FinPlanCo

NEWSLETTER H1 2020

1 ENVIRONMENT UPDATE

The current investment environment is dynamic. We provide a short update relating to markets and our current financial planning approach.

2 ANNUITY STRATEGIES

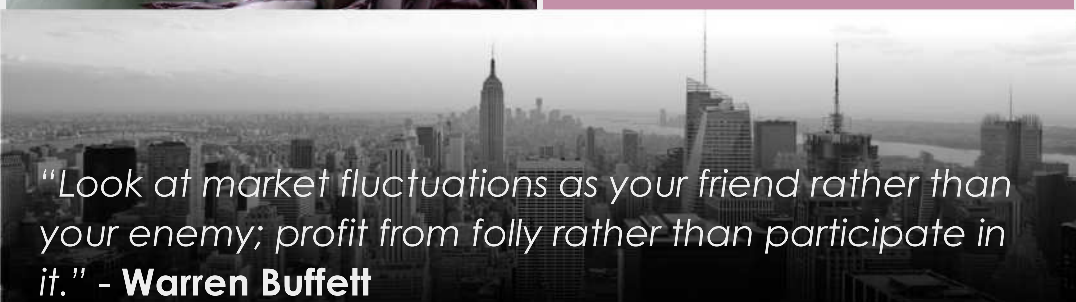
Considering the extreme market movements, living annuity investors are concerned. We look at ways to mitigate risk in an annuity portfolio during tumultuous markets.

3 LIKELY DEPRESSION?

Current events are being compared to the Great Depression. Is this a valid comparison or can we avoid the same mistakes?

4 FINANCIAL FAQ

In this section we share interesting financial planning questions received from clients recently and attempt to answer them broadly.



"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." - **Warren Buffett**

WELCOME

It is with great pleasure that we provide you with your first newsletter from FinPlanCo, in what we hope to be a longstanding tradition of continued communication with our clients.

We aim to use this document to provide you with interesting information regarding financial planning and the current trends therein. At the same time, we plan to address topical issues and events to provide our views to clients in a concise manner.

Recurring sections will include a consideration of the current investment environment, articles on current events or financial planning topics and finally interesting questions that came up during the quarter.

This year has kicked off with no lack of drama as society and the world economy face the unprecedented challenge that the Covid-19 pandemic presents. Governments and Central banks are pulling all available levers to try and migrate both the humanitarian and economic fallout…

ENVIRONMENT UPDATE

"Even as we find ourselves at a moment of great peril, even as great sacrifices are demanded, even as we dare not allow our vigilance to waver, we look ahead to a better future." – President Ramaphosa

After the initial shock and panic of early March, asset prices have improved, and markets have at least partially recovered. While this is heartening to see and supports investors who have remained stoic in the face of the uncertainty, these improvements come on the back of extreme policy response and anecdotal evidence of progress concerning a viable treatment/vaccine.

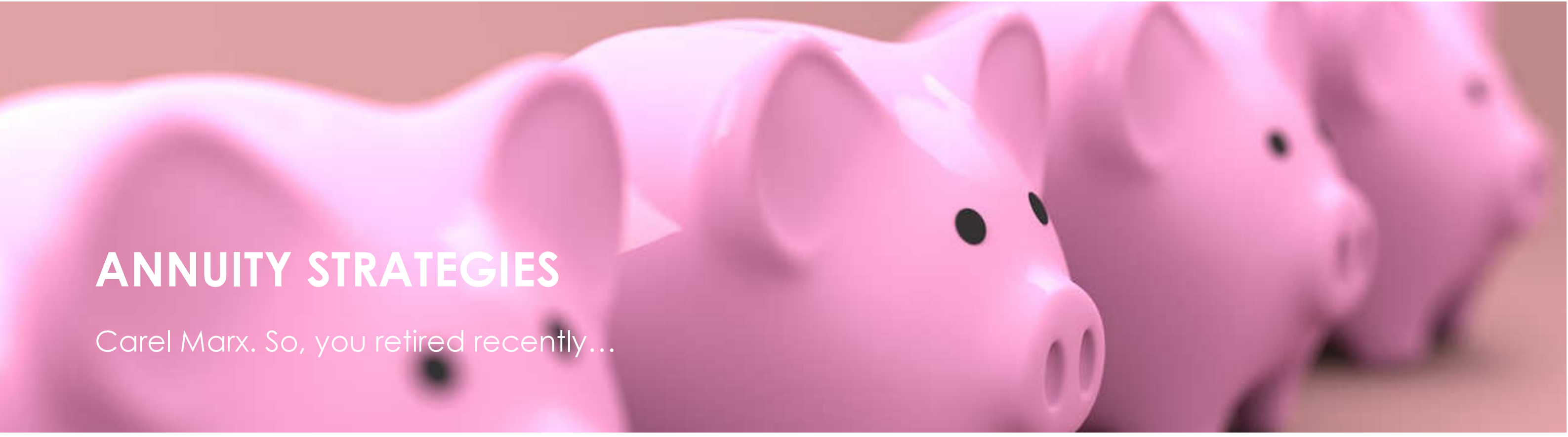
Yet much uncertainty still remains regarding: when an effective treatment/vaccine is produced, when lockdowns will safely start to lift, when the virus will finally be curbed, what the impact would ultimately be on the economy and the lives/livelihoods of people, what the ultimate humanitarian cost will be, etc.

Recent events have made it clear that there is a trade-off between supporting the health system, the financial/economic system, and the livelihoods of individuals. The lockdown has placed our health system ahead of the curve at an immense cost to our economy and the livelihoods of individuals. This can only last so long until permanent damage is done which will inevitably lead to poverty and strive on an individual level.

It may sound callous to consider the economic implications ahead of the risk to human lives, but they are inexorably linked in the medium term, as economic strive will lead to death by poverty or social unrest (particularly in SA). We do not envy the government in having to balance the various considerations carefully to minimise the negative impact. In our mind the slow lifting of the lockdown seems prudent to build up economic activity while continuing to track, test and treat.

The fact is that it is too soon to make any meaningful calls about the true extent of the virus's economic impact. The world is still reeling, and it will take time to settle into a "New Normal" seeing that our old normal is likely never to fully return. Investment markets are forward looking and will consider the current information, digest it and then project scenarios into the future, all the while repricing assets to suite the evolving news. We therefore remain cautious in our financial planning approach and still consider that "it may get worse before it gets better". Our focus remains on our client's risk tolerance, risk appetite, planning objectives and term with current added emphasis on budgeting and immediate cash-flow requirements.

"It is one of the beautiful compensations of life that no man can sincerely try to help another without helping himself." – **Ralph Waldo Emerson**



ANNUITY STRATEGIES

Carel Marx. So, you retired recently…

We often lie awake at night for the very same reasons our clients do. Currently we spend our nights thinking about our retired or soon-to-be-retired clients. In this article we will try to focus on the living annuity structure and possible options to reflect on considering your retirement.

You work for forty plus years and every month you try to put money aside for your old age. Most of us aspire to retire early but in reality, most of us end up working longer and still end up short of a comfortable retirement for various reasons.

Let's take one step back. When you retired you had a choice of buying either a "life annuity" or a "living annuity".

Guaranteed or life annuities used to be very popular but have fallen out of favour in recent time. I guess it is fair to say that investors are no longer willing to pay away their life savings for an income and if they live shorter than expected, their families lose everything. On top of this, they also take on the risk that the insurance provider offering the annuity stays operational during their lifetime. However, if you selected the guaranteed life annuity and you've paid away your money, then you should feel fairly satisfied with your choice at this point because you have a contractual agreement with a life company to pay you an income for the rest of your life. That income could be passed on to your spouse if you loaded a second life assured. The investment risk and longevity risk are passed onto the life company issuing the life annuity.

If you did not opt for a life annuity but rather invested in a ***living annuity***, then things are not looking as rosy currently. In fact, if you retired within the last 10 years and you were aiming for inflation +4%, you most likely did not achieve that target.

What can you do if you have a living annuity?

Start by looking at the variables that you can control.

- Do not to panic and sell.
- Revisit your portfolio structure and strategy to make sure that it is still appropriate.
- Revisit your budget and the annual increase on your income in the near term.

The Association for Savings and Investments South Africa has produced table that indicates to a retired person how long they can expect their capital to last under different scenarios. The table on the next page provides an indication of how long it would take at a certain drawdown rate and a certain annual return, before the inflation-adjusted income of the living annuity will start to decline. This decline is mainly caused by the withdrawal ceiling of 17.5% being reached.

YEARS BEFORE YOUR INFLATION-ADJUSTED INCOME WILL START TO REDUCE					
Annual income rate selected	Investment return per annum (before inflation and after all fees)				
	2.50%	5.00%	7.50%	10.00%	12.50%
2.50%	21 years	30 years	50+ years	50+ years	50+ years
5.00%	11 years	14 years	19 years	33 years	50+ years
7.50%	6 years	8 years	10 years	13 years	22 years
10.00%	4 years	5 years	6 years	7 years	9 years
12.50%	2 years	3 years	3 years	4 years	5 years
15.00%	1 year	1 year	2 years	2 years	2 years
17.50%	1 year	1 year	1 year	1 year	1 year

Source: ASISA Standard on Living Annuities 2010

How are we approaching it?

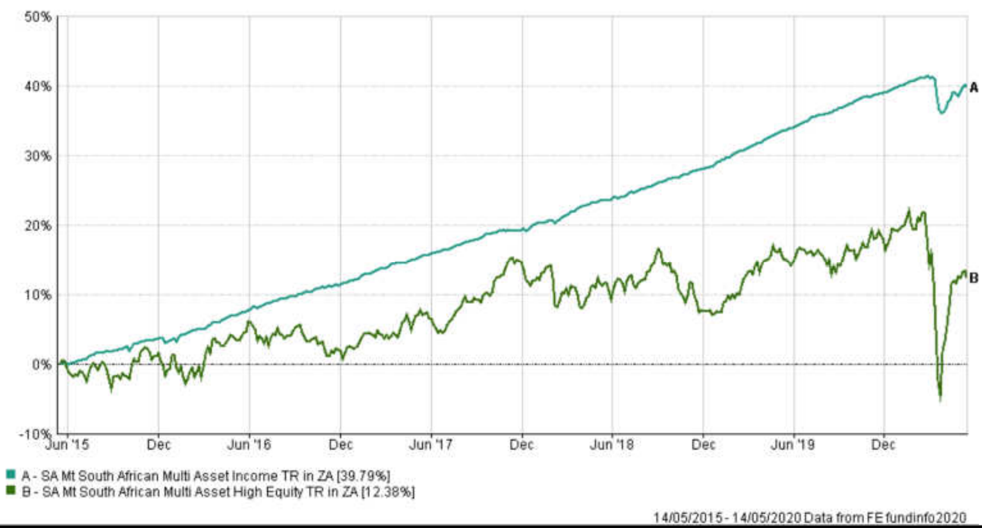
At FinPlanCo, we make use of what is known in the industry as a "bucket strategy".

Step 1: Create 3 buckets namely income, moderate growth and high growth.
Step 2: Allocate the investment to the different buckets according to the client's income requirements and risk profile.
Step 3: Rebalance the portfolio every time you have some meaningful upside on the moderate and high growth buckets in order to buy more income.

It sounds fairly simple but there is a lot of work and consideration that goes into each of those steps. In down markets or weak growth markets, the income bucket becomes of critical importance as this allocation effectively buys the investor time inside the market. If you have not rebalanced the portfolio recently then consider the amount of time you have left before the income bucket is depleted and then decide on whether to rebalance or not.

The income bucket functions as a capital preservation tool over a 3-month period and it gives the longer-term investments time in the market to move through the cycle and produce the desired return. The capital preservation part is important because you don't want to be selling investments that are down and could recover in the short term.

The last five to six years have been extremely difficult for Living Annuity clients no matter what the strategy. Cash or close to cash instruments were your best bet and even then you would have not reached your return goals. If you had a high equity balanced type strategy over this time (which most retired investors have), you had very little significant rebalancing opportunities.



Moving forward

Diversification by asset class and by fund manager strategy is important in any portfolio setup. Not all funds were hit equally and the weakening in the Rand offset most stock market losses. This means that your portfolio might have some holdings/funds/ETFs that went down very little or stayed flat and these are the investments you can look to sell first. The idea we get from the big asset managers in SA today is that they aren't scared of bringing some offshore exposure back to SA for two reasons: the Rand is very weak with a lot of the bad news already priced in and secondly, SA assets are more attractively on a relative basis.

We think that the last thing on any investors minds today should be a move to cash. Just because other assets classes have not performed well over the last few years does not mean that this weakness will continue. On the flipside, interest rates are so low that short term deposits are not remotely attractive relative to longer term debt or stocks.

Finally, investors should consider life annuities as part of their retirement strategy and consider passing the investment and longevity risk to the life insurer. Most product providers today offer life annuities inside their living annuities which we think makes a lot more sense and gives the client much better control.

Snapshot: South African Government Bonds During March and April, the South-African Government Bond yields increased markedly because of the elevated risk caused by the Covid-19 pandemic and other economic risk factors such as the downgrade to junk status. The SA government's risk profile has increased and this means that if the government would like to borrow funds, to fund their budget deficit or expenditure projects, it will have to do so by issuing bonds at a relatively high coupon rate to compensate investors for the increased credit risk. These high rates provided fund managers with a buying opportunity, but the window was limited.

When Brazil was cut to Junk in 2016 their bonds and currency reacted sharply up to the decision day, things improved thereafter. Brazilian bond yields went as high as 16% at the time (meaning bond prices fell) but thereafter they improved to around 7% at present (much better than SA). This because the country implemented fiscal discipline, curbed corruption and excessive spending. Similar results can be found in Greece and Portugal: first the rates blow out totally, then changes are put in place (perhaps not so much in Greece) and then lenders came back creating demand and improving bond prices.

However, other forces are at work in a low interest rate world. Money can flow towards high yields even if the risk is high. European investors have flocked to Greek bonds because they provide at least some return when bank deposits give zero. This is however somewhat counterintuitive. Greek bonds are risky but because demand is high, the yields on these bonds have come down a great deal (prices up, yields down). This may very well have bearing for RSA, if investors can buy cheap Rands and invest into our government bonds for double digit returns they will do so, even with the risk. There is simply nowhere else to go… which may partially explain the subsequent "quicker than expected" recovery in the sorter dated bond yields, illustrated in the graph above.

RECESSION OR DEPRESSION

Wilhelm Tempelhoff. Drawing parallels between The Great Depression and The Great Lockdown.

Depression Breadline sculpture in Washington DC by George Segal. The term "Breadline" literally refers to the poorest in society having to que for bread outside charitable institutions and soup kitchens during the Great Depression.

The media and market commentators are drawing parallels between the current market conditions and The Great Depression of the 1930's. While this makes for some captivating headlines, we thought it prudent to provide our clients with a more insight into this comparison. Is there compelling evidence to suggest that we are heading for a depression or has the world developed/learned enough to avoid it?

<u>Depression vs. Recession</u>

It's useful to consider the differences between a Recession and a Depression as a starting point. A recession is at its core a period during which economic growth is negative. In SA we define this as two consecutive quarters of negative GDP growth. Common indications include weak economic numbers, low trade and production, limited availability of credit, higher unemployment, lower company profits, etc. Recessions happen relatively often and while they can last years, they are usually shorter "cooling down" periods that form part of the business cycle.

A depression on the other hand is not as easy to pin down. It is broadly considered a long, drawn out period during which the economy grows negatively or very little for many years. Indicators are normally very low demand, large declines in production, high increases in unemployment, etc.

It is reasonably clear that we are in for a recession because economic growth will be negative for the foreseeable future, and the World was arguably due for a recession for a few years now. The question is whether this can turn into a long, drawn-out period and eventually become a depression?

With the IMF expecting global growth to contract by 6.3% (-5.2% by Fitch) this year, and the fact that both developed and developing economies are in a recession (not seen since the great depression), some comparisons to The Great Depression (GD) are valid.

History.com succinctly summarises the GD as "*…the worst economic downturn in the history of the industrialized world, lasting from 1929 to 1939. It began after the stock market crash of October 1929, which sent Wall Street into a panic and wiped out millions of investors. Over the next several years, consumer spending and investment dropped, causing steep declines in industrial output and employment as failing companies laid off workers. By 1933, when the Great Depression reached its lowest point, some 15 million Americans were unemployed and nearly half the country's banks had failed.*"

It certainly sounds like the expectations and headlines of today, i.e. "*Industrial output in March suffers largest drop since 1946*", "*US now has 22million unemployed*", "*The risk of a US double-dip depression is real*". Global growth is falling, consumer demand has fallen, unemployment has increased while trade and production have diminished greatly. Arguably the hallmarks of a depression. The main difference being that these economic hardships are being "self-imposed" and endured because of a global health crisis. Something we hope to be temporary in nature. The facts surrounding the GD were different, considering that the financial and business system itself caused the initial recession with subsequent structural issues and policy miss-steps leading to a prolonged depression.

In the roaring 1920's there was a sense of euphoria on Wall Street with the stock market having reached record highs by the end of the decade. These high stock prices were not supported by future earnings however and the US economy had already begun to slow. Yet the stock market moved ever higher until late 1929 when investors started dumping overpriced shares at an alarming rate.

The Fed and regulators at the time did not put a stop to risky lending practices linked to the stock market. Investors would aggressively borrow to buy shares. When the stock market started to drop in late 1929, the stitching started to unravel as loans or "margins" were being called in and further forced selling took place.

When the average American started losing faith in the banking system in the early 1930's, the illiquid banks could not pay out the depositors fast enough and over a thousand banks failed. Here the American policy makers did not initially step in to aid the banks and allowed them to fail, and by extension many average Americans lost their deposits/savings in the process. Only with Roosevelt's election in 1933 did banking legislation change, although the US treasury (on the gold standard at the time) could not provide any support (they had trouble paying their own government workers). Roosevelt's reforms were not all good however and one piece of legislation outlawed the private ownership of gold, forcing Americans to convert their gold to paper money equivalents at the time. The US needed gold to back their currency, more gold meant more money could be created.

Arguably the recession changed to a depression when the banks start to fail. Without banks, business (companies, farms, stores, etc.) could not function normally, and the financial system fell over. This led to extreme unemployment and poverty. It took many years for some semblance of normality to return and America's involvement in the Second World War eventually helped expand industry and reduce unemployment.

One cannot speculate what would have happened if the banks were thrown a lifeline in the 1930's but it would have certainly avoided much hardship for the average person at the time. Therefore, governments and central banks are currently supporting the banks and large corporates in a bid to protect the man on the street from a similar outcome. The governments of the world do not have to contend with the gold standard anymore, they can borrow or 'print' money to support banks and businesses to protect the average Joe. This has its own set of problems however (inflation, hyper indebtedness, currency issues, etc.)

With the "Great Lockdown" being considered a health-crisis, the policy makers cannot use the normal avenues of economic support, i.e. to stimulate spending. The current stimulus packages are therefore aimed at supporting corporates, banks and the financial system itself. Policy makers have reacted very quickly to shore-up the financial system and the banks to avoid a GD situation. They are acting as a lender of last resort, which they could/would not do in the 1930's.

The global recession may have a similar initial magnitude (global growth falling off a proverbial cliff) to the GD but the structural and policy issues differ greatly. The 1930's had long-lasting problems and mistakes. A similar outcome can only be avoided if the same miss-steps are not made and the Lockdown/Covid-19 does not persist significantly longer than expected.

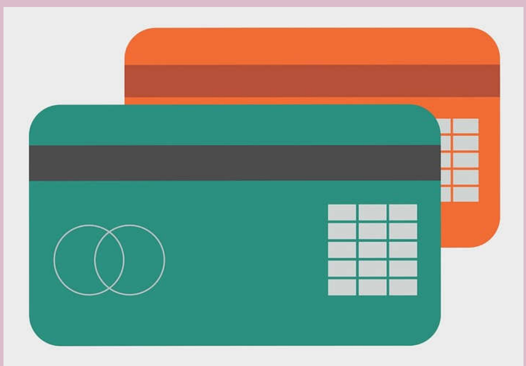
It is true that the global economy was showing signs of slowing down but it was not yet in a recession. The Corona virus is seen as an external impact, lowering growth in the world, and putting pressure on asset prices and company profitability temporarily by most expectations. The economic situation during the GD was more permanent in nature and needed cyclical recovery after major permanent job and company losses. Yet similarities do exist insofar permanent job and company losses may very well occur on a large scale in the near future unless businesses are supported so that they can in turn support employees.

The IMF recently published their updated World Economic Outlook in which they explain their base case scenario/expectations for economic growth for the next few years. They assume that headway will be made against the virus and its impact in the latter half of 2020. They believe that the policy response from governments around the World will prevent an outcome like that of The Great Depression by curbing job losses, limiting the strain on the financial system and avoiding widespread company bankruptcies. Their expectation is that World growth will strongly rebound in 2021 although they see growth remaining below their initial expectations from before the virus because of losses in global GDP.

Will a depression develop out of the current recession?

This is not an easy question to answer with so many variables in play, but the short answer is that it is too early to tell. To avoid a depression the world must effectively overcome Covid-19 and its economic impact. Business, and the financial system on which it relies, must be supported and maintained. Throughout all this however the danger to human lives must be the core consideration. Governments and Policy makers must consider the trade-off between the livelihood and the lives of their people.

We believe that the technology, infrastructure and communication systems of the modern world will be our edge to avoid a depression, allowing the world to push through a recession and settle into the "new normal".



Snapshot: Global Debt In January, the global debt was estimated at $253Trillion (that is $253 000 000 000 000.00) and with the current interventions global debt will increase. This includes household, company and government debt and it represents a debt to GDP ratio of 322% for the globe. The world therefore needs a strong recovery for income/tax revenue to support the additional debt servicing and repayments.

A partial saving grace would be that current interest rates are very low, although this may be temporary. The developed World is better equipped to deal with this debt while the rest of the world may eventually need to request some form of debt relief or restructuring. Investors and savers could be negatively affected in such a scenario. This is perhaps a topic for another day but sufficed to say the increase in debt is not ideal, the alternative is however initially much worse. We may be leveraging our future to pay for our present.

FINANCIAL FAQ

"Unfortunately, the pandemic is like a War in that the end date is undeterminable." – ***Recent client comment***

Is my Retirement Annuity protected against creditors?

This is a very astute question. Retirement annuities are aimed at providing you with an income in retirement and to protect this aim, The Pension Funds Act (section 37) specifically protects your retirement fund savings from being attached by creditors. There are some exceptions however such as Divorce and Maintenance claims.

Do I need to pay tax on a donation that I received?

Donations tax is payable by the donor but if the donor does not pay the applicable tax within the allowable timeframe, the donor and donee become jointly and severally liable. This means that SARS may request payment of the tax from either party or both parties, only when the full donations tax is paid will SARS be satisfied.

Remember that certain donations by natural persons are exempt from donations tax, such as donations between spouses, donations to an approved public benefit organisation, total donations of less than R100 000 for the year, bone fide maintenance payments, etc.

How is a tax-free savings account handled when I die?

Tax-free savings or investments accounts are generally considered to fall inside your estate for both estate duty and executor's fees calculations. These accounts are free of all major taxes, but their value is included when calculating estate duty.

Some of these accounts however allow you to nominate a beneficiary or beneficiaries which means that the value of the account is paid directly to your beneficiaries at death. This avoids executor's fees but does not avoid any estate duty consequences. If you cannot, or do not, nominate beneficiaries the value of the account will be paid out to your estate and handled according to the provisions of your Will.

How does one buy physical gold?

Most investors invest in gold by using exchange traded funds or notes (ETFs or ETNs) which provide paper-based alternatives to physical gold. It also allows for smaller holdings, no need to store/insure the gold and ease of transactability. If, however one does not entirely trust the financial system or when one is concerned about a warlike state in the world, there is no substitute for physical gold.

Gold is mostly bought in bullion form or in coin form. When buying gold, one generally pays VAT on the commodity in bar format. This is not true of Krugerrands because they are considered legal tender in RSA and thus not subject to VAT. Consider buying bullion Krugerrands and not the proof version, which sells at a large mark-up. All you really want is the gold although even bullion Krugerrands have a margin when buying and selling them (as much as 5% depending on the dealer). A list of the local Krugerrand dealers can be found on Rand Refinery's website http://www.randrefinery.com/