCredo Specialist. Based in Johannesburg, Christelle assists clients with MyCredo training and implentation. Christelle is a Human Development specialist with qualifications in Financial Planning, Life coaching, Neuro Linguistic Programming and Hypnotherapy. Prior to joining Credo, Christelle worked for Old Mutual for 12 years in financial planning, training and development, marketing and support management.

### Ed Fincham

Investment Analyst. Ed read Politics, Philosophy and Economics at Durham University, specialising in macroeconomics and Tibetan Buddhist philosophy and holds an MSc in Economics & Finance, also from the University Durham. He is keen on film photography, art and enjoys running and cycling.

### Guy Prescott

Client Services. Guy recently moved to London from Leeds where he worked for Capita Financial. Guy is an avid film fan having previously made short films with friends and premiering one at a New York film festival. He is also a football fan having previously played for a local team while in Leeds.

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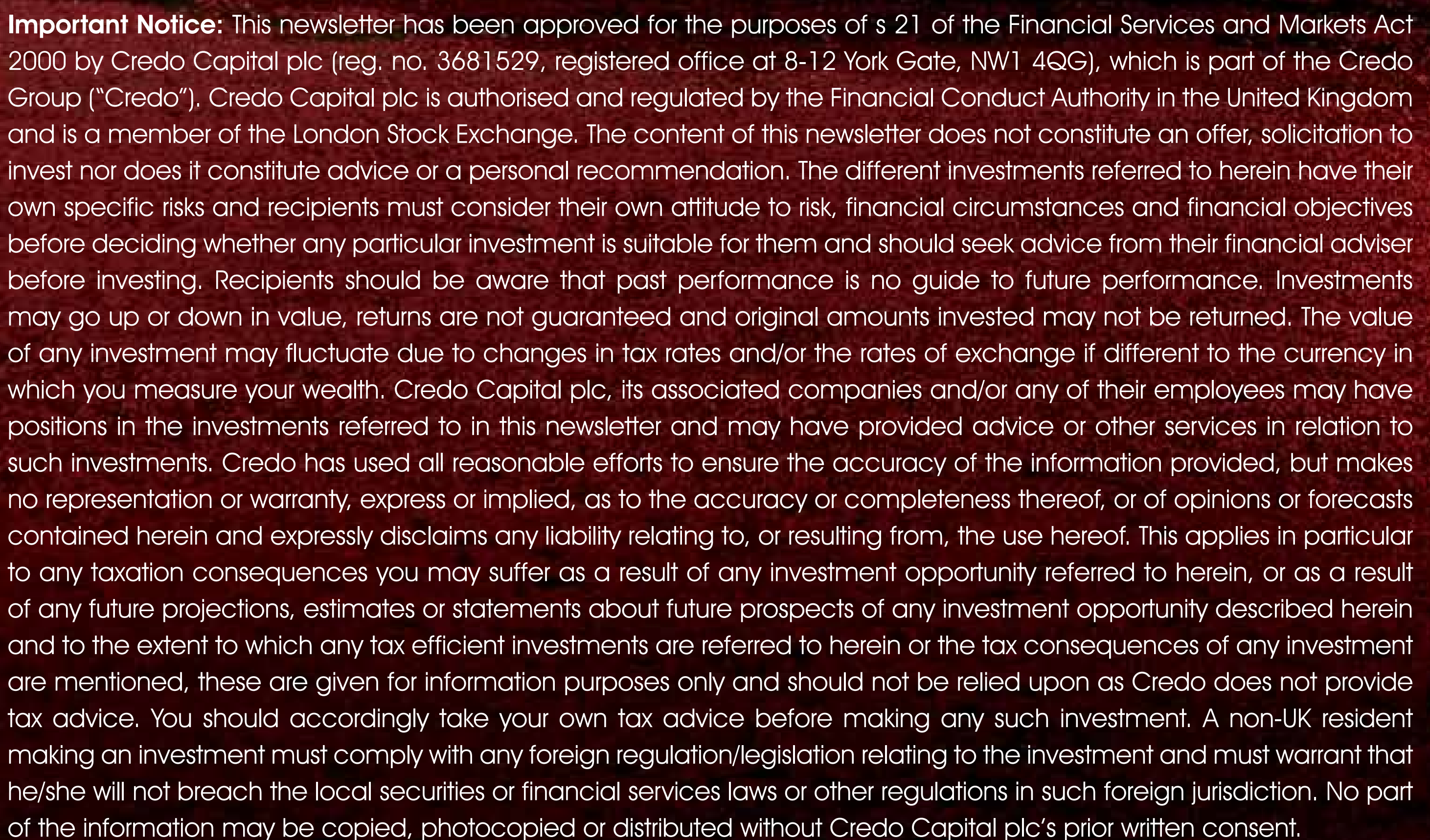
CREDO
WEALTH



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