galileocapital
Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – September 2014

The African Bank saga

The big economic event of August was the abject failure of African Bank (ABIL) as a business and an investment. When the news initially broke, we watched with interest, but not too much trepidation: the bulk of our clients are so well diversified in their portfolios that we felt ABIL would simply be an unusual market event from which our clients would recover without too much damage.

Unfortunately, we had not counted on the fact that many of our newest clients had exposure to ABIL via their investments in the Nedgroup Core Income Fund. We use this fund as a parking place for money that is being phased into new investments at Nedgroup, and it had 6% of its assets invested in ABIL bonds and money market instruments.

The net result was that our clients lost the equivalent of one month of interest. A further 6% of their capital has been ring-fenced until such time as the ABIL investments can be sold. The SA Reserve Bank has guaranteed the value of the assets that have been ring-fenced and we understand that the interest will still be paid.

While the actual losses were small, we were all taken by surprise, as low-risk funds like these (most banks had money market funds that were affected) are not meant to lose money. Sadly, we have all learnt a lesson – any investment can lose money.

What do we take from this?

We have been reminded that the only real defence against a permanent loss of capital is to ensure that your money is highly diversified across asset classes, eg. cash, bonds, property and shares. In addition, any investment aiming to beat inflation must be made with the plan to leave the capital invested for at least five years or longer so that short-term losses can be recouped over time.

Our view of Nedgroup’s actions in response to this event are mixed. With the benefit of hindsight, we would have preferred no exposure to ABIL and we would have preferred that they found a better solution to the ring-fencing of assets. However, they were in a difficult position and under significant time constraints to find a solution.

They have since argued (possibly correctly) that our clients have benefited from superior interest rates from ABIL investments over a nine-year period and that a loss like this needs to be seen in a context of long-term superior growth. We do, however, have a fundamental disagreement with them on the issue of fees.

We have strongly recommended that they reduce their investment fees on Core Income for as long as it takes to resolve this issue in its entirety. They have not agreed to do this as they view these losses as part of a normal market event.

Having spoken to a number of different fund managers, we have received the same feedback from all of them. These types of losses are unusual but they have happened in the past – Saambou was the last example. By the time the fund managers realise that there is a problem, there is nothing they can do to resolve it; there were no buyers for the investments they wanted to sell.

While we have sympathy with this explanation, we feel their initial communication about the real risks of these funds was poor. Most importantly, we are very disappointed that they are unwilling to reduce their fees until the ABIL issue is completely resolved.

- Theo and Warren

You are your portfolio

The traditional model for asset allocation for individual investors consists of ascertaining the return requirement, bounding those in by considering risk tolerance, tossing in a liquidity buffer for just-in-case, the settling on of an investment horizon and interweaving a tax rate appropriate for the individual.

In particular, the traditional model focuses on financial wealth, and winds up ignoring a concept known as ‘human capital’. This is defined as the actuarial present value of future labour income: an expectation on the size and shape of an individual’s future expected earnings. What this means, is that your total wealth is represented by financial and human capital.

Human capital is contingent on the investor’s life and is often the largest asset you have. Younger investors have more human capital than older investors – as people grow older, they convert their human capital into financial capital. The value and risk characteristics of human capital depend on age, income, education, health and profession, etc. This means that this approach provides a framework not only for thinking about investment, but also lifestyle.

Failure to look after your education (whether formally or just by sensible reading choices), health (assorted recreational habits) or professional standing, all apply negative pressure to your personal portfolio.

At first glance, this kind of distinction seems both obvious and needlessly picky, but certain career choices actually have some correlations with different asset classes.

For example, a university professor with tenure has a future income similar to the bond market. Someone like that should diversify his overall total wealth with a large weighting in equity investments. By contrast, a high-flying entrepreneur or company director with a bundle full of equity options, for example, should tone down his exposure with some bond or preference share investment.

In practice, though, we know from experience that these two types of people are likely to do the exact opposite without the appropriate guidance – ensure you take both your financial and human capital into consideration when designing your investment portfolio.

- Warwick Lucas, Galileo Asset Managers

5 coffee-fuelled facts

There are days when it seems as if most of business is fuelled by coffee. Coffee culture has invaded the world, and it doesn't just give us a boost; all kinds of deals are brokered in coffee shops around the world. Here are some things you might not know about your favourite brew:

1. Over 2.25-billion cups are consumed in the world every day.
2. Caffeine works the same part of the brain as cocaine, amphetamines and heroin. It just has milder effects.
3. The lethal dose of caffeine in a human is 150-200mg per kilogram of body weight, which is the same as consuming 100 cups in four hours.
4. Twenty-five million small producers rely on coffee for a living.
5. Drinking even small amounts of coffee will produce a tolerance and your body will need more to get the same stimulation.

And if you're worried about your waistline, here's a calorie-counting guide to some common coffee choices:

- Latte 165 cals
- Cappuccino 150 cals
- Café au lait 140 cals
- Americano 15 cals
- Espresso 3 cals