Dave Pohl & Associates

FINANCIAL INFORMER

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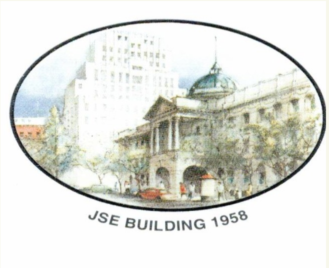

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Getting the (risk) balance right

Risk taking is a necessary evil and understanding how risk taking pays off is important. Risk is part of history and present in every domain of life. Waging war over scarce resources, hunting for food, mate selection – all these activities contain risk. And they require courage.

However, it would be delusional to think that plunging head first into peril should result in a positive payoff. You don't simply go to war with no knowledge of the lay of the land and no strategy, carelessly believing that your chances of success increase with courage. Even the skilled hunter makes a careful study of his prey, knowing full well that the tables can easily turn.

Eyes wide shut

It goes without saying that taking a risk is something that you only do when you have a competitive edge and in the right context. So where did the idea that to get rich you need to take risk and that risk taking begets higher returns? Unfortunately, driven in part by academic theory, too many investors naively think that simply taking risk generates the payoff for such risk. This is a problem, as it discourages the type of follow-up that makes risk taking productive in the first place.

Wrong turn

To understand this problem, we need to look at the history of what is known as the standard model of portfolio theory. The standard model came into existence during the boom period of the last century in financial markets research during the 1960s and early 1970s. The coming together of two forces resulted in a model known as the Capital Asset Pricing Model (CAPM), which would occupy a lot of academic energy for another 40 years.

These two forces were:

1. The publication of seminal works of Markowitz (1952), Sharpe (1964), Lintner (1965) and Mossin (1966), and
2. The creation of the first ever comprehensive database of historical stock prices by researchers at the Centre for Research in Security Prices (CRSP) at the University of Chicago. This database demonstrated that the aggregated stock indexes had earned a sizable return premium of 5% over treasury bills over the 1926 to 1962 period. This seemed to confirm a prediction by the theory. It is important to note that this return premium occurs in between asset classes. The basic claim of the standard model was that the expected return on any security is a linear and increasing function of its risk, in turn defined as its covariation with the 'market' portfolio.

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A large amount of empirical work followed until finally, 20 years later, it was properly refuted by Fama and French (1992). They proved that increasing risk was empirically associated with decreasing returns, when we look within common stocks as an asset class.

The Standard Model - epic fail

Fortunately for scientific progress, we are now living in perhaps the second most highly fertile financial markets research period since the beginning of portfolio theory. The financial crash of 2008 served up a very strong test of the standard model and it failed the test miserably. Grouped together under the term "low volatility anomaly", there has been a resurgence in interest in the exact nature of the payoff to financial risk taking.

Cause and effect

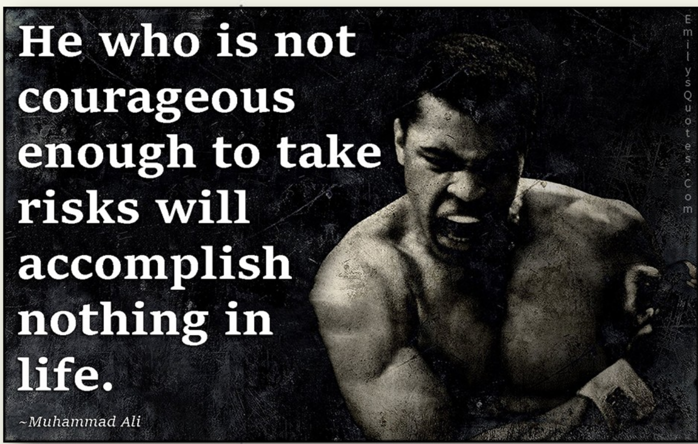
The effect does not show up in stocks only. Eric Falkenstein (2012) presents practical evidence for an inverted risk-return relationship in 17 asset classes. In his introduction he says: "No other article, paper, or book puts all this evidence together, primarily because no one thinks this general absence of a positive risk-return relation implies it might not actually be there." What about South Africa? It has been known for a while that low risk stocks on the JSE have nearly double the average monthly return compared to high risk stocks over an extended period of time (Van Rensburg and Robertson, 2003). But what about getting the balance right?

Finding a balance

The now useless standard model assumes that people are paid to withstand a universal undesirable. For example, like receiving an amount of money for every courageous extra minute you leave your hand in hot water. Those who have the highest pain tolerance achieve the highest returns on average. In contrast, throughout life we understand that courage is productive only if balanced with caution, which takes into account your special capabilities for your opportunities. There is no linear 'courage premium'.

The myth lies in moving too hastily from the particular to the general. Some risk taking in a specific context, in a specific way, yields a positive payoff. This does not guarantee a positive payoff for all risk taking in general. Instead, mindless exposure to risk is the path to financial ruin. This is the central message from those who have uncovered the low volatility anomaly. Fifty years of evidence from stocks and additional evidence from 17 other asset classes must surely re-classify an observed empirical effect from anomaly to norm.

Those who possess a stronger survival instinct should sit up and take notice.



Law of the Jungle

Studies have shown that on average, men are more likely than women to take risks, and the researchers theorized that these differences could be explained by the role of testosterone.

A recent study also showed that stock market traders made more money on days when their testosterone levels were highest.

The new study, detailed online in the journal *Evolution and Human Behavior*, is the first study to directly examine the relationship between testosterone and financial risk-taking, the researchers say.

The research showed that men whose testosterone levels were greater than the average, beyond normal variation, invested 12 percent more in the risky investment than the average-testosterone participants. The researchers also scored players on facial masculinity. Those who had the manliest faces invested 6 percent more than their average-face counterparts.

The findings may help to explain the biological foundation of why some people are more inclined toward risk-taking than others. Perhaps the wheelers and dealers on Wall Street are just playing their parts in the game of evolution.

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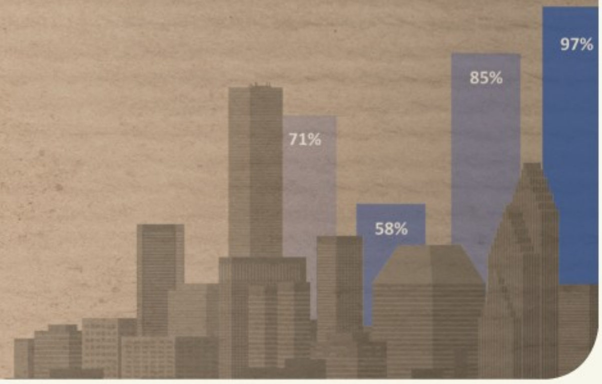

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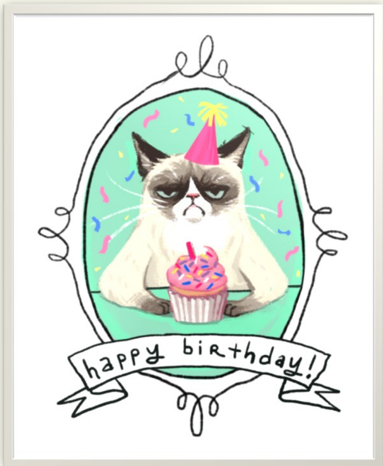

Birthday Blues

In what must have been the least celebrated birthday in our country's history, Income tax in South Africa celebrated its 100th birthday last year. During 1914, General Jan Smuts, in his capacity as Minister of Finance, tabled legislation in the Parliament of the Union of South Africa introducing income tax in the country. Taxpayers in South Africa became liable to pay income tax with effect from 20 July 1914.

Getting your house in order

A family home is often the most valuable asset that a person acquires during his or her lifetime. Particular care should be taken when planning your estate to ensure that your home is left to surviving heirs without any problems.

Mortgage bonds

In order to transfer an immovable property to an heir, any mortgage bond over the property will need to be cancelled. Often a homeowner lacks sufficient cash in his or her estate to settle a mortgage bond. It is imperative to have sufficient life assurance in place to cover outstanding mortgage bond obligations if one wishes to avoid a forced sale of the family home. This is true even if you own a property jointly with another, such as a spouse.

Transfer costs

The good news is that SARS do not levy transfer duty on transfers of immovable property from a deceased owner to his or her heirs. But your executor will have to appoint a conveyancing attorney to register the transfer to your heirs in the deeds office. One should plan for conveyancing fees and bond cancellation fees.

Property description

If you specifically bequeath your immovable property to a beneficiary in your Will, be careful to describe the property accurately including the erf number or sectional title description. If you subsequently sell the property and buy a new one, be sure to update your Will to reflect the new property's details. A bequest in a Will of a property which you no longer own when you die will simply fail.

Usufructs

Sometimes a homeowner wishes on to leave the property in question to his or her children on death, but at the same time guarantee a surviving spouse shelter for the rest of the spouse's lifetime. A common planning tool used in these circumstances is to leave a spouse a "lifetime usufruct" over the property while bequeathing underlying ownership (called "bare dominium") to the children. On death the property will be transferred to the children but a usufruct – the right to live in or rent out the property – will be recorded on the title deed in favour of the spouse. If you plan to grant a usufruct in your Will, you should discuss and plan for the possible pitfalls with your estate planner. For example, the spouse as "usufructuary" (the person to whom to usufruct is granted) will by law be responsible for the maintenance and running costs of the property, possibly creating an unintended future burden. Also the spouse will not be able to sell the property without consent of the children if he or she wishes to relocate and acquire an alternative property. The children may likewise

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find themselves unable to sell the property while it is subject to a usufruct. A bequest of the property to a testamentary trust may be a more practical solution.

The most crucial tool in making sure an asset as valuable as a family home reaches heirs without complications is a properly planned and executed Will. To achieve this it is recommended that one seeks advice from appropriate professionals.

Taxing times

In South Africa the first quarter of each year sees one of the most important events in the financial calendar: the presentation of the nation's annual budget. This year, on 25 February, Finance Minister Nhlanhla Nene will table the 2015 Budget in Parliament, in what is colloquially known as "the budget speech".

The budget is the national government's document presenting its proposed revenues and spending for the coming financial year. In the budget speech the Minister will also announce any changes to the tax rates effective for the 2015/16 tax year, which commences on 1 March 2015. Based on announcements made by Minister Nene in October last year, many commentators expect an increase in income tax for higher earners, and possible increases in capital gains taxes and estate duty for wealthier individuals.

The Laffer Curve

In economics, the Laffer curve is a representation of the relationship between rates of taxation and the hypothetical resulting levels of government revenue. The Laffer curve intends to illustrate the concept of "taxable income elasticity".

The curve suggests that as taxes increase from low levels, tax revenue collected by the government also increases. It also shows that tax rates increasing after a certain point (T*) would cause people not to work as hard or not at all, thereby reducing tax revenue. Eventually, if tax rates reached 100% (the far right of the curve), then all people would choose not to work because everything they earned would go to the government. Governments would like to be at point T*, because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard.

The curve is named after American economist Professor Arthur Laffer. Laffer reportedly sketched it on a napkin in a meeting in 1974 with officials of President Gerald Ford's administration to illustrate his argument against proposed tax increases. Laffer does not claim to be the inventor of the curve and notes that a similar concept is found in the writings of the 14th century Arab philosopher Ibn Khaldun .