FinPlanCo

NEWSLETTER H1 May 2021

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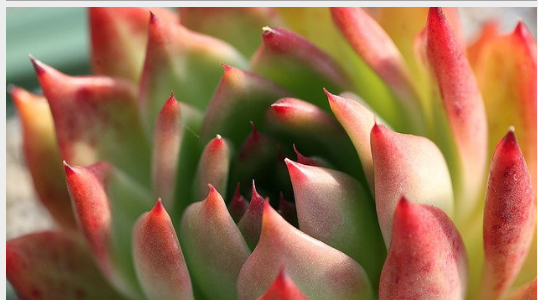


4 LOW HANGING FRUIT

Where to start with Financial Planning to improve your financial health and preparedness. Followed by our **FINANCIAL PLANNING FAQ.**

"Three great forces rule the world: stupidity, fear and greed." – **Albert Einstein**

INTRODUCTION

It is worth mentioning that we spend a lot of time reading, researching, and attending online seminars, some of which are hosted by big asset management businesses. It is sometimes very easy to see striking similarities in the way large asset managers think.

Every investor or market participant uses the same set of economic data to evaluate the economic backdrop for future returns given the different asset classes. This set of data is the same for all but could be interpreted in many ways.

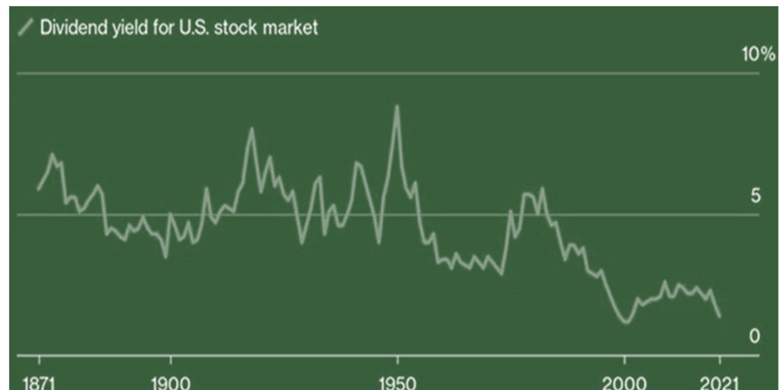
Continued on the next page…

INVESTMENT ENVIRONMENT UPDATE

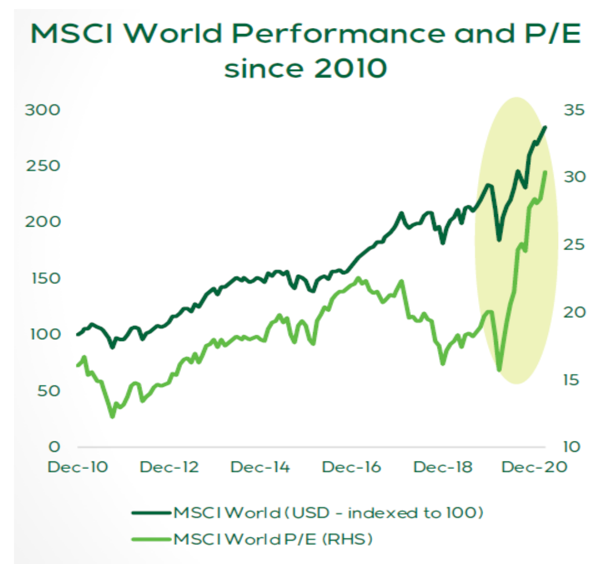
Carel Marx. Yellen says rates may have to rise to prevent overheating.

Here are some key economic points that we have picked up from our recent engagements with large asset management businesses:

- The tech orientated businesses are expensive, mostly in the US - The Nasdaq is up 20% per annum for 10 years now, it seems like investors think it is a "one-way bet".
- Global stock markets are on all-time highs, pushing dividend yields to all-time lows. See graph on the right.



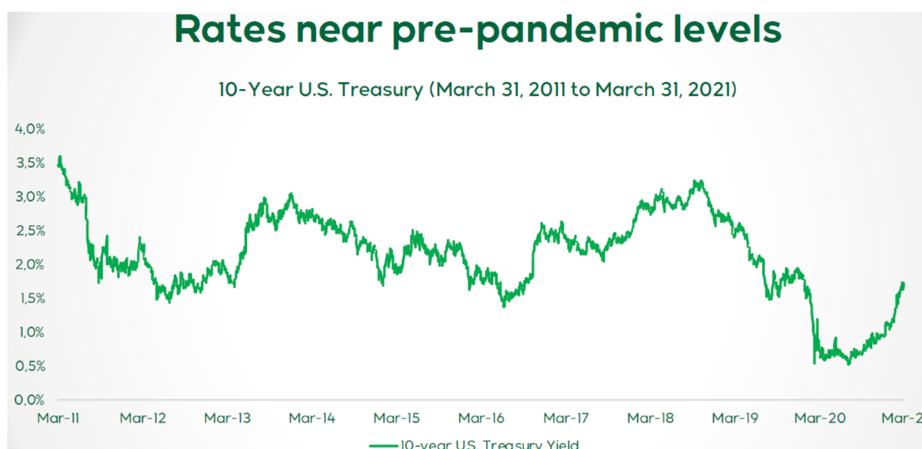
- MSCI World Equity Price to Earnings (PE) now close to 35 times with the Nasdaq closer to 40 times (refer to the graph on the right).



- Most commodity prices at all-time highs.
  - A lot of talk about a new commodity BOOM.
- Most quantitative easing ever - after Covid crash.
- Average Inflation globally at all-time lows.
- Interest rates are still at all-time lows.
- Developed market bond yields at all-time lows.
- Expected GDP growth set to reach record levels in 2021 worldwide (US expected to outstrip China!)
  - World growth forecasted at 5.5% in 2021 (IMF)
  - Growth rate above 5% last seen in 1976.
- Government and public debt at all-time highs.
  - World debt reached $281 trillion (+-R3 990 000 000 000 000 or 1000 times the size of the total RSA economy) at the end of 2020 and set to increase further in 2021.
- The difference between the expensive stocks and cheapest stocks are the widest it has ever been (graph on the right: 3 years until 5 May 2021 in US$).
- and Bitcoin reached all-time highs recently.

There is one clear common thread in the above bullet points: prices or measures are on all-time highs or lows. The market is at extreme levels and this could mean that a reversal back to normality is possible unless our idea of normal has shifted…. What would normality look like?

- Governments will gradually stop buying into the economy or stimulating the economies - No more artificial stimulation of the economies.
- Bond yields will start picking up - As governments or central banks stop buying bonds, demand decreases, and yields go up.
- High levels of economic activity will lead to inflation (wait for Covid to end).
- Interest rates will start picking up - Monetary policy reacts to inflation by increasing interest rates.
- The level of interest rates is an important input to determine the price of securities.
    - Higher discount rates lead to lower prices.
    - Higher rates offer alternatives to equity.



Its perhaps insightful to quote Jamie Dimon from the JP Morgan Chairman's letter of April '21:

"… while we are going to hope for the Goldilocks scenario – and we think there is a chance for that to happen – we will anticipate and be prepared for two other negative scenarios:

1. *The new COVID-19 variants may be more virulent and resistant to vaccine, which would obviously reverse a booming economy, damage the equity markets and reduce interest rates as there is a rush to safety, and*
2. *The increase in inflation may not be temporary and may not be slow, forcing the Fed to raise rates sooner and faster than people expect."*

<u>What does it mean for clients and their investment goals?</u>

The answer is not obvious as we don't know what will happen but, in our view, it is important that clients don't deviate to far from their risk profile or objective driven investment profile. The dislocation in the market seems to be obvious to all participants but very little of them are predicting any negative outcomes in the short term. That is why Jamie Dimon refers to the "Goldilocks" scenario, where growth is high, inflation stays low and interest rates stay low. In that environment we will see equity markets continue to rally.

We think that the environment for active managers is looking a lot more attractive. Active fund managers had a dreadful decade compared to market indices. Even if you had a global bond ETF you would have done well. Active managers have been avoiding low yielding bonds, that have been in a bull market since the GFC, and they've been avoiding the expensive parts of the stock market that kept on moving higher. If the next decade looks different to the last, where would you invest? We think the best strategy is backing an active fund manager approach considering the risks and possible changes to the market cycle.

WHAT TYPE OF INVESTOR ARE YOU?

Wilhelm Tempelhoff. Investors and investment managers use various investment approaches and strategies. We outline these and ask which one you prefer.

Both professional and private investors usually invest according to a strategy or an investment methodology or philosophy. The strategy you choose depends on the type of person you are, your objectives and the results you seek.

In this article we aim to outline the most pertinent investment approaches and ask the question: Which type of investor are you?

Value

This strategy involves being a bargain hunter. You are looking for undervalued assets to buy, with the expectation that the value of the assets increases back to what you consider to be "fair value". You believe that investment markets can be irrational and that investors can get spooked easily by short term noise which creates an opportunity for you to buy good assets at lower prices than normal. This strategy does have some pitfalls including where assets are "cheap for a reason" or they take a long time to increase in value again.

Growth

Here you are seeking assets that have good growth trajectories. You would like to invest in fast growing areas of the world, industries or sectors – the next big thing. You are likely willing to pay a premium price for an asset that you believe will continue to grow. Growth investors are not looking for dividends if they buy shares, they would prefer that the companies reinvest their profits to grow more and thereby improve their share prices. An example here would be the technology industry, which is arguably expensive, but has potential for further growth.

Quality

Here you are more concerned with the quality of an asset than the price thereof. You prefer to invest in established assets that have barriers to entry because they are incumbents in their areas of expertise. You may also pay a bit more for a quality asset than you would expect to pay, but your expectation is good stability and continued growth and cash flow, albeit at a potentially slower pace than the more uncertain alternatives. Here you are perhaps more of a tortoise than a hare but who would not like to own the big global players and household names?

Deep Value

Similar to the normal value strategy you are a bargain hunter, but you are also looking for unloved assets with an unfairly bad reputation or situation surrounding them. You are willing to take greater risk than the normal value investor to buy ultra-low-cost assets which may have more visible risks that you don't necessarily agree with as being negative or persistent forever. Here the risk is that you invest in value traps where something that is already cheap, was cheap for a very good reason and becomes even cheaper after you bought it. Be careful of catching a falling knife.

Momentum

You like following the latest trend and taking part in growing assets where the prices seem to be headed in the right direction. Here you believe that the strong will get stronger and that certain

assets will continue their recent runs into the future. Here you are trying to ride the wave of certain assets and you may also think that the assets with falling prices will continue to drop. There is some inherent risk with this strategy, and you may want to jump ship when the trend reverses.

Contrarian

Investors using this strategy believe that you should be buying when others are selling, and vice versa. Here you would like to go against the herd mentality and look for assets that are unloved but with good prospects and values. You will likely sell assets as they become stronger, thereby taking profit when everyone else seems to be comfortable holding on. You may have a bit of a value investor in you as well. You tend to buy and sell too early.

Passive

Unlike the other investor types, you believe that markets are rational most of the time and that there is not much benefit to trying to beat Mr Market. You prefer to buy a whole asset sector or a basket of assets that represents the market closely. This makes investing easier and can keep the costs down, but you realise that you will not beat the market. You are happy to "be" the market.

It is often helpful to blend styles to suite your preferences and diversify your portfolio's investment approach. One does not have to stick to just one style but it's prudent to use ones that complement each other well, for example Quality and Contrarian. There is no right and wrong strategy, some markets can however benefit certain strategies more than others. For example, post the Great Financial Crisis of 2008/9, the Momentum-, Growth-, Quality- and Passive strategies were most favoured with Value-, Contrarian- and Deep Value strategies less so. This may well change soon.

Broadly speaking unit trust and investment fund managers fall into these categories as well. Investors can therefore choose their collective investment schemes (unit trusts) to match their personal preferences. Bear in mind though that a manager that is broadly considered to be "Value" for example, can have a Momentum or Passive strategy fund within their offering.

Quick take: Where are interest rates headed in SA?

The table below shows the SA Reserve Bank Monetary Policy Committee's latest expectations of where the Repo rate is headed. In their March meeting they said that they expect to increase interest rates by 0.25% in the 3rd and 4th quarter of 2021, ending the year at a Repo rate of 4% (therefore Prime of 7.5%).

The table compares the official interest rates for the near past to the MPC's current forecast of interest rates at the end of the three years ahead. We think this is likely a good gauge for where interest rates are headed bar any inflation surprises.

	Actual				Forecast		
Year	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Repurchase rate (end of period)	6.75%	6.60%	6.50%	3.50%	4.00%	4.95%	6.07%
Prime rate (end of period)	10.25%	10.10%	10.00%	7.00%	7.50%	8.45%	9.57%

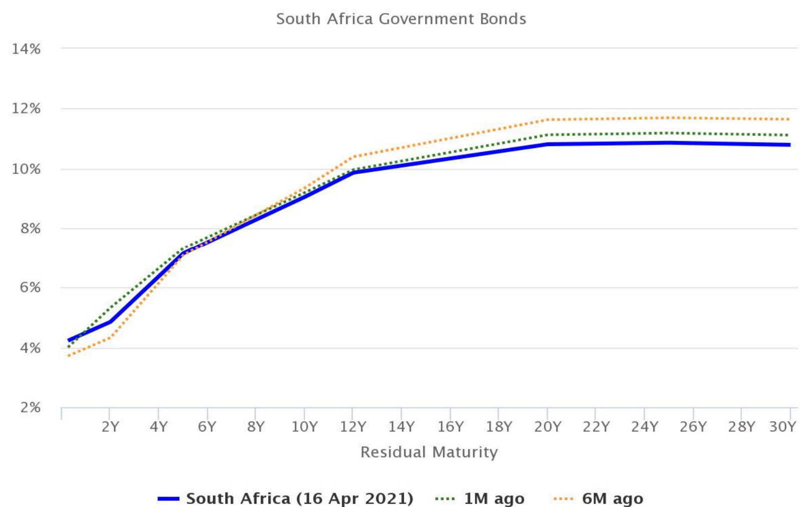
Source: MPC Forecast March 2021

WHAT IS THE YIELD CURVE AND WHY DOES IT MATTER?

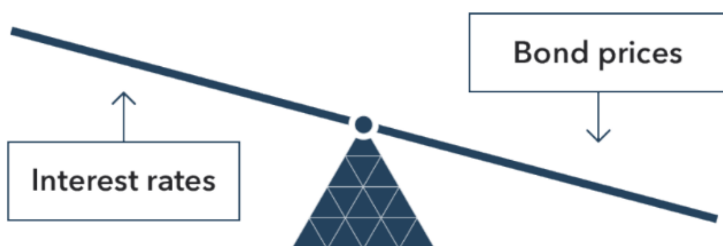
Carel Marx. Market commentators often refer to the status of the yield curve, what is it and why does it matter?

Let's start with the definition of the yield curve. It is a curve that has time on the horizontal axis (X) and interest rates on the vertical axis (Y). The normal yield curve is the easiest one to explain; the shorter the term of the debt, the lower the interest rate. As you move along the horizontal axis (time), the higher the interest rate becomes. It simply means that the longer the period that I need to part with my money, the higher the interest rate I would demand.

Let us look at a real-life scenario. The yield curve on the right (blue line) is for SA government bonds. This yield curve implies that investors would demand +- 9% from the SA government if they had to loan money to them over a 10-year period. The 9% effectively takes into account all the risks (probability of not being able to service the debt) associated with the SA government over the next 10 years as at the 16th of April 2021.



Let us assume you buy, on auction, a new 10-year nominal government bond today for R1 million, it will yield 9% per annum for 10 years (maturity). These bonds typically pay bi-annual distributions/coupons to lenders and these make up the 9% over a 12-month period. The government undertakes in this situation to pay bi-annual coupons to the holder of this bond and at maturity, they repay the R1 million capital.



What happens if you buy the bond as per the above example and now yields move up, as was the case in the yield curve graph 6 months ago (orange dotted line). Lenders now demand 10% from the SA government for the same bond because expected growth in SA may look weaker or the credit risk of RSA has worsened, thereby increasing the risk of this loan. If you had to sell your bond in this scenario then you would need to reduce the original buying price from R1 mil because the coupon will only give investors 9% but they demand 10%. Reducing the capital amount paid would then increase the overall return profile if the new investor holds on to maturity. They will receive 9% in coupons plus some capital gains as they paid less than R1 million for the bond.

Why does it matter?

The yield curve gives you an idea of what you should be earning on the short term of the interest rate market, think about money market funds or short-term bank deposits. It is also an indication of what you should expect in terms of the 5-year fixed deposit rates. You can obviously continue along this curve to see the rate applicable for each maturity.

Not only can you read the rate from the graph, but the shape of the graph also tells a story in itself. We spoke about a normal yield curve, but this curve could be flat or even inverted at times. Firstly, the higher the yield required by investors, the higher the perceived risk of the government not being able to service the coupon payments and or the repayment of capital after reaching maturity.

Inverted yield curves normally happen when lenders expect short term interest rates to lower drastically in the near future, this is normally a precursor to a recession. This means short term instruments have higher interest rates than their long-term counterparts and this is a rare occurrence.

The yield curve is also very important to consider when you are allocating money to the different asset classes. Think about other income producing assets, like a company paying annual dividends, a listed property company or maybe even your own fixed investment property.

All these asset classes and or individual securities will have different risk factors to consider and as such could have a higher or lower yield than the government bond. You have to however consider that the government bond, according to theory, should be among the least risky assets within your country (it might not always be the case) and as such if we had to compare it with fixed property income yields, we would say your income yield should at least be close to the bond market yield on a 10-year basis.

Comparing risk is important but you also need to consider the different tax rules that apply to interest income, dividends and property income.

The current yield in SA for maturities between 7 and 12 years seems to be attracting a fair number of investors. At a yield between 8% and 10%, you earn between 5% and 7% above the current inflation rate. This is referred to the "real yield" and is one of the most attractive spreads among emerging markets. This is a significant tailwind for the Rand as foreign investors search for yield, find it in RSA and allocate capital accordingly.

LOW HANGING FRUIT

Wilhelm Tempelhoff.

We have all heard the adage that "if you fail to plan, you plan to fail". Planning does not have to be a complex exercise, here are a few simple starting principals that can put you on the right track.

The planning fallacy was first defined by Daniel Kahneman and Dan Lovallo. They defined it as "*the tendency to underestimate the time, costs and risks of future actions and overestimating the benefits of those actions*". This fallacy can often affect our financial lives negatively as well. We may for example overestimate our financial knowledge, underestimate the time left until retirement, underestimate the impact of tax or overestimate returns. This mainly happens when our opinions are formed without due consideration and research.

Starting to build a good financial plan can help avoid this fallacy by providing an objective framework within which one can make financial decisions. This leads to the setting of realistic goals that are quantifiable, objectively measuring your progress, actively reviewing your plans and trying to incorporate the unexpected.

While it is helpful to have a professional assist you with setting and maintaining a financial plan, there are many financial planning principals that you can start with on your own. Simple changes in the way your approach your finances that can make a big difference to the outcome.

These include:

Building up a cash buffer – Emergencies can wreak havoc on your finances. More recently Covid-19 proved this point quite vividly. It helps to have a cash buffer when disaster or unforeseen expenses hit. Normally financial planners advise building up 3-6 months' worth of your household fixed expenses as an emergency fund. This is also an important step to help avoid using easily available credit.

Setting a budget and tracking it monthly – it may sound like an onerous task but setting and following a budget can be very rewarding. Knowing what "comes in" and what "goes out" helps you understand your spending habits and identify imbalances. An exercise to streamlining expenses rewards you even further by freeing up some cash-flow that can be allocated elsewhere to debt, savings or lifestyle improvements.

Focussing on the important expenses and prioritise – Some expenses should be prioritised above others (shelter, safety, food, debt, etc). Categorise the important expenses as "must have" expenses, and the less important once as the "nice to haves". Debt is often called "saving in reverse" and for this reason it's one of the most important expenses to cover first and allocate extra to if you can.

Understand your debt profile – "good debts" can be debt over assets that can grow in value over time or provide extreme utility, an example would be a home loan over a property that can increase in value. "Bad debts" can refer to debt over assets that immediately lose value after purchase, an example would be buying clothes on credit. Debt is a useful tool, and it should not be avoided at all costs, rather it should be used prudently and with care.

Postponing lifestyle upgrades – It may be tempting to make the most of your income by upgrading your lifestyle to the panicle of affordability, but it leaves little room for unforeseen events. When next you receive a salary increase or pay off your existing car, evaluate the need for lifestyle upgrades critically and rather opt to postpone upgrades by leaving well enough alone.

Paying yourself first – Ideally you should be saving some of your income to cover your future needs. Save towards retirement, start a tax-free savings account, create an investment for your medium-term plans, etc. In other words, allocate money to where you can use it in future. Aim to do this first thing in the month by considering your budget as opposed to seeing what remains at the end of the month.

Using the available concessions – structure your financial life in such a way that you make the most of what financial concessions are available to you. If you can qualify for a discount, rebate or subsidy then you should apply for it. If you get a tax concession on certain types of investments or savings versus others, prioritize them appropriately.

Insuring only what you need to – Insurance is a tough one and it is easy to motivate for or against it. Ideally one should critically evaluate the need for every insurance type and prioritise those that are most applicable. The guiding principle is: insure when you don't have enough reserves to cover the risk for yourself. Self-insurance is important and this is much easier when you have an emergency fund in place. Who needs that extra "*tire damage insurance add-on for only R15 per month per tire*" if you can afford to replace a tire yourself should you ever get a blowout? With a little planning and a little saving, you can self-insure more than you would expect.

Consider also finding an "accountability buddy" to help you stick to your plan and the undertakings you made for yourself. Remember to be critical of your thinking and assumptions and do your research if you feel unsure.

It's never too late or too early to start with a financial plan and it certainly does not have to be a complex exercise. It is important to get the basics right and then pull in someone knowledgeable to help when you need it.

Snapshot: Our view on Crypto Currencies?

Normal investment theory requires that the security or asset has some type of market value. This could be due to owning certain assets, generating certain cash flows, or paying certain income streams to the holder or owner of the asset. Bitcoin has none of those attributes. It does not own property, there is no income stream and hence, it is incredibly hard to put a value on it. How would we then know if $60 000 for a Bitcoin is an appropriate value/price? Yes, it is scarce, but scarcity does not denote value.

There is no doubt that blockchain technology will change the future of transacting and the banking system. It might also mean the end of FIAT money but at this point in time, we are not advocating that clients invest in Crypto currencies as part of their portfolio.

On a connected note, the FSCA wrote recently in their "*Crypto Health Warning*" that "*Crypto-related investments are not regulated by the FSCA or any other body in South Africa. As a result, if something goes wrong, you're unlikely to get your money back and will have no recourse against anyone.*"

"I'd just as soon pay a little tax than not pay tax… at least paying tax means I am making money. I would however, prefer to pay no more than I need to."– ***Recent client comment****.*

Is an Endowment a good investment option?

As usual the answer is "it depends". An endowments policy could be a great investment option, but it is more useful to some than to others. Endowments are 5-year term policies used as part of a financial/investment plan. They can have insurance components added, have guaranteed outcomes or be simple investment linked policies. In our view an investor considering an endowment policy should firstly have a marginal tax rate above 30%, have used their full SARS interest abatement (R23 800 below age 65 and R34 500 above age 65), have already make full use of a tax-free savings account and have a five-year time horizon.

My daughter is getting married, are there any financial considerations for the marital regime?

The default marital regime is Marriage In Community of Property (COP), this means that all assets and liabilities are joined together. Under this regime any debts incurred by one party will form part of the joint estate. It also means that one spouse will need the other's permission to enter certain contracts and agreements.

The default of COP can however be changed by creating an ante-nuptial contract (ANC) which will mean that they are Married Out of Community of Property, either with or without the Accrual system. This means that the estates of the spouses remain separate from each other and no consent is needed to handle their own affairs.

With the accrual system the size of the parties' estates before marriage is compared to the estate sizes at the time the marriage is ended (death or divorce) and half of the difference is owed by the larger estate to the smaller. For the purposes of the accrual estate calculation certain amounts can be excluded such as inheritances and donations received.

Should I nominate beneficiaries on my Endowment, Retirement fund, Living Annuity and Life insurance?

Perhaps the answer is a bit wide for one paragraph, but the short answer is yes, especially if you have reason to do so. It may be easier to explain what happens if you do not nominate beneficiaries and pass away. The policy in question then pays out to your estate and is handled according to the wishes set out in your Will. This does however mean that your estate will end up paying executor's fees on the value received and the proceeds form part of the lengthy process of winding up an estate.

If liquidity is needed in the estate, it may be useful to not nominate a beneficiary but where liquidity is already adequate in the estate, consider nominating a beneficiary to save your loved ones the executors fees and delay in receiving their inheritance.

Interestingly Living annuities, Life insurance policies and Endowments are all governed by the Long-Term Insurance Act and you should be able to freely nominate beneficiaries thereon. A Retirement Fund however is governed by the Pension Funds Act and subject to Section 37C thereof. It stipulates that even though beneficiaries are nominated, the trustees of the retirement fund have a duty to identify and provide benefits to your dependents, which can override your beneficiary nominations.