

Quarterly Newsletter

Fourth quarter 2010



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Our investment approach

We help you find Best of breed™ fund managers and the right investment solution

When you invest, you want the most appropriate fund manager to look after your savings. We assist you in this process by actively researching and appointing fund managers to manage our fund range.

Our independence is our strength

Our fund manager research process helps us to identify managers with specific traits that we believe will enable them to deliver superior results over the long term.

We focus on monitoring fund managers so that you don't have to

Things do change. To help you manage this, and to ensure that our range remains Best of breed™, we actively monitor and review the appointed fund managers. If we think it is necessary, we will replace specific fund managers that are no longer deemed appropriate.



Nic Andrew
Head of Nedgroup Investments

Dear valued client

Albert Einstein called compounding the 8th wonder of the world. Compounding simply means that you can earn returns on your initial capital as well as on the returns that you have accumulated. To benefit from the power of compounding, it is important to understand and follow three principles when you invest:

1. The longer you remain invested the better

For young investors, starting early has a material impact on how much wealth you can accumulate. Furthermore, regular contributions to your savings can have a significant impact on your wealth over time. For investors nearing retirement, any ability to extend your working life, delay making withdrawals or reducing the amount of your monthly withdrawals can significantly improve your financial position and your chances of not running out of money.

2. Appropriate asset allocation and lower costs help

Small differences in returns each year can make a big difference over time. Higher returns can be achieved in two ways: By investing in funds that outperform over time and/or by lowering the costs associated with investing. Of the two factors described above, ensuring that you are paying reasonable fees is the easiest to achieve. Identifying investment managers in advance of good performance is more difficult and requires in-depth research and continuous monitoring.

Ensuring that you are investing in an appropriate mix of asset classes will also help improve the odds of you achieving your goals. Although an investment in a money market fund may give comfort in the short term, it is likely that after tax, costs and inflation your spending power will be eroded over time.

3. Avoiding large drawdowns aids the compounding process

Avoiding losses can also be important. It is a mathematical fact that compounding is rendered less effective if the volatility of returns increases. The fact that you need a 100% return to get back to your starting point if you incur a 50% loss illustrates this well.

Because we take our responsibility to you seriously, we ensure that we select investment managers who understand and pro-actively manage downside risk and who we believe are well positioned to provide long-term outperformance. This approach should help you meet your long-term goals.

A good illustration of these concepts is the Nedgroup Investments Rainmaker Fund which has just celebrated its 10-year anniversary. Over this 10-year period, an initial investment of R10,000 has grown to R81,600 compared to R45,250 for the average general equity fund. This makes the Rainmaker Fund the top performing general equity fund over the 10-year period. Had investors contributed an additional R500 per month over the 10-year period, their wealth would have grown to an astonishing R255,000 even though their contributions only increased by an additional R60,000. This shows the power of a regular savings strategy and of compounding superior returns over time.

Regards,

Nic



Nedgroup Investments Rainmaker Fund celebrates 10th anniversary as best performing general equity fund

Shaun Anderson
Head of Business Development

The Nedgroup Investments Rainmaker Fund had double celebrations on 30 June 2010. They commemorated their 10th anniversary, and celebrated being ranked the best performing general equity unit trust fund for this period, with an annualised return of 23.4% pa, after fees.

The faces behind the fund

Consistent with the Nedgroup Investments Best of breed™ approach in which we partner with – and continually monitor - the country's leading independent fund managers, the fund has been managed by Tim Allsop and his colleagues from Abax Investments since its inception.

Performance of the fund

The table below shows the annualised and cumulative performance of the Rainmaker Fund versus the Average General Equity Fund (the fund's benchmark) and the All Share Index.

Fund	Performance per annum	Cumulative performance
Nedgroup Investments Rainmaker Fund	23.4%	716%
Average General Equity Fund ¹	16.3%	353%
All Share Index ²	16.7%	367%

Source: Morningstar. 10-years to end June 2010

The table highlights the fact that the Rainmaker Fund has outperformed both the Average General Equity Fund and the All Share Index by around 7% pa. If we look at this over ten years it amounts to approximately twice the cumulative performance of these two benchmarks (716% versus 353% and 367% respectively).

'At Nedgroup Investments we spend a considerable amount of time and effort to identify those managers that we believe are best placed to outperform over the long term.'

¹Sector average excludes funds that have not survived

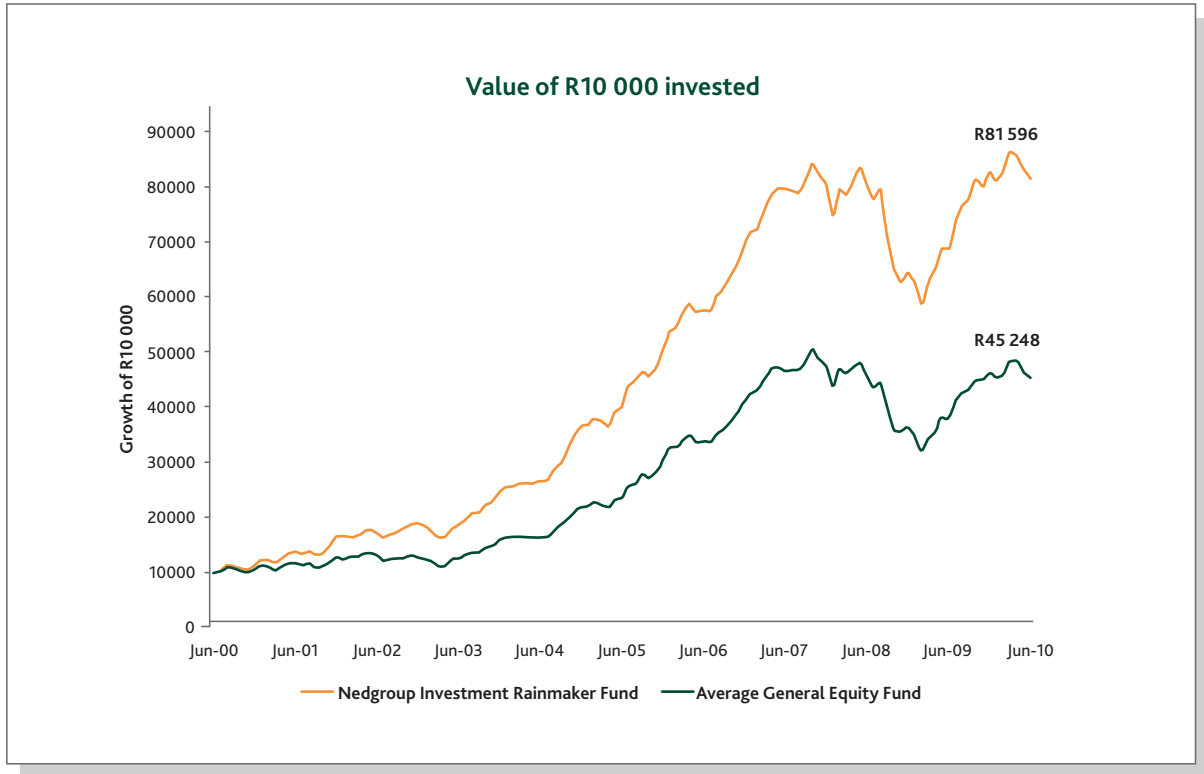
²All Share Index does not include fees, the inclusion of which would lead to a lower reported return

³The Nedgroup Investments Rainmaker Fund has a minimum initial investment of R10,000 and a minimum monthly debit order of R500 per month

Team boasts equity track record of 15 years

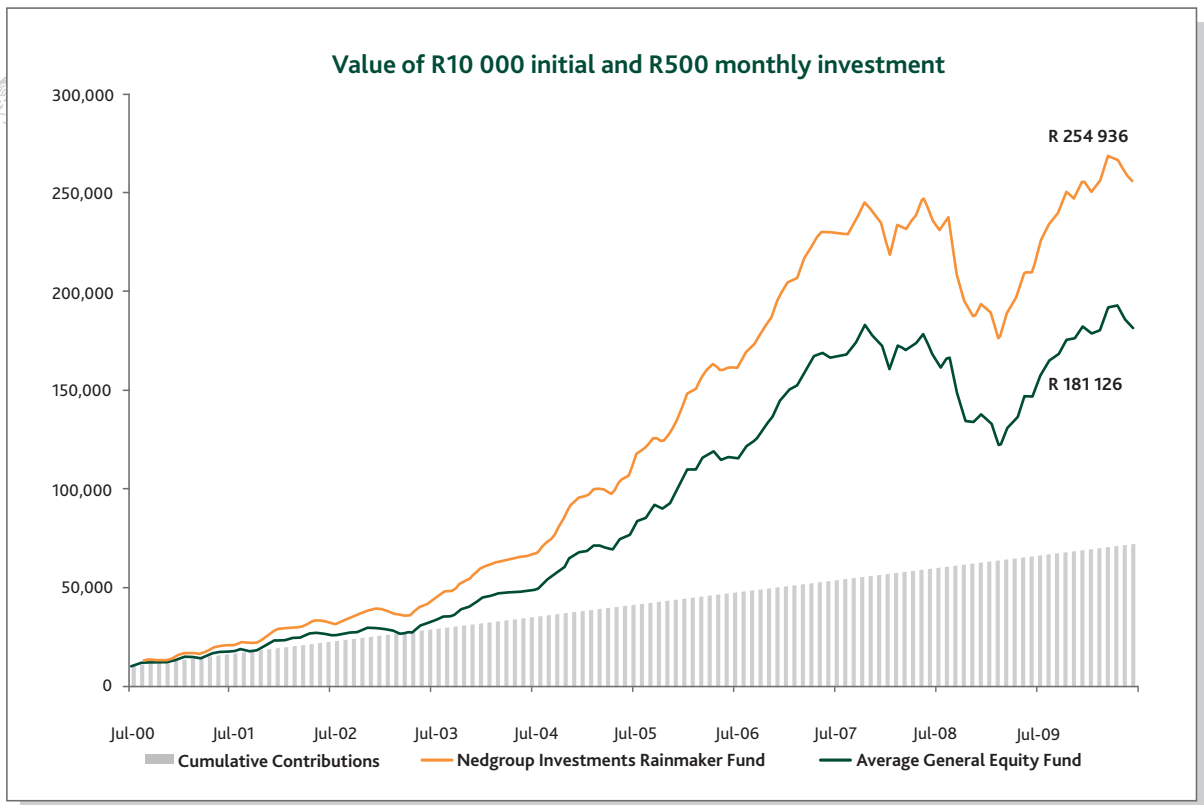
Although the Rainmaker Fund now has a 10-year track record, Tim Allsop and the team have an equity track record dating back to 1995. Over this 15-year period they have outperformed the Average General Equity Fund and the All Share Index by around 8% pa.

As can be seen in the chart below, a R10 000 investment³ in the Rainmaker Fund made 10 years ago would have grown to R81 596 today, versus R45 248 for an investment in the Average General Equity Fund (both after fees).



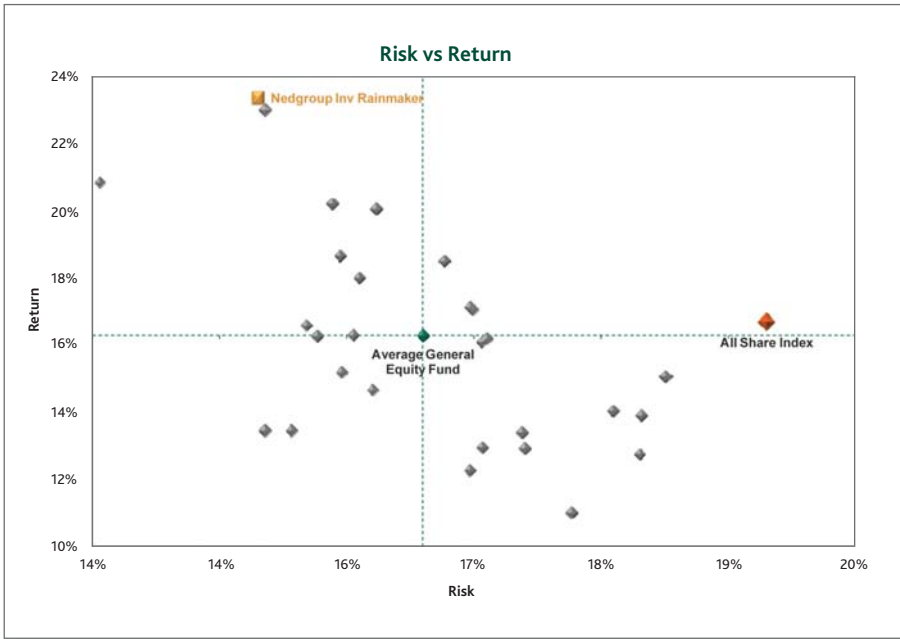
Power of a regular savings strategy

The power of a regular savings strategy can also be illustrated in the following chart, which shows the cumulative value for investors that contributed R10 000, 10 years ago, and an additional R500 a month, after that. The total contributions over the 10-year period amount to R70 000, but the cumulative value of this investment in the Rainmaker Fund grew to R254 936 versus R181 126 for the Average General Equity Fund.



Outperformance with lower volatility

Our research shows that the Nedgroup Investments Rainmaker Fund has achieved this outperformance despite having a lower level of volatility than the average fund. Volatility (a commonly used measure of risk) of the Rainmaker Fund over the period has been 15.3% pa compared to 16.6% for the Average General Equity Fund and 19.3% for the All Share Index. This also makes the Rainmaker Fund the top performing general equity fund on a risk-adjusted basis over the 10-year period.



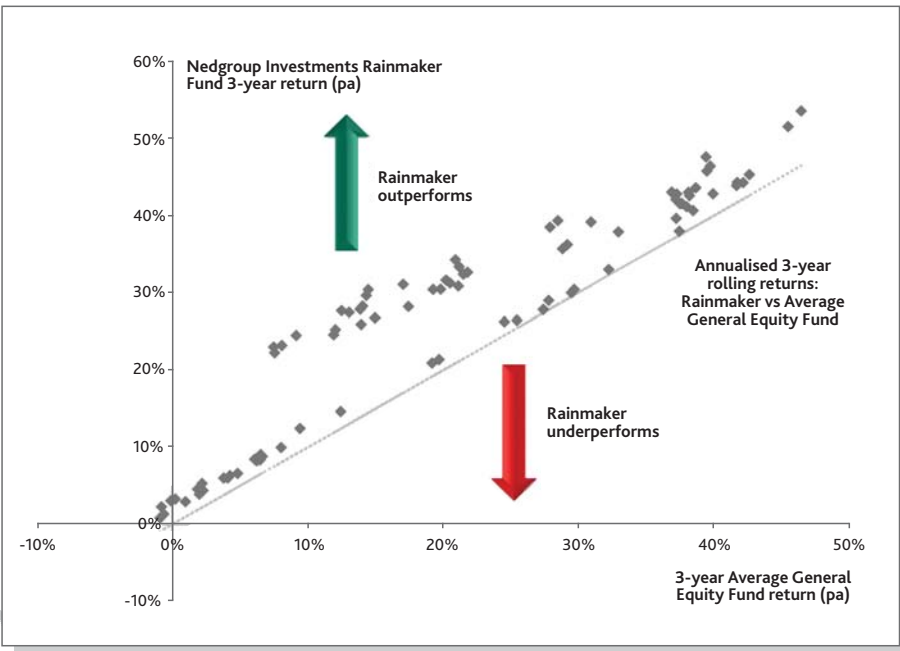
Consistent results achieved

Our final exhibit illustrates the consistency with which these results have been achieved. The chart below (bottom left) shows the fund's performance compared to the sector average over all rolling 36 month periods over the past 10 years.

The performance of the sector average is plotted on the horizontal axis, while the fund's performance is plotted on the vertical axis. As you can see, all of the dots plot above the diagonal grey line, indicating that the Nedgroup Investments Rainmaker Fund has outperformed the sector average over all 36-month periods so far. There also has yet to be a 36-month rolling period over which the Rainmaker Fund has produced a negative return. There have been four occasions where the Average General Equity Fund has produced a negative return.

Skill and stock selection lead to success

While it is unreasonable to expect that the fund will never underperform the sector average over a three year period⁴, this chart attests to the fund manager's skill and stock selection abilities over the medium and long term.



Find an experienced investment manager and stick with him

The key to choosing a suitable fund requires two primary considerations. First, you need to find an experienced investment manager who follows a sensible philosophy backed by a rigorous and repeatable process. Second, you need to have the conviction to stick with them through the inevitable periods of underperformance.

At Nedgroup Investments we spend a considerable amount of time and effort to identify those managers that we believe are best placed to outperform over the long term. By continually monitoring our manager partners we are also able to better understand the reasons for short-term underperformance, or the impact of other issues, such as a change to the investment team.

Investors can take comfort from the fact that we will replace our managers if we no longer believe that they are the most appropriate choice. This ensures that our clients' savings are always in the hands of the best investment managers available.

⁴5-7 years is a reasonable period over which to measure the performance of an equity fund manager



Building the Nedgroup Investments Brand

Phatheka Ncwana
Head of Marketing

At Nedgroup Investments we focus on helping investors achieve their investment goals and in so doing we grow, and protect our clients' savings and wealth.

Since the inception of the business seven years ago, we have spent a considerable amount of time and effort developing:

- sound investment offerings,
- a differentiated value proposition, and
- strong relationships with financial planners, consultants and clients.

This effort has borne fruit as our assets under management have grown from R7bn to R90bn - an achievement that is well beyond our initial expectations.

Feedback from the market is that we are still relatively unknown

Over the last year, we undertook a market research study. The feedback from financial planners, consultants and clients is that despite our success as a business, we are relatively unknown in the market. To address this, we have decided to take two key actions:

- Build a stronger Nedgroup Investments brand in the marketplace.
- Create more visibility and awareness of Nedgroup Investments.

Central to this effort will be an advertising campaign at the heart of which will be our first television commercial.

What is the story behind the new campaign?

The message and story behind our new advertising campaign aims to broaden the reach of a single key message about one aspect of growing and protecting investor wealth. It is a message that we continue to repeat and is based on one fundamental truth that we believe undermines investors' potential to achieve their investment goals, ie an inability to manage emotion effectively.

Fear and greed are the two most powerful emotions that influence investor behaviour and they destroy value.

Emotions often have a greater influence on our behaviour than facts because they are spontaneous. They can inspire us and paralyze us, both of which can cause us to make bad investment decisions and choices. We remember feelings above facts. Through thousands of years of evolution as human beings we have trusted feelings to keep us safe from danger. Emotions can be positive and life affirming, but they usually hamper us when we need to make investment decisions.

In this campaign, we wish to create awareness of the power of emotions and educate investors so that they make better investment decisions, based on reason rather than emotion. And of course we want to grow awareness of who we are. We hope this in turn supports the work of financial planners, whether their clients are individuals or retirement funds, because they play a critical role in investor decision-making.

Look out for the campaign - it is launching on 4 October 2010

The campaign is an integrated one and will launch on 4 October 2010 on TV and various media platforms. We hope that our adverts resonate with you and your clients; and although building a brand is much bigger than a single advertising step in the journey, we look forward to your comments and feedback.





Trustee education - the basics are key

Rob Macdonald
Head of Institutional Business

The uncomfortable truth - when fiction is closer to fact

Imagine the situation...

You are ill. You go to your doctor who assesses your condition and suggests that in the interests of your long-term health you need to have an operation. At the hospital you discover that things don't work quite as you would expect. There is a board of trustees who govern the hospital and they have chosen the surgeon who will do the operation you need. While you are surprised, you are reasonably happy because you have been saved from doing your own quality check, especially as it is a carefully selected board who you believe are equipped for the role they are playing.

Introducing the board

The board has been set up to represent all stakeholders of the hospital. Four members are appointed by management, and four are elected by the employees of the hospital. In the management group there is a doctor, nurse, an accountant and an IT specialist. In the employee-elected group there is a medical technician, an HR officer, a chef and a cleaner. The fact that there is only one doctor and one nurse on the board of trustees is not something you're aware of before your operation. However, what does strike you as odd is seeing some of the trustees standing over you in the operating theatre before you succumb to the anaesthetic. Fortunately, you are asleep and don't witness the trustees questioning the surgeon and telling him what he should do next at certain points during the operation.

The people behind the title – are they really suitable?

You might have counted yourself lucky if you had known that these trustees represented the surgical sub-committee of the board. However, you may have been slightly worried if you knew exactly who the members of the sub-committee actually were. Yes, the doctor is there, although his speciality is rare infectious diseases originating in Asia, a part of the world you've never been to. The accountant is there because she sits on all the sub-committees of the board. Her grandfather was a surgeon but he's been dead for 20 years now. The fascinating stories he used to tell always sparked her interest in medical matters, but only enough for her to read about them and form strong opinions on a range of medical subjects.

The HR officer and the medical technician are part of the sub-committee because there needs to be equal representation between employer and employee trustees and they have the highest qualifications of the employee trustees. They enjoy being part of this sub-committee because of the benefits but they don't contribute much during surgical sub-committee meetings.

The impact that this has on you

Fortunately you are unaware that the surgeon is very frustrated with the interference he has been subjected to in the operating theatre, but he can't show his frustration as this would place his job in jeopardy. What you would be aghast to know is that he quietly estimates that he has probably reduced your life expectancy by at least 10 years because he has compromised his professional knowledge and skill to make the surgical sub-committee happy.

Perceptions can be deceptive

Unfortunately you go home none the wiser about what has happened in the operating theatre. You're a little sore but reassured that you are on the road to recovery, particularly

after being given a copy of the hospital's annual report with photographs of all the trustees and some wonderful statistics about all the patients that the hospital has helped over the past year.

Confused?

Right now you are probably wondering whether you're reading the Nedgroup Investments Newsletter or an attempt to bump JK Rowling off her pedestal as the principal source of fantasy fiction! In fact this story is uncomfortably close to reality when we parallel it with the retirement fund industry. If we re-read the fictional example above and we substitute the words 'retirement fund' for 'hospital', and 'investment manager' for 'surgeon', we start to see an all too familiar reality playing out.

Lack of expertise leads to reckless conservatism

Lack of relevant expertise has never held trustees back from making decisions that are not fully in the interests of their members. Sometimes these decisions are influenced by the apparent perks of the trustees' job, such as hunting trips, hot air balloon rides, or a weekend at an international jazz festival. At other times these decisions are influenced by poor or ill-informed judgment.

For example, the Myners Report, which reviewed the UK retirement fund industry in 2002, referred to the 'reckless conservatism' of trustees where they were more concerned about quarterly relative performance than long-term growth of members' assets. As a result they invested in assets like cash and bonds to limit the chance of quarterly negative returns, rather than more volatile shares. The result of this 'reckless conservatism' is a bit like your experience in the fictional example given earlier – 10 years taken off your life because of the trustees' interference in the surgical procedure.

The situation in South Africa

The same happens in South Africa. Trustees are recklessly conservative when, for example, they apply investment options that see members reducing their exposure to growth assets as they approach retirement, when their investment lifetime may still be 20 to 30 years. What informs this type of decision is usually ill-informed judgment rather than negligence or post-perk euphoria.

Trustees must have an in-depth understanding of the funds' membership

This raises the question of how we should handle trustee education to help trustees carry out their duty most effectively.

A comprehensive understanding of the funds' membership, including their needs and relevant history **has** to be the starting point of any meaningful trustee education programme.

The real challenge – trustee education

That's the easy part. The next step presents the real challenge when it comes to trustee education. It seems that standard practice in the industry revolves around knowledge transfer. A bit like in our fictional example earlier where the surgical sub-committee trains in surgical techniques, when in fact their role (theoretically and theatrically) is to select surgeons and review their work. Why do they need to know about surgical techniques? Similarly, when it comes to investments, why do trustees get involved in asset allocation decisions? Is this any different from giving an opinion on how the surgeon should cut their patient? It also prompts the question, why would a trustee train on how to value a share?

Is there really any value in a 3-day training course?

A genuine investment expert, best identified as someone with a CFA qualification, studies for at least seven years and needs at least three years of practical experience to qualify. Is there anything meaningful that a trustee can learn in a 3-day training session when you consider the knowledge and experience of the experts?

Core areas of trustee education

Trustees don't need to be investment experts; therefore, their training should not be about trying to make them experts in particular areas of the investment world, but rather expert trustees.

To achieve this I believe there are three core areas that trustee education should cover:

- Basic principles of the functional areas of a fund such as investments, administration and risk;
- How to select, manage and review the experts; and
- How a trustee board, as a team, operates effectively.

Basic principles are key

If we go back to our fictional example, trustees should know what makes people healthy, such as diet and exercise, and the trained experts can then provide the diagnosis to the trustees.

In the investment arena for example, trustees should understand basic investment principles, such as having clear objectives; the importance of diversification in managing risk and the role that time plays in growing assets. They should be able to recognise when basic principles are not being adhered to. But the understanding and responsibility for the implementation of investments must remain the domain of the experts. Strangely enough, in reality, when it comes to administration, risk or accounting, trustees are happy simply to understand the basic principles and leave the detail to the experts. However, the investment arena is the trustees' Achilles heel because it is here that they most often want to get more involved.

Selecting the experts

Trustees have to make use of relevant experts when appropriate, so a key element of trustee education must focus on how to select these experts, and how to get the best out of them.

When assessing service providers, an in-depth knowledge of investments, administration or risk is not what is needed. Rather, it is about making sure that when a service provider is selected, the trustee is clear why they have been selected and what can be expected from them. Only when service providers fail to deliver on expectations should their position come under the spotlight outside of the normal review cycle.

For example, if an administrator says up front that they will only issue a new member certificate two months after a member has joined the Fund, it is unreasonable for the trustees to want this to happen earlier. Similarly, investment managers usually come under the spotlight when their short-term performance relative to other managers is poor.

Yet this should only be the case for managers who promise short-term relative outperformance on a consistent basis, an expectation which they would agree with the trustees up front.

Working effectively as a trustee team

Working effectively as a trustee team is perhaps the area that needs the most attention and training. However, one aspect of this which does receive attention is about acting ethically, acting in the best interests of the member and managing conflicts of interests. Ironically, this is an area where trustees probably fall short most often. Surely a trustee receiving a gift from a service provider is inappropriate, given that the trustee is acting in a fiduciary capacity?

Apart from the ethical considerations, which are critical to the healthy functioning of a trustee board, it is the interpersonal ability of the individual trustees that is likely to have the most impact on the board's effectiveness.

The white elephant in the room

The reality is that when a board of trustees meets, there is always rank in the room. What this means is that usually there are two or three senior employer-appointed trustees who have organisational status and thus the confidence to speak on any topic, whether expert or not.

The challenge is for the more junior employees, usually employee-elected trustees, to make themselves heard. After all, trustees are supposed to have equal status. Trustee education that empowers the voice of those without rank is critical, and it has nothing to do with functional expertise.

A trustee may not have knowledge in one particular area, but they can be trained on what sort of questions they should be asking, and also coached on how to challenge the viewpoints of more senior colleagues.

Trustee assessments

Apart from some basic interpersonal skills training, an important element missing from most trustee boards is a personality assessment for each trustee. This would make sure that the Chairman of the Board knows the profile of each of the trustees and can help their participation in the Board with more insight. It is undoubtedly the Chairman's duty to make sure all trustees take part in decisions. Appropriate trustee training on interpersonal effectiveness could go a long way to making the Chairman's role easier, thereby helping to build a more effective trustee team.



The great risk and return illusion

Matthew de Wet
Head of Investments

One of the greatest barriers to investing successfully is the belief that history is the precursor to the future. In the investing world, far too much effort goes into analysing and extrapolating the past.

Simplifying decisions

The human brain is very powerful, but making complex decisions based on incomplete information is tricky. Studies have shown that we try to simplify decisions by pattern recognition, and that we feel more comfortable making a decision when our reasoning fits one of our many ingrained rules of thumb. That the future will broadly echo the past is one such rule. The stark reality is that the past is not a prologue and that this type of approach can lead to poor results.

Choosing the right investment model

Theoretical constructs invented by the brightest ivy-league professors during the 1960's, such as the Capital Asset Pricing Model (CAPM) and Modern Portfolio Theory, have permeated the investment industry to such an extent that anybody who studies investments formally will have more exposure to this model than any other investment framework. This model, although mathematically elegant – and therefore academically appealing – is based on a number of false assumptions that render it more dangerous than useful.

Confusing risk and uncertainty

One of the central tenets of the CAPM is the concept that risk is defined as volatility. This means that the riskiness of an investment is determined by how volatile the market price of the investment has been through time. The more erratic the price, the more risky the asset is assumed to be. Also integral to the model, is the assumption that higher risk begets higher returns. The interaction between these two factors has had a significant negative impact on investment decision making. This is because volatility is a wholly inappropriate measure of risk¹, as this definition has little bearing on the true risk (uncertainty of the outcome) of an investment.

Defining risk through numbers

To highlight the inadequacy of the current accepted definition of risk, consider the Dow Jones Industrial Index which has an historical daily volatility in the region of 0.8%. Based on this, the academics will tell us that the statistical probability of a so-called '5-sigma' daily price move occurring is about 1 in 10^{30} (that is a 1 with 30 zeros on the end). But there have been five such extreme daily moves in the past 100 years alone.

To put the scale of such odds into perspective, there have only been 10^{10} days since the beginning of time²! On Black Monday in October 1987, the intra-day market drop of nearly 30% was theoretically a 1 in 10^{50} event. Clearly, the widely accepted definition of risk is inadequate in explaining extreme events.

The credit spread trap

Credit spreads – the yield offered above the risk-free rate to compensate for investing in the debt issues of companies, rather than those of the government – is another misused measure of risk. This is because spreads tend to decrease as good times continue.

Unfortunately, compressed spreads are usually the result of a benign environment and are incorrectly associated with future safety. Ironically, it is when investors feel most secure in their investment choices that they may be most at risk. This is because the lower spreads are, the lower the compensation for taking on the risk that the issuer may default, and the higher potential losses will be when the environment becomes more uncertain. It is comparable to being blindfolded and picking up pennies in front of a steam-roller.

Prior to the current financial meltdown, credit spreads had been declining systematically for decades (with a few blips along the way), and reached record lows. They subsequently exploded to their highest levels since the Great Depression. This resulted in terrible losses for those investors that were seduced by the apparent steady returns and perceived low risk that has, up until recently, characterised corporate debt markets.

Market return assumptions

Many investors believe that the best forecast of equity returns is merely an extrapolation of history. The fact that most equity markets around the globe have provided returns in the region of 5 to 8% above inflation over the past 100 years or so, does not mean that forward looking equity return assumptions should be similar.

Rather, investors should try to understand the sources of long-term equity returns. It is no coincidence that the earnings of the companies that make up the market (with dividends reinvested), have also grown by about 5 to 8% above inflation over the same period. This is the more certain *investment* return offered by the market – a return that is fairly stable over time and is closely linked to the long-run economic potential of an economy. Of course, over shorter periods, the market return differs vastly from the long-term averages.

Mood of investors as a driving force

This speculative component of return is driven by the mood of investors – the value they are willing to ascribe to the stream of earnings and dividends that companies generate. The price earnings multiple of the market is a good proxy for the current speculative element in the market.

Looking through your rear-view mirror could give a distorted view

Over time, the *speculative* component tends to mean-revert, as the investment community's mood swings from exuberance to despair and all the way back again. The natural consequence of this is that if the *speculative* component is significantly above long-term norms, future equity market returns are likely to be lower than recent history implies and vice versa.

Unfortunately, it is at these times that past returns will also be outsized, causing investors that allocate with a rear-view mirror to over-invest when future return expectations should be lowest, and under-invest when they should be highest.

Efficient portfolios and diversification

Asset allocation decisions are often made with the aim of maximising the portfolio return for a given level of risk, or minimising risk for a given level of return (the so called 'efficient portfolio' methodology).

Theoretically, this approach makes perfect sense, but because the definition of risk is inappropriate, and there is an over-reliance on historical (sometimes even recent) returns, this focus often leads to poor results.

Certain types of assets; assets that are leveraged, trade infrequently, are traded over-the-counter or have embedded derivatives, can give false clues that encourage asset allocators to use them in 'efficient' portfolios. This is because the true risk of these assets can be masked if viewed in terms of volatility only – they appear to be safe during the good times, only to disappoint once the bear market arrives.

It is usually under stress that the desired diversification benefits of these difficult-to-value assets fall away because these instruments begin to correlate more closely. This can result in significantly larger negative returns for a portfolio than the efficient framework would have predicted based on the past risk, return and correlations of the assets in the portfolio.

What to consider

Consideration of what price you are paying for those sources of return is critical. Investors need to recognise that purchasing an asset when the *speculative* component is well above average levels can lead to a disappointing result.

Also important is the awareness that a reliance on traditional risk measures and correlation benefits might not help you when you need them most. Due consideration of all of these elements will enable you to better structure your portfolio to avoid the traps that lure poorly informed investors in and out of the market at inappropriate times.

¹Volatility does, however, have a (not well understood) negative impact on compounding. All things being equal, higher volatility increases the differential between average and compound returns. This effect is exacerbated when the investor is withdrawing from their savings. See article in previous quarterly newsletter for more on this topic.

²13 billion years

'Ironically, it is when investors feel most secure in their investment choices that they may be most at risk.'



Value in financial planning businesses

Edden Kift
Practice Management Consultant

A growing issue of importance in the financial planning industry is how financial planning businesses are valued. There are two key drivers of this. One is the demographics of the profession, while the second is regulatory change.

Demographics of the financial planning profession

The average age of financial planners in South Africa is about 55, which means a significant number of financial planners should be starting to think about retirement and succession plans for their businesses and their clients. In reality, not enough financial planners are doing this. The Institute of Practice Management estimates that 60% of financial planners in 2010 are over the age of 60, and that only about 15% of financial planners have succession plans in place.

The pressures of regulatory change

There are challenging qualification and ongoing education requirements for financial planners, and new conflicts of interest legislation which increase the costs of doing business for financial planners. There is no doubt that this regulatory pressure will force some financial planners out of the industry. Financial planners affected by either of these drivers of change will undoubtedly be thinking about how much their business is worth, whether to sell, or how to plan for internal succession.

Importance of valuing your business

In the practice management consulting work that we do at Nedgroup Investments, we believe that financial planners should always have a sense of the value of their business, whether or not they are thinking of selling. If a financial planner manages their business with an understanding of its value, it will undoubtedly provide a sound basis for decision-making in the business.

Two key questions you need to answer

In considering the value of a financial planning business, we believe there are two key questions that need to be answered: What is of value in a financial planning business? And, how do you measure the value of a financial planning business?

1. What is of value in a financial planning business?

The key area of value in a financial planning business is its clients. However, this does not mean that a business with many clients is a valuable business. The key to value is having an institutionalised client base. This means having a client base that has been through a consistent advice process and whose financial plans have been implemented consistently. In other words, two clients of a similar profile and needs would end up in similar investment and risk solutions.

An important aspect for bigger businesses of an institutionalised client base is that clients deal with more than one advisor. This reinforces the idea that the client is a client of the business rather than of any particular individual.

◦ A brand and trust are key

Mark Hurley, a US investment banker who runs a business which takes minority stakes in financial planning businesses recently published a paper on valuing wealth management businesses in the US. He says there are two other key factors that provide value in a financial planning business. One is having an institutionalised brand. In other words, the business has a brand that represents something more than the names or personalities of the founders of the business. This also helps reinforce the institutionalisation of the client. The other key factor is a culture of compliance.

Because advising on and in some cases, managing clients' money, is a process that requires high levels of trust, compliance is critical. Any slip-up in this area will dramatically erode trust.

◦ Culture of compliance vs being compliant

Having a culture of compliance is very different from being compliant. A culture of compliance is about how advisors and staff act every day, rather than what goes into a business' compliance report.

Hurley suggests that any due diligence of a financial planning business would begin with these areas. Once they are in place, the second part of a due diligence process would look at another six factors:

- Quality and structure of client base

In many financial planning businesses the 80:20 rule applies - 80% of the revenue is generated by 20% of the clients. This is a sign of an overconcentration of the quality clients, and detracts from the value of the business.

- Number, quality and incentives of successor professionals

Hurley views the recruitment and retention of professionals in the US as a huge challenge. The same is likely to apply in South Africa where financial planning businesses must attract professionals like accountants and lawyers as the industry becomes increasingly professional. A business that has already done this, and put successor professionals in place, will have more value.

- Quality of management

The classic challenge that faces most independent financial planning businesses is that they are run by financial planners who often prefer being financial planners rather than business managers. We believe the key way to address this problem is to appoint a practice manager whose main responsibility is to look after the operations, administration and compliance of the business. In this way the client-facing advisors are freed up to do what they do best - meet with existing and potential clients.

- Maturity and sustainability of governance structure

Having a sound governance structure in place is critical given the key fiduciary role that a financial planning business plays. If a business has a board of directors with independent directors and other structures, such as a Client Advisory Panel, the value of the business will be enhanced.

- Ability of the business to retain and recruit clients after the departure of its founders

Often financial planning businesses are built on the personality and expertise of the founders. The value of a business will be influenced enormously by the extent to which clients can be kept, and new clients gained, after the departure of the founders.

- Level of ongoing reinvestment into the business and its likely additional future capital requirements

For many financial planners, their business is a lifestyle business. It is a way to earn a good income, provide a valuable service and enjoy an autonomous way of life. The reality is that these lifestyle businesses have no real value when the founder decides to move on. To create value in a business it is important to reinvest earnings in people, processes and technology. Without this reinvestment, very few of the elements that actually provide value in a business will be developed.

2. How do you measure the value of a financial planning business?

Traditionally there have been three key ways of measuring value in a financial planning business:

- o Multiple of recurring revenue;
- o Multiple of recurring income; and
- o Multiple or percentage of assets under management.

The challenge when using these valuation methods is deciding on an appropriate multiple. The extent to which a business has the nine factors that we now consider in place will impact on the multiple that is used in the valuation process.

Which category do you belong to?

This can be seen from research done in Australia by Stephen Prendeville of Kenyon Prendeville, an Australian business that specializes in helping Australian financial planning businesses buy, sell, merge and expand. He put financial planning businesses into three categories, based on the extent to which they had the factors in place that provide value. And then based on this, he found it is possible to clearly differentiate between the type of multiple that has applied in actual transactions. The table below shows the different types of businesses and the average multiples that have applied to transactions involving these types of businesses in Australia.

The Australian Experience		
Premium	Average	Less organised
Database segmented, well organised, electronic	Database not segmented, but review clients identified	Database not segmented and not up-to-date
Services defined, priced, relative to segments	Services not defined for all clients	Many clients receive no service at all
Systematic and organised process for delivery of service	Larger clients reviewed and charged, smaller clients dealt with on adhoc basis	Service largely adhoc but best clients are reviewed
Systematic and organised process for client reporting and review	Processes in place for reviews and other services but not clearly defined	
Client agreements in place for defined service and price	Review clients have signed client agreements, others not	No client agreements
Management Information Systems (MIS) used as a management tool	No MIS	No MIS
Control of income and margins and ability to replace commission with fees	Mixture of fees and commissions	Largely commission income
No problem transferring client relationships to new owner	Review clients may be transferred, but others unknown	Client relationships tend to be with an individual, making transfer difficult
3.3 x recurring income 6 x EBIT*	3 x recurring income 5 x EBIT*	2.7 x recurring income 4 x EBIT*

Source: Kenyon Prendeville

As can be seen from above, the Premium business commands a significantly greater price compared to the other average and less organised businesses.

*Earnings Before Interest & Taxes

Value for the business as a whole

This article views value from the perspective of value for the business as a whole. There is, of course, value in a business where an acquirer is not interested in anything else but the client base as they have all the systems in place and will thus integrate the acquired client base into their systems. In this way financial planners will get value for their clients. However, the potential for greater rewards is from a business that has built value into the business as a whole.

Seven steps to building value

The obvious way to build value in a financial planning business is to put factors in place that provide value and develop each of these as effectively as possible. The seven key steps to building value that Hurley advocates are:

1. Recruit and retain the next generation of professionals.
2. Institutionalise the business' client relationships.
3. Build a base of clients that is profitable, not concentrated, but is demographically diverse.
4. Institutionalise the firm's marketing capabilities and brand.
5. Evolve the company's management and governance structure.
6. Create a robust culture of compliance.
7. Reinvest in the business.

Planning leads to real value

However, as Hurley points out, these seven steps won't happen quickly and building value is an incremental process at the heart of which needs to be a strategic plan. In the case of building value in a business, the words 'failing to plan is planning to fail' could not be more apt.

Hurley suggests that in the US, of 18 000 independent wealth management businesses, only between 200 and 400 have real value.

Our research suggests that in South Africa things are not much different. The Nedgroup Investments consulting team has conducted 18 audits of independent financial planning businesses this year. What is interesting is that only one of the 18 indicated that they had a documented three-year strategic plan in place. This suggests that the reality on the ground is that many businesses in South Africa have not yet embarked on planning to build real value in their businesses, never mind actually building the value itself.

'A culture of compliance is about how advisors and staff act every day, rather than what goes into a business' compliance report.'

Fund range	Risk	Benchmark	Minimum recommended term
Income funds: aim to provide investors with high levels of income (at low levels of capital volatility), by investing primarily in fixed income asset classes. These funds are often appropriate for clients with shorter investment horizons.			
Nedgroup Investments Money Market Fund	1	STeFI Composite Mean	None
Nedgroup Investments Flexible Income Fund	1	110% STeFI Call Rate	6 months
Nedgroup Investments Optimal Income Fund	1	STeFI Call Rate after income tax (40%)	1 year
Nedgroup Investments Bond Fund	2	All Bond Index	2 years
Nedgroup Investments Property Fund	4	Domestic Real Estate General Unit Trust Mean	5 - 7 years
Asset allocation funds: aim to provide investors with moderate levels of income and capital growth (at moderate levels of capital volatility), by investing in a range of different asset classes. These funds are often appropriate for clients with medium to longer investment horizons.			
Nedgroup Investments Positive Return Fund*	2	CPI + 4% pa over rolling 3-year periods	3 years
Nedgroup Investments Stable Fund*	2	CPI + 4% pa over rolling 3-year periods	3 years
Nedgroup Investments Managed Fund*	3	Prudential Medium & Variable Equity Unit Trust Mean	3 - 5 years
Nedgroup Investments Balanced Fund*	3	Prudential Variable Equity Unit Trust Mean	3 - 5 years
Nedgroup Investments Bravata Worldwide Flexible Fund	3	CPI + 5% pa over rolling 3-year periods	3 - 5 years
Equity funds: aim to provide investors with high levels of capital growth (at high levels of capital volatility) by investing in listed equities. These funds are often appropriate for investors with longer investment horizons.			
Nedgroup Investments Rainmaker Fund	4	General Equity Unit Trust Mean	5 - 7 years
Nedgroup Investments Value Fund	4	Value Unit Trust Mean	5 - 7 years
Nedgroup Investments Growth Fund	4	Growth Unit Trust Mean	5 - 7 years
Nedgroup Investments Equity Fund	4	General Equity Unit Trust Mean	5 - 7 years
Nedgroup Investments Quants Core Equity Fund	4	General Equity Unit Trust Mean	5 - 7 years
Specialist equity funds: are equity funds that are invested according to a specific sector or theme. They tend to display higher levels of capital volatility.			
Nedgroup Investments Entrepreneur Fund	5	Smaller Companies Unit Trust Mean	5 - 7 years
Nedgroup Investments Mining & Resource Fund	5	Resources & Basic Industries Unit Trust Mean	5 - 7 years
Nedgroup Investments Financials Fund	5	Financial Unit Trust Mean	5 - 7 years
International Rand denominated funds: if you wish to have exposure to international investment opportunities, you may consider the following range of rand-denominated funds that provide this exposure for lower minimum investments and without the hassle of having to apply for foreign exchange control approval.			
Nedgroup Investments Global Cautious Feeder Fund	3	USD Libor 1 Month (in Rands)	3 - 5 years
Nedgroup Investments Global Balanced Feeder Fund	3	Foreign Flexible Unit Trust Mean	3 - 5 years
Nedgroup Investments Global Equity Feeder Fund	4	Foreign Equity Unit Trust Mean	5 - 7 years
Nedgroup Investments Int'l Equity Feeder Fund	4	Foreign Equity Unit Trust Mean	5 - 7 years

1 = Low, 2 = Low to medium, 3 = Medium, 4 = Medium to high, 5 = High

* Comply with Regulation 28 of the Pension Funds Act



www.nedgroupinvestments.co.za

unit trusts | offshore | retirement solutions

Cape Town

Physical address
BoE Clocktower
Clocktower Precinct
V&A Waterfront
Cape Town
8001

Postal address

P O Box 1510
Cape Town
8000
Tel: 0860 123 263 (RSA only) or +27 21 416 6011 (outside RSA)
Fax: 0861 119 733 (RSA only) or +27 11 263 6067 (outside RSA)
Email: clientservices@nedgroupinvestments.co.za

Gauteng

Physical address
Nedbank Building
4th Floor
G Block
135 Rivonia Road
Sandton
2001

Postal address

PO Box 2242
Houghton
2041
Tel: +27 11 295 5315
Fax: +27 11 294 0319
Email: clientservices@nedgroupinvestments.co.za

Durban

Physical address
Second Floor
Clifton Place
9 Hurst Grove
Musgrave
4062

Postal address

P O Box 50995
Musgrave
4062
Tel: +27 31 268 6421
Fax: +27 31 268 6600
Email: clientservices@nedgroupinvestments.co.za

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Address: PO Box 1510, Cape Town, 8000. Trustees: The Standard Bank of SA Limited, PO Box 54, Cape Town, 8000.