Dear

The second quarter GDP data was released during August 2014 and showed that the South African economy has managed to avoid a recession (widely defined as two consecutive periods of negative growth). The growth rate of 0.6% did fall below expectations as mining continues to weigh on the economy.

Resource prices were down in August which had an impact on the share prices of the large listed mining companies. The drop of 5.4% in the FTSE/JSE Resource Index resulted in the JSE All Share Index losing 0.5% for the month. This is the first time in a number of months that the local stock exchange has shown some divergence against world markets. The major indices of the world all finished higher for the month.

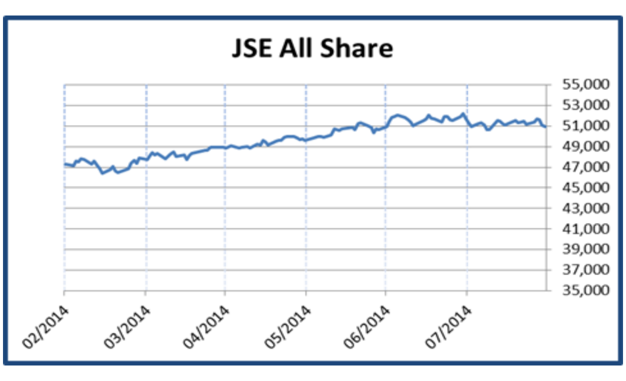
CPI reduced to 6.3% year on year. The biggest contributor to rising prices from the prior month was the introduction of new tariffs by many municipalities. Food and transport continue to rise faster than other components within in the basket of goods.

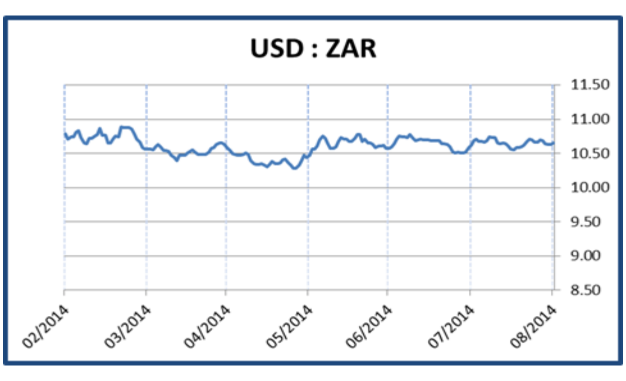
The Rand performed well in the month tracking a strengthening US Dollar. The Rand strength translated well against other major currencies with the Rand at a nine month high against the Euro. With the Rand maintaining its position against the US Dollar and the oil price weakening we are about to have a reduction in our petrol price of 67 cents per litre. Please remember to avoid filling up today and rather waiting until tomorrow.

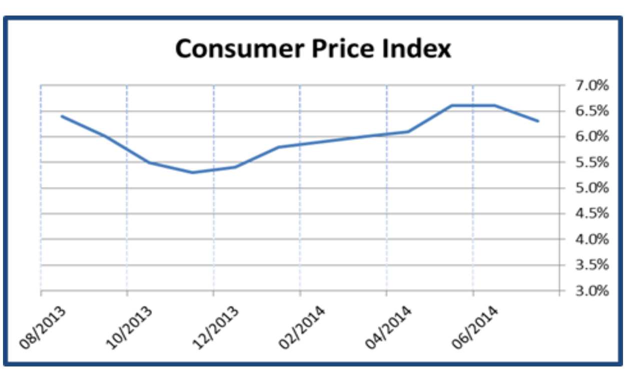
The big event that was on everyone's lips during the month was the Reserve Bank having to step in to assist African Bank. The bank has been placed under curatorship as they try to separate the good assets from the bad assets. Plenty has been written in the media about the lending practices of some of the branches of African Bank. The strike within the platinum sector would have placed the bank and its clients under severe financial pressure. It does appear that the sustainability of the business model was impacted by the practice of "throwing" more good money after bad money.

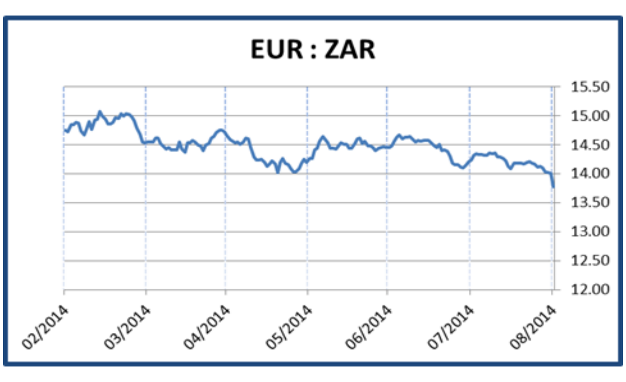
Magwitch Securities

MARKET INFORMATION









FINANCIAL PRODUCT IN FOCUS

THE BASICS OF BONDS

In our Financial Product in Focus this month we look at bonds. This theme is topical at the moment because of the collapse of African Bank which resulted in many local investors suffering losses based on the asset managers' equity and bond holdings in African Bank. The losses were actually larger within the conservative asset classes as African Bank issued a number of bonds to raise capital to finance their lending book. The restructuring details released by the Reserve Bank indicated that the senior debt would be transferred into the new "good" bank at a 10% discount whilst the subordinated debt was to be left behind in the "bad" bank. We will look to demonstrate how bonds work and indicate why African Bank was reliant on them.

Bonds

A bond is a debt instrument issued for a period longer than one year whereby the investor loans money to the issuer for a fixed period of time at a defined interest rate. Bonds are typically issued by large corporates, to finance long term investments, and by governments to fund long and short term expenditure. Bonds are negotiable and thus can be traded in a secondary market. The prices of these bonds are constantly changing as demand within the market moves. South Africa has one of the most liquid bond markets within the world and due to the ability to enter and exit positions easily there is a large percentage owned by foreign investors.

Principal

The principal amount is the amount that the issuer of the bond borrows from the investor. This is the amount on which the interest is calculated and generally the amount to be repaid at the end of the period.

Maturity

A bond is issued with a fixed date of maturity which is the date that the principal amount will be repaid. After the repayment of the principal amount the issuer will have no further obligations to the investor.

Coupon

The coupon is the rate of interest that the issuer pays to the holder of the bond. The coupon rate can either be fixed or linked to a floating rate. An example of this would be bonds linked to the JIBAR rate (Johannesburg InterBank Agreed Rate). The issuer is always liable to pay the coupon amount as per the bond instrument and they are unaffected by the price movements of the bond within the secondary market.

Yield

The yield is the rate of return received by the holder of the bond. As the instrument is tradable and the price fluctuates continually the yield changes based on the price the new investor pays for the bond. If the investor purchases the bond on its issuance and holds it through to maturity then the yield will be equivalent to the coupon rate. The yield is calculated by dividing the cash inflows from the bond by the current bond price.

This can be demonstrated with a basic example. For this example we use a R1 000 bond with a 10% coupon rate.

	Bond at Par Value	Bond at a Premium	Bond at a Discount
Traded Bond Price	R1 000	R1 100	R900
Coupon Payment	R100	R100	R100
Yield	10.00%	9.09%	11.11%

As one can see the yield has an inverse relationship to the bond price. The reason that the price moves is because the coupon rate is set at the issuance. If new instruments are issued at higher rates then the investor will wish to sell their current instrument and rather buy the new instruments. To compensate, the new investor will want to purchase the bond at a discount to give them a higher yield. Bonds often trade at a premium when interest rates are low. This is currently the case worldwide and the bond market appears to be coming to the end of a prolonged bull market.

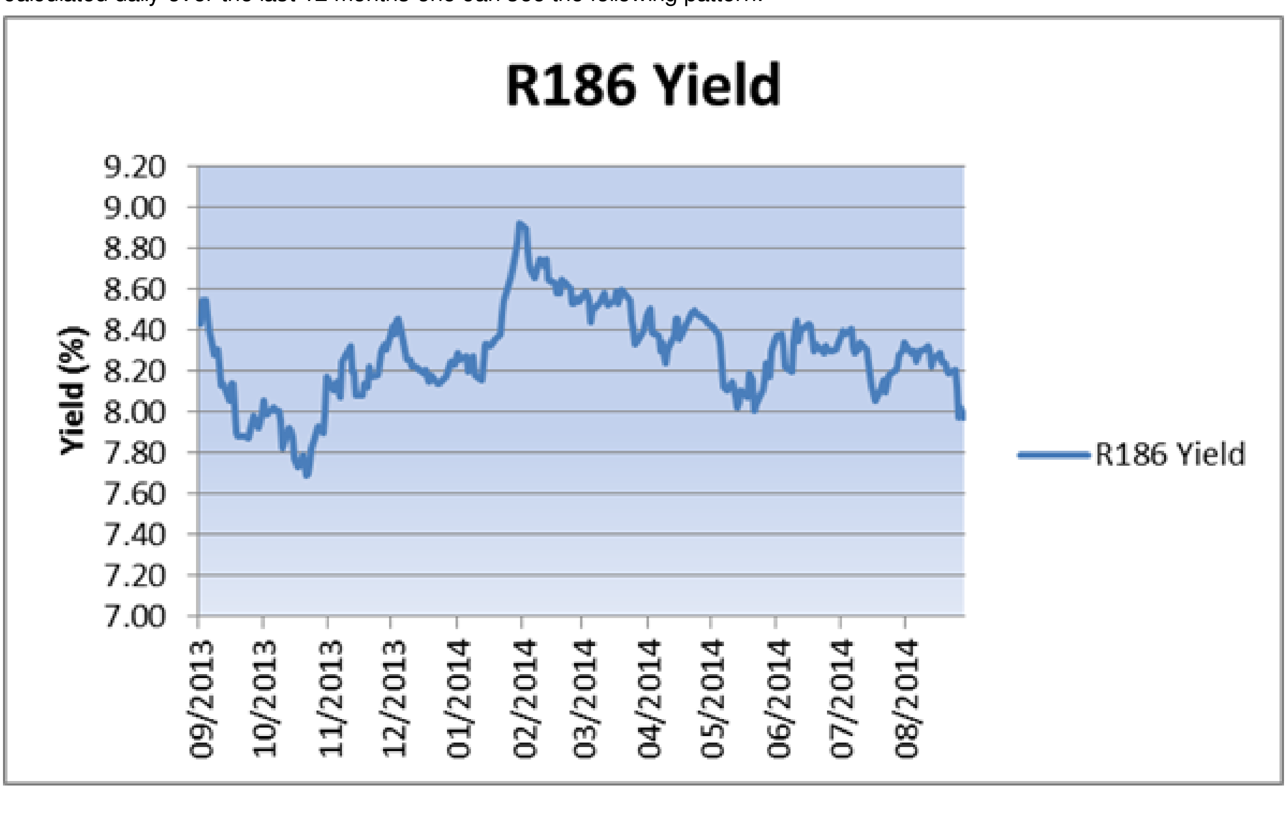
Credit Quality

The quality of the bond refers to the probability that the bond holders will receive the amounts at the due dates (both coupon payments and the principal repayment). The bonds are given ratings by credit rating agencies with AAA being the rating for prime bonds. Often bonds with lower ratings will have to be issued with a higher coupon rate to compensate investors for the increased risk.

The largest credit rating agencies, namely Moody's Investor Services; Standard & Poor's; and Fitch Ratings issue ratings for 95% of the market.

Price Movements

As discussed earlier the price of the bond moves in line with the demand for that bond. Values fluctuate continuously as the instrument is traded in the secondary market. We've plotted the daily yield on the R186 government bond which is a long term instrument with maturity date at the end of 2026. The coupon rate of the bond is 10.5%. If one looks at the yield calculated daily over the last 12 months one can see the following pattern:



Because of the global trend of artificially depressed interest rates the bond is currently trading at a yield below the coupon rate. The bond price of the R186 for a yield of 8.2% would be R1 280 for every R1 000 borrowed. The expense for the government remains at 10.5% no matter how the yield moves.

The large move in January 2014 was due to the surprise interest rate hike that was announced at the end of the month. With the interest rate hike money market investments became more appealing so demand for the bonds dropped and this resulted in the bond offering a market related yield.

African Bank

African Bank issued bonds to provide the bank with the cash receipts to be able to grant unsecured loans to their clients, ie the South African population. With their lower credit rating they issued the bonds at a higher coupon rate which made them very attractive for cash type unit trusts wishing to deliver a higher return using African Bank bond instruments. Bonds have preferential claims when compared to shareholders. In the event of liquidation shareholders are last in queue. African Bank issued a second type of bond in which the bondholders had subordinated their claim below the claims of other creditors and bondholders. These bonds were issued at an even higher coupon rate in order to compensate the bond holder for the additional risk. Unit trusts with an exposure to these subordinated debts would have suffered a full write down of these debts.

Conclusion

Bonds are usually classified as low risk investments but as seen above capital values do fluctuate with interest rates. Government bonds are classified as risk free, however as currently the case with Argentina this is not always true. Corporate bonds carry more risk and will offer a higher yield to compensate. In the African Bank scenario it was demonstrated why corporates need to offer a higher coupon rate to incentivise investors to invest in their bonds.

Bonds are critical in a balanced financial portfolio as they provide a regular income stream. The yield on bonds is above that paid by money market investments to compensate for the volatility in the price. That being said price volatility ceases to be a concern if the intention is to hold the bond through to maturity.

ABOUT MAGWITCH

Magwitch Securities is a Financial Services Broker offering the following products as a comprehensive financial solution to both individuals and businesses:

- Employee Benefits
- Medical Aid
- Risk Benefits
- Short Term Insurance
- Retirement Planning
- Investment Planning
- Estate Planning
- Foreign Exchange
- Money Market
- Investments
- Treasury Management

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