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Up, up and away

Inflation is increasing and interest rates are going up. It is not unusual for them to move in the same direction because interest rates are the primary tool used by our Reserve Bank to control inflation. Whilst higher interest rates are not happy news for many, it is nevertheless good news for some. Negative real yields have not been beneficial for pensioners and income funds who rely on interest rates. The only asset class that benefits from higher interest rates is cash and for some that is very good news indeed.

After more than a few years of low to almost no interest rates across the developed world and some developing markets, things have changed. Yes, interest rates and inflation are going up, up and away!

Inflation has hit a multi-decade high in the USA, the world's largest economy. By March 2022, the US rate of inflation was sitting at 7.9%. That is the highest it has been since January 1982. The US government has also changed its view that inflation in the country is transitory; it now admits that inflation will be long term.

That means that interest rates are going to go up because interest rates are used to curb and control consumerism which ultimately drives inflation. Higher prices will lead to less demand which in turn impedes economic growth. We may for some time experience stagflation in the US with stagnant demand and persistent high inflation….

Expect the US Federal Reserve to start raising interest rates soon, with the European Central Bank to follow.

Back in good old SA

In South Africa things are not quite as bad as in the US. Who thought we'd be able to say that! As a small country with a high level of imports our inflation is very dependent on external factors – such as the oil price which has been bouncing all over the place, thanks to the war in Ukraine, and started trending higher again of late. Increasing costs in food, labour and electricity all contribute to our inflation rate which is edging to the upper end of the inflation target band of between 3% and 6%. The Reserve Bank now sees headline consumer prices peaking at 6.2% in the second quarter of this year and averaging 5.8% in 2022. That's well above the 4.5% midpoint point of its target range at which it prefers to anchor expectations. As with all countries our Reserve Bank (Sarb) uses interest rates to control inflation.

Expect Sarb to enter a phase of regular

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interest rate increases. Expectations are that the interest rate may be increased by 0.25% per quarter for the duration of 2022 and 2023. That means 2% increases are on the cards over the next two years.

Interest rates have broadly been way too low for too long. Negative real yields do not bode well for pensioners and income funds who rely on interest rates. An upward adjustment of interest rates is necessary to bring the financial system back into equilibrium. Almost free cash via loans has increased debt levels globally and the effect of debt incurred to finance assets such as property and vehicles will have to be watched very carefully and interest rate increases will have to take place moderately. A strategy of too aggressive interest rate adjustments may just trigger the next financial crisis such as what we experienced in 2008.

Ironically, the country that over the past year imposed strict regulations on some sectors, which caused havoc on the share prices of many companies including our own Naspers, is going against the trend. China recently reduced its interest rates in an attempt to counter the slowdown of its economy over the past year. The Hang Seng is the worst-performing index over the past year, with a return of (-) 16.7%. For investors that is not a bad thing. Actually it may be a huge investment opportunity which does not come along too often. But that is another story and needs to be considered independently.

What about your investments?

How would higher inflation, resulting in higher interest rates, impact your investments?

The only asset class that benefits from higher interest rates is cash. All other asset classes are negatively affected by higher interest rates.

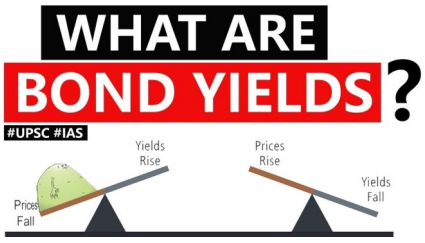
How will things change?

Bond yields (see explanation right) react inversely to interest rates. Since the coupon rate on a bond is fixed the real return compared with cash varies according to the interest rate changes. If interest rates increase, the demand for the bond will reduce thereby reducing the value of the bond and vice versa.

So, if interest rates increase, bond values will reduce, leading to an increase in bond yields. Newly issued bonds will take this into consideration and be issued with higher coupon rates.

With one exception. With inflation-linked bonds the coupon is fixed at a rate above inflation. Although the rate is fixed, the overall return will follow inflation + the fixed coupon rate. For example, if the **linker** (see explanation right) is inflation + 3% the return will be 7% if inflation is 4%; it'll move up to 9% if inflation increases to 6%.

We can expect income fund managers to increase their exposure to linkers during this time of expected interest rate increases.



What is a Bond Yield?

A bond's yield is the return to an investor from the bond's coupon (interest) payments.

It can be calculated as a simple coupon yield, which ignores the time value of money, any changes in the bond's price, or using a more complex method like yield to maturity.

What is a linker?

Daily inflation-indexed bonds (also known as inflation-linked bonds or colloquially as linkers) are bonds where the principal is indexed to inflation or deflation on a daily basis. They are thus designed to hedge the inflation risk of a bond.



South African bonds still offer one of the best yields in the world.

With interest rates rising globally, global bonds will become even less attractive (many of them already provide negative real yields) and demand from foreign buyers for SA bonds may just increase.

How will property react?

Property tends to act in a very similar way to long-dated bonds. In SA the property sector has been through turmoil for various reasons. It is also experiencing a boom in some places (like the Garden Route) and decrease in value in places like Johannesburg. Covid has also played its part in the destruction (and increase, depending on where a property is situated) of value within the sector. The tendency will however still be that demand will determine the price.

Properties that are highly **geared** will be impacted more than those that are less geared, since the financing cost of bonds/bank loans will increase as interest rates move higher.

It will therefore be important to understand what properties are included in a portfolio; how much gearing is applied; and if the leases are linked to interest rate increases and/or inflation.

How will Equities be effected?

Different sectors will be impacted differently and gearing, as in property, will be the determining factor of how company prices will be affected. Those with higher gearing will be more adversely affected than those companies that are cash flush. Fortunately there are many cash-flush companies in SA. Dividends of companies with high gearing will also be affected since the companies will use the gearing to fund the dividends resulting in a lower dividend. This may in turn reduce the demand for such companies which will ultimately lead to lower share prices of such companies. Lower consumer demand due to a higher interest burden on consumers will ultimately also influence profits and the value of some companies.

From a value perspective, investors value a company by using a discount rate to calculate the present value of its future cash flow, also referred to as the discounted cash flow method.

When this valuation methodology is applied, increases in the interest rate will result in a higher discount rate, and thereby reduce the present value of that company's future earnings, and consequently, the price that investors are willing to pay for that share. Picking the right share will become increasingly important in an environment of rising interest rates.

Onwards and upwards

Higher inflation and rising interest rates aren't a new phenomena. The financial mechanisms that were put in place to ease the fallout from the pandemic have, unfortunately, allowed us to become accustomed to low inflation and unrealistically low interest rates.



However, there is no reason to panic and move portfolios to cash. We rely on the ability of fund managers to select the appropriate share and investment instruments to continue providing meaningful returns over the long term.

With every uncertainty an opportunity is created. SA shares are cheap and it is clear that prominent fund managers have adjusted their portfolios over the past 12 months to include more SA shares than five years ago. This is not because they are bullish about South Africa or the South African economy. Actually, quite the contrary. Their decisions and strategies are based on fundamentals and pricing.

Rising interest rates are often the equaliser in a market where sanity has gone astray. Stay invested and stay calm. We are for once entering a normal investment environment.



Power Failure

Making decisions is an important part of our lives. Almost every day we make decisions relating to matters such as where we live, our health care, education, employment, social contacts and financial affairs, and dealing with the concluding of legal contracts. The answer is a Power of Attorney...until it isn't. Here we look into legal incapacity and when the Power of Attorney runs out of power.

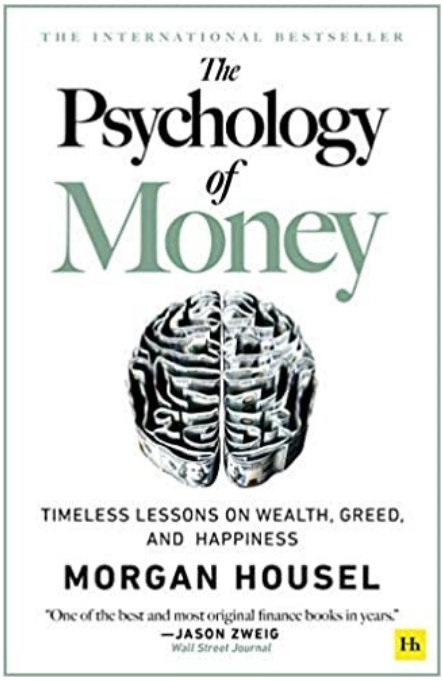
For a legal transaction to be valid the law requires that the parties be able to understand the nature, purpose and consequences of their actions. Where these requirements are absent the law attaches no consequences whatever to the expressions of will by the person who purported to engage in the legal transaction.

Diminished capacity

Some people cannot make legally effective decisions because of diminished mental capacity. Diminished capacity may result from a number of causes such as mental illness, intellectual disability, brain injury or disease, a stroke, dementia or incapacity related to ageing in general. The general principle is that if a person is not able to fully understand or interpret all the consequences of their actions due to a mental illness or intellectual disability, it is said that such person lacks capacity to perform a specific act and the act is consequently void. It makes no difference whether the person has not yet been declared mentally ill and a curator appointed to him or her, or that the other party to the transaction was unaware of the person's mental condition. The general rule though is that adults are presumed mentally and legally competent to manage their own affairs until the contrary is proved. The onus of proving that a transaction is invalid for lack of mental capacity normally rests on the party alleging it.

Getting on a bit

Many people, when they get older and frailer, give a general power of attorney to a trusted person, usually a family member, or their attorney, accountant or financial advisor (their agent) to transact business on their behalf. This usually includes the power to administer bank accounts and investments and to buy and sell assets, shares and immovable property. It can also include the incurrence of expenditure relating to the day-to-day living of the person who grants the general power of attorney (the principal) and his or her family. In this way the person is saved the trouble of having to go to the bank, or having to go to the attorney's or investment company's office, or having to do their own shopping etc. An



Doing well with money isn't necessarily about what you know. It's about how you behave. And behaviour is hard to teach, even to really smart people.

In **The Psychology of Money**, award-winning author Morgan Housel shares 19 short stories exploring the strange ways people think about money and teaches you how to make better sense of one of life's most important topics.





Margin Call (2011)

The principal story takes place over a 24-hour period at a large Wall Street investment bank during the initial stages of the financial crisis of 2007–2008.

In focus are the actions taken by a group of employees during the subsequent financial collapse. The title comes from a finance term for when an investor must pay back borrowed funds.

agent has to act in good faith and in the best interests of the principal and is accountable to the principal for his or her actions.

A lapse in reason

Although the power of attorney is a handy instrument for assisting the elderly and the frail in the administration of their estate, it can only validly be used in those instances where the principal is still mentally competent of making his or her own decisions and has contractual capacity. In South Africa the power of attorney remains valid only for as long as the principal is still capable of appreciating the concept and consequences of granting another person his or her power of attorney. The moment a person becomes mentally incapacitated and is no longer capable of managing his or her own affairs, the power of attorney lapses.

The problem of a power of attorney ceasing on incapacity has been resolved in various jurisdictions elsewhere in the world by the introduction of the "enduring" power of attorney, which will remain valid and effective should the person who granted the power lose his or her mental capacity at any stage after the power has been given. This means that decisions can continue to be made without major disruption or expense. Unfortunately the enduring power of attorney does not form part of South African law despite the fact that the South African Law Commission recommended in 1988 that it should be introduced. Frequently family and caregivers of mentally incapacitated persons are under the incorrect impression that the power of attorney signed by a person in their care will be effective until that person dies and they continue to act on behalf of such person, even after that person has become mentally incapacitated.

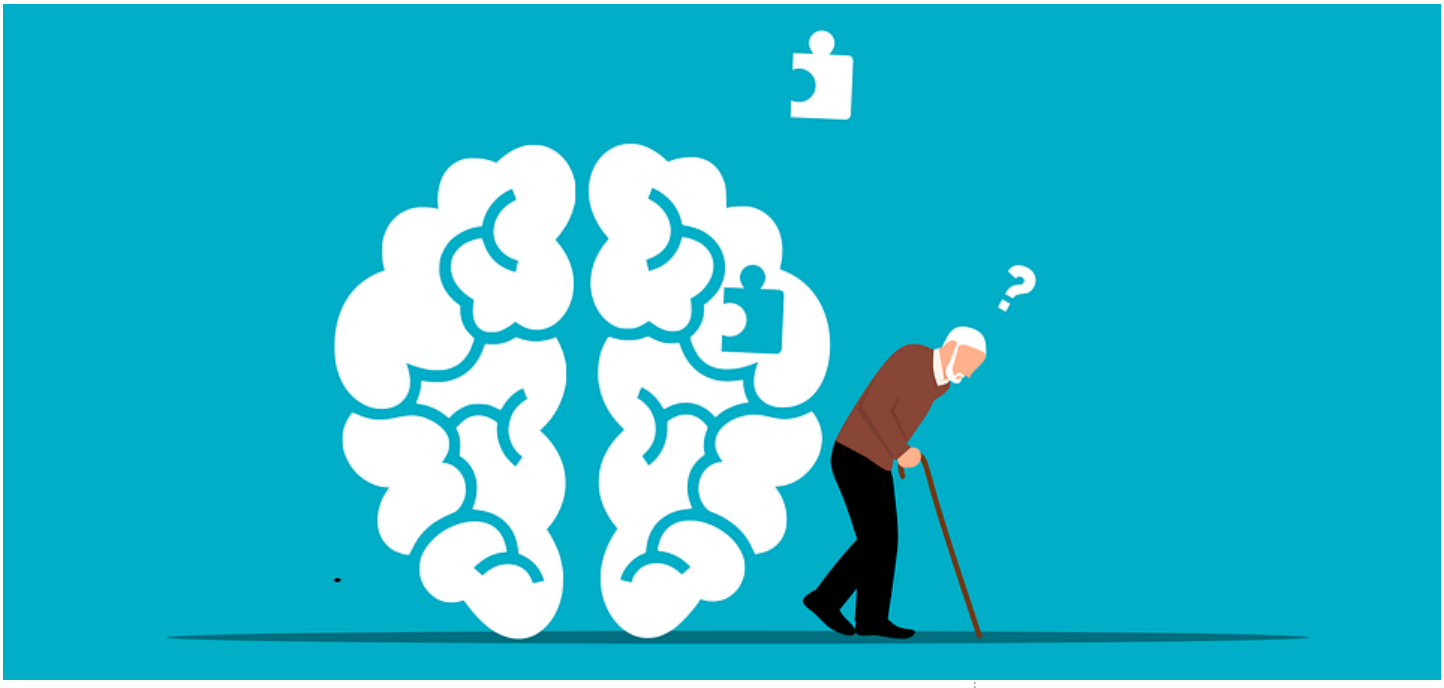
South African solutions

When a person becomes incapable of managing his or her own affairs, especially the administration of his or her estate, it follows that someone should be legally appointed to assist the person who has become incapable. At present there are two legal procedures in terms of which someone can be appointed to administer the affairs of a person who is found to be incapable of managing his or her own affairs. These procedures are (1) the common law procedure for the appointment of a curator that requires an application to the High Court or (2) the appointment of an administrator as set out in the Mental Health Care Act.

1. Curatorship

In terms of common law, a High Court may declare a person incapable of managing his or her own affairs appoint a curator to the person and/or his or her property. The curator appointed to administer the estate of a person declared incapable of managing his or her own affairs is known as a *curator*





bonis, while the curator appointed to take decisions as to the care, custody and welfare of the person, or to consent to medical treatment on behalf of such person is called a *curator personae.* The application to appoint a curator may be brought by any interested party and must set out the facts and circumstances relied on to show that the patient is of unsound mind and incapable of managing his or her affairs, and must include two recent reports by medical doctors. The court will then appoint a *curator ad litem* (who is usually an advocate) to investigate the matter and to report to the court and the Master of the High Court, the government office which administers and oversees the administration of deceased and curatorship estates. As the appointment of a *curator bonis* involves a High Court application, this procedure is relatively expensive, with the average costs ranging between R40 000 and R60 000. These costs are usually borne by the estate of the person in respect of whom the *curator bonis* is appointed.

2. Administrator

The other procedure, in terms of the Mental Health Care Act, permits the Master of the High Court to appoint an administrator to manage the property of a person who has been positively diagnosed as mentally ill or a person with severe or profound intellectu-

What is the difference between Alzheimer's and Dementia?

Dementia is the term applied to a group of symptoms that negatively impact memory, but Alzheimer's is a specific progressive disease of the brain that slowly causes impairment in memory and cognitive function. The exact cause is unknown, and there's no cure. Although younger people can get Alzheimer's, the symptoms generally begin after age 65.



The effects of Alzheimer's on the brain

In people with Alzheimer's disease, brain cells die and connections between brain cells may break down. One of the hallmark symptoms is abnormal protein deposits in the brain called plaques and tangles.

Plaques are dense clusters of protein that can block communication between neurons. Tangles are proteins that twist together that lead to the death of healthy brain cells.

In advanced Alzheimer's, the brain shows significant shrinkage. Changes in the brain may occur a decade or more before symptoms start.

It's impossible to diagnose Alzheimer's accurately while a person is alive. The diagnosis can only be confirmed post mortem during an autopsy. However, specialists can make the correct diagnosis up to 90 percent of the time.

al disability. As no High Court application is required for the appointment of an administrator, the procedure is far less costly than the common law (High Court) appointment of a *curator bonis*. The applicant can lodge the application directly with the Master's office in whose area of jurisdiction the person in respect of whom an administrator is to be appointed, resides. The applicant does not need to work through an attorney, although in practice applicants often call upon attorneys for assistance with the lodging of the application with the Master. There are also no application fees charged by the Master in processing the application.

Taking responsibility

The duties of a curator bonis or administrator are to take care of and administer the property of the person for whom he or she is appointed and to carry on any business or undertaking of that person. However, there are acts considered to be too personal in nature to be performed by a *curator bonis*. For example, a *curator bonis* cannot make a Will or exercise parental authority on behalf of a person.

The *curator bonis* or administrator must keep detailed records of his or her administration of the estate and must lodge administration accounts, together with proper vouchers and receipts for all entries in the account, with the Master of the High Court, annually.

The costs

The fees of a *Curator Bonis* and administrator are prescribed in the Administration of Estates Act. It is 6% on the annual income of the estate and 2% on the value of the capital assets of the estate at termination of the Curatorship. The Master may however reduce, disallow or increase the fees if special reasons exist. A *curator bonis* or administrator may be called upon by the High Court or the Master to furnish security for the proper administration of the estate for which he or she has been appointed. In such instances the curator or administrator is required to lodge a bond of security by an approved financial institution for the full value of the property which he or she is required to administer, with the Master of the High Court, before letters of authority are issued to the said curator or administrator.

Be prepared

Many people are unprepared to deal with the legal and financial consequences of a serious illness such as Alzheimer's disease.

Legal and medical experts encourage people recently diagnosed with a serious illness – particularly one that is expected to cause declining mental and physical health – to examine and update their financial, legal and health care arrangements as soon as possible.

Preparation, in advance, will be key to navigating the disconcerting realities of declining mental capacity.