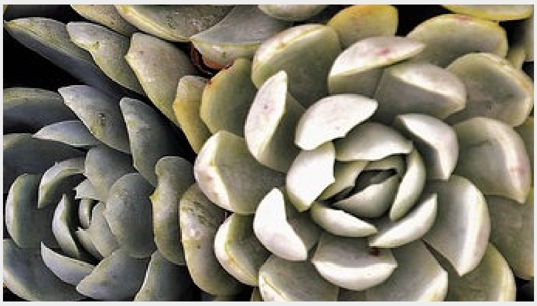
FinPlanCo

NEWSLETTER H2 Oct 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 DON'T LET A CRISIS GO TO WASTE

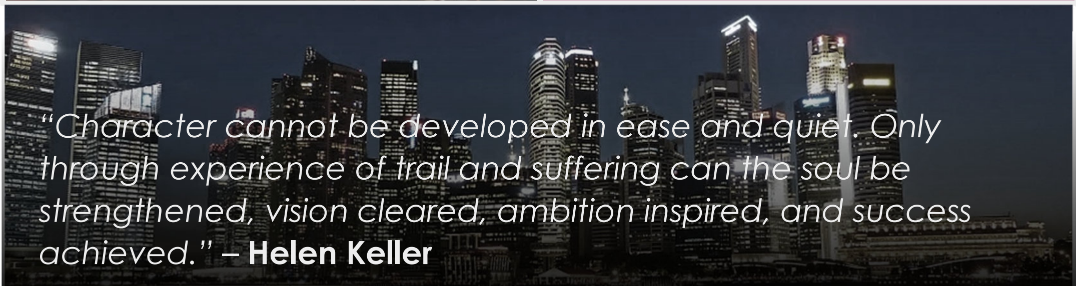
The current economic & investment environment may provide some interesting opportunities for asset managers to consider.

3 PRESCRIBED ASSETS

How concerned should we be that the government considers compelling private pensions & retirement savers to fund SOEs, infrastructure projects and spending?

4 EDUCATION SAVINGS

A short discussion on educational savings and how tax-free investments can add value here. Followed by our **FINANCIAL PLANNING FAQ.**



"Character cannot be developed in ease and quiet. Only through experience of trail and suffering can the soul be strengthened, vision cleared, ambition inspired, and success achieved." – **Helen Keller**

INTRODUCTION

As with the first half of 2020, a lot has changed while many things remained the same.

Economic conditions have deteriorated and sweeping changes took place to the way society functions and interacts.

As we head into the US elections uncertainty again rears its head from a Political, and Geo-political, front and the question is whether Trump will be able to hold on for another term. A term during which most Presidents act more radically because there is no chance for a third term in any case. Alternatively, the current front runner Joe Biden and his Democrats have their turn at the wheel leading to political stability and further economic stimulus, but at a cost of increased tax in the US.

Closer to home we have started to see the corruption enquiries bear fruit and summons being laid while arrests are being made. Yet, we still hear of ten of millions being embezzled from money earmarked for Covid relief.

Continued on the next page…

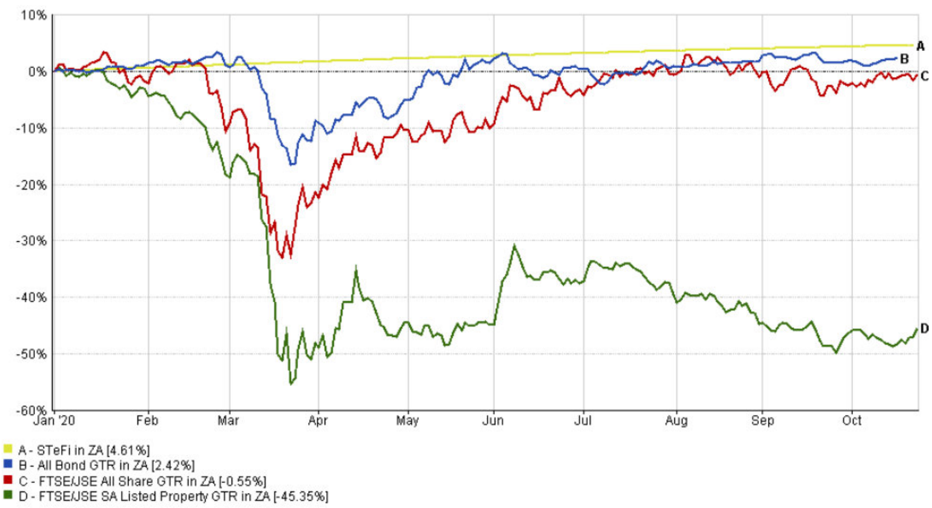
ENVIRONMENT UPDATE

"While we recover from COVID, it is necessary to ensure that we 'Build Back Better' and enhance the resilience of our economies and societies to future disruptions caused by environmental degradation and change." – Shoko Noda, UNDP.

Brexit is still an ongoing issue with the UK set to leave the EU at the end of 2020. Trade talks between the two parties are set to continue towards the end of the year but Covid has delayed much of the decisions and discussions. The concerns around a second wave of Covid-19 infections remains at the top of discussions in many countries. France and Germany are already back in preliminary lockdown after their fears became a reality. Finding a vaccine for the virus is still a hot topic and hopefully the world will see an affordable drug early next year. That will certainly go a long way to calm the markets and improve business confidence.

The Rand strengthened significantly from the weakest levels earlier in the year but remains weak because of the general uncertainty in emerging markets and ultimately because of the RSA centric risks. Our medium-term budget turned out as expected, the numbers are scary, and the government debt levels are increasing at a rate ahead of most emerging markets. More plans were made to curb spending while the reality set in: If the Government pays so much away to servicing its debts, what is left to stimulate growth and support the people and the economy? More debt seems untenable, so the question becomes how the budget shortfall is funded from here? We certainly would not like Minister Mboweni's job, and we would hate to see him go, especially considering the 5-year plan and the effort needed to see it through.

In our previous newsletter we used the same market constituents and graph below (1 Jan 2020 to end May 2020). At that stage only cash (STeFI index) was positive. Looking to the end of October 2020 we still have cash as the best performer while bonds turned positive and the All Share index is near breakeven. Property shares are up since May 2020 but only slightly as the uncertainty in the sector remains.



The investment environment post Covid is very different to what we've seen over the last 10 years. One of the biggest changes is the interest rate environment. On the short end of the yield curve, i.e. 7 to 32-day bank deposits or a money market investment, the rates are now between 2.5% and 4.6% p.a. On the longer end of the yield curve one can consider a government bond with a maturity of 10+ years and receive more than 10% (you need to hold it until maturity). The yield gap between the short end and the longer end is clearly stretched.

Real Estate in SA is still struggling but this is a worldwide trend with most real estate businesses under pressure. Globally not all parts of the stock market performed well. Global tech and select large consumer staples have done well. The "value" part (historically cheap) of global equity markets continued to struggle.

DON’T LET A GOOD CRISIS GO TO WASTE

***Carel Marx**“It is a time of extraordinary opportunity but only if you have the right mindset. Fear of the future breeds inaction and leads to strategic paralysis. We put off decisions until we can have certainty. We look for signals. We wait. And while we do that the world moves on around us.” – Bruce Whitfield*

The Covid-19 crash was short, sharp and devasting for almost all asset classes. Some asset prices recovered as quickly while others left most investors licking their wounds and no room to manoeuvre. In some cases, e.g. South Africa and other emerging markets, many assets were exposed as being venerable and they have yet to recover (or fall over). For patient investors, these assets may offer opportunity, but it is contingent on the return of growth and an economic recovery over the medium term.

South African Specific Shares & Listed Property – total performance 12 months

Does the mid-cap, small-cap and SA Listed Property sector still represent a buying opportunity at these depressed levels? If we look back at the 5 years leading up to the Covid-19 crisis, the performance of these sectors was similarly poor. Weak performance on a graph normally means low prices but often for good reason. Without going into too much detail, these prices are low because of the increased risks in South Africa and its viability as a business destination; the environment in which businesses operate has deteriorated with low economic growth, low confidence and a weak consumer. For a price recovery to take place we need renewed hope for economic growth.

Most investors locally and offshore are giving South Africa very little chance of recovery and the net capital flow into our market has been negative. More investors are leaving vs. those coming in.

In our view the chance of economic recovery is not zero. There are points of light that are worth mentioning:

- We have seen numerous politicians and businesspeople being arrested over the last few months with more likely to follow.
- The Asset Forfeiture Unit is taking back assets from corrupt activities, this means the state is getting back some of its money it wrote off completely.
- The president and the rest of the country is taking a firm stance against corruption and measures are being put in place to prevent it from happening again. An example is the new enhanced tender process.
- SA and Eskom will be buying power from independent power producers. This can solve our power problems and boost economic activity.
- Land distribution has started to take place and the ANC Government has not taken land without compensation; they are distributing government owned unproductive land in the hopes of converting it into productive space.
- Our resource and mining companies are doing well and with increased demand from countries like China a resulting increase in tax revenue is highly likely.

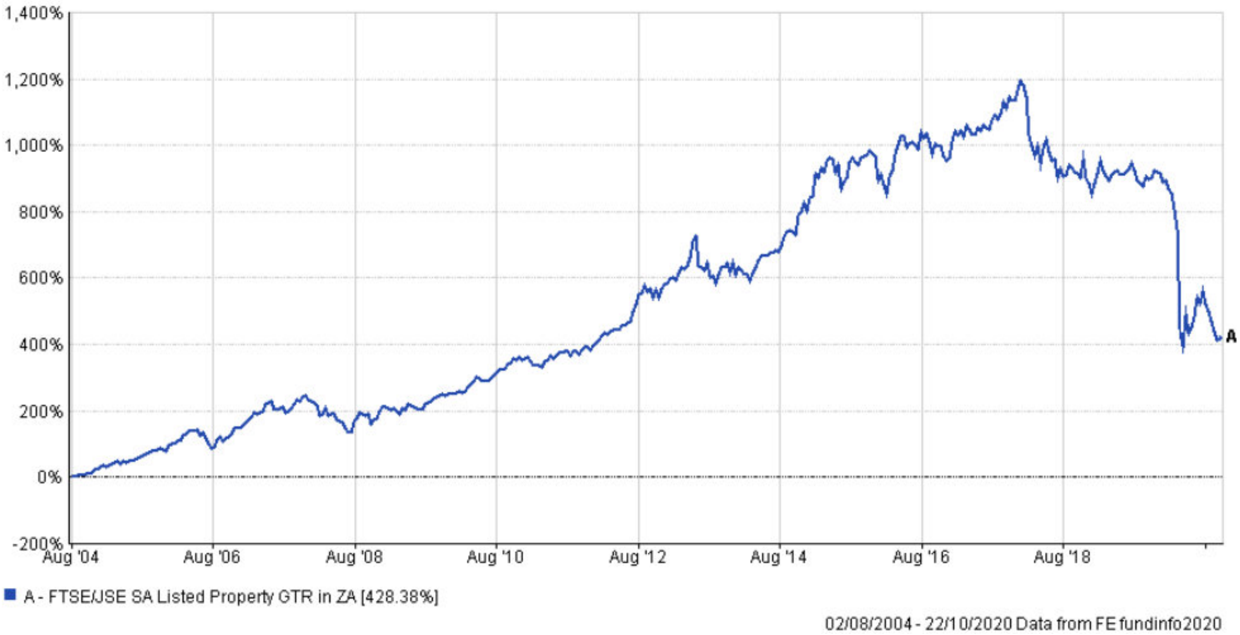
There are various positives happening and it might just be the start of a turnaround in SA. The road to economic recovery will be a long one but not impossible. The key is perception and the return of "hope". The economy does not have to grow by 5% for the market to go up. Asset Prices will improve with the first indications of future growth improvements. The parts of the market that were hit the hardest, i.e. SA centric stocks and property, will offer the biggest opportunity in a normalising economy.

Direct Property and listed Property

We are firm believers that a good retirement plan includes rental property of some nature. The residential property market is offering long term investors an opportunity to buy at a good price. Interest rates are very low and that it makes the repayment more affordable.

If one earns a rental income yield above normal money market rates and closer to the 10-year bond yield, it would be a good outcome for investors. In percentage terms it means between 5% and 9% per annum. Each property should be evaluated on its own merits but an after cost rental income of between R4 160 and R7 500 per month provides a lucrative investment on a R1mil property.

A recovery in the SA economy would likely improve residential rental demand and prices move up again. When it comes to office and retail space, structural changes likely took place, and the outcome could be less attractive.



Listed property used to be the darling of the SA investment world but over the last 3 years it has lost almost 60% of its value. Is a 60% devaluation a fair reflection of the change in the property market? Is the current property yield on offer (in many cases north of 10% per annum) in line with the rest of the market? Property is an asset class can provide diversification benefits to investment portfolios and financial plans can benefit from its inclusion. If you were thinking of adding a rental property to the mix, now may be a good time. The asset/fund managers are re-evaluating their property holdings as well.

Government Bonds

This is by far the most popular asset class in SA today among asset managers. Most managers in SA bought a significant amount of Bonds in March and April 2020 when yields spiked after the Covid-19 crash. A 10-year SA government bond today, yields 9.5% p.a. This means if you buy it now and hold it until maturity, you will earn 9.5% per annum form that investment. To put this into perspective, the official inflation rate is closer to 3%, which makes your real return near 6-7% per annum. This is one of the most attractive real yields in the world.

Naturally there is risk involved here: Inflation could pick up again and go to 7% or 8%. The Rand may weaken significantly against all other major currencies. The SA government may struggle to return your capital at the end of the term or stop paying the coupon. For a Rand investor these risks are more muted, but one can see why foreigners have been net sellers.

Direct holdings in short term government bonds can be attractive while the longer-term bonds provide strong returns but more uncertainty. The asset managers are likely to hold onto their RSA bond holdings until an alternative presents itself or until the risks raise to imprudent levels.

In closing

Its best to trust an asset manager to make the appropriate calls regarding asset-, sector- and share-allocations on your behalf. Not all fund managers will agree that SA-centric shares offer value just as many will disagree that listed property offers good value on a risk adjusted basis.

At FinPlanCo we believe in, and focus on, diversification by asset manager as well as fund strategy. It is impossible to know which of the above asset opportunities will pay off and which will be a value trap. We endeavour to identify the fund managers that we believe will prudently make the most of these opportunities to the extent that the fund manager is comfortable with the risk adjusted potential. We would like our clients to have a consistent above average outcome over time, in the quest of reaching their goals and maintaining their financial plans.

We invite our clients to share any residential property purchasing plans they may have, and we would be happy to help evaluate investment opportunities with them in this regard.

PRESCRIBED ASSETS

Wilhelm Tempelhoff. Is this an exaggerated threat or a way for Government to access our hard-earned retirement savings?

Recently the threat of prescribed assets has reared its ugly head again as the financial industry asks itself: Where will the government find funding for the Fiscal Deficit and expansionary initiatives? It is an easy target for fearmongering because the argument for its inevitability seems logical. Yet the ANC has stopped banging this drum loudly and even gone so far as to veer away from their initial comments made in 2019. The question is therefore: how concerned should retirement savers be?

Perhaps its first important to clear up the terminology. The term "Prescribed assets" refers to the practice of a government compelling the retirement savings industry to use investors' savings to purchase government-backed assets like shares and bonds. These assets are normally issued by the Government to fund infrastructure, by SOEs to obtain finance or directly through infrastructure projects. In the ANC's election manifesto of 2019, a proposal was made to "*investigate the introduction of prescribed assets on financial institution funds within a regulatory framework for socially productive investments…*".

This is not a new concept with the Apartheid Government instituting prescribed assets at various levels from the late 1950's to the late 1980's. In 1988 the Jacobs Committee recommended ending the practice because of the negative implications to investors' outcomes. Investors received lower returns to the tune of 2.9% lower during the 1980's and 8.6% lower in the 1970's.

The potential damage to the retirement savings and greater financial industry is clear and it seems logical to believe that Government needs to find funding and can easily target the retirement savings pool. For this reason, it has become a political hot topic with the media and political parties using the treat and dangers thereof to generate support.

More recently however Enoch Godongwana, the ANC economics chief, explained that the party does not intend using prescribed assets as a policy tool but rather wishes to create the environment where trustees of pension funds can invest into profitable infrastructural projects. Note the use of "can" and not "must". Similarly, there was no mention of prescribed assets in the ANC's recent discussion document on Economic Recovery.

This speaks more towards an expansion of Regulation 28 compared to a compelled investment. South-Africans already live under a form of prescribed assets where we must invest 70% of our pensions locally (60% SA and 10% Africa ex-SA) and only 30% offshore. This according to regulation 28 of the Pension Funds Act. Our foreign allowance was even increased in 2018 from 25% to 30%.

Indications are that Regulation 28 will be amended to include a separate or wider category, to allow retirement funds to invest in infrastructure projects directly. It seems the argument has shifted to including a wider range of instruments that can be considered by pension fund trustees for their investment portfolios. Regulation 28 institutes maximum allocations for a pension fund portfolio into certain assets but does not impose minimums at this stage.

It is important to note that retirement funds have a board of trustees that manage the fund and its underlying asset allocation. These trustees work within the limits that legislation provides to ensure that the assets and investments are managed to the best benefit of the fund members.

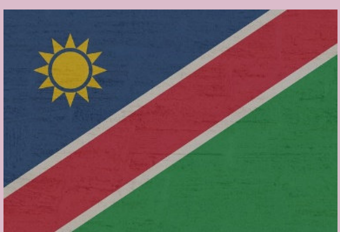
Therefore, if government projects are commercially viable and offer compelling investment alternatives for trustees to explore on behalf of retirement savers, they will invest. It is as simple as that. In the recent past there have been many successes in this regard, such as SA's renewable energy program which garnered more than R200bil from the private and pension fund sectors that funded over 100 projects and provided the investors with good returns.

We need to bear in mind that prescribed assets will also affect the Government Employees Pension fund which holds roughly half of the assets that could be influenced by it. This is also a defined benefit fund, so it needs to be managed well to ensure its longevity and to prevent state pensions from running out.

The Association for Savings and Investment South Africa's chief executive, Leon Campher, said that although ASISA members were opposed to prescription, they do not believe that there is an imminent threat of this happening. Politicians unfortunately also have a point when saying that if all else fails, prescribed assets will be the outcome.

While there is always a chance of the government going down this road to find finance, they do however need to consider the implications on a wider field. The dangers and drawbacks are very real, whether such dangerous action is already a given seems unlikely. In our opinion, the Government will firstly try to create attractive projects to raise funding by way of economic logic before it forces the issue. While this might sound like a dubious endeavour by Government, they have shown in the past that profitable projects are possible, and that finance is readily available in this regard.

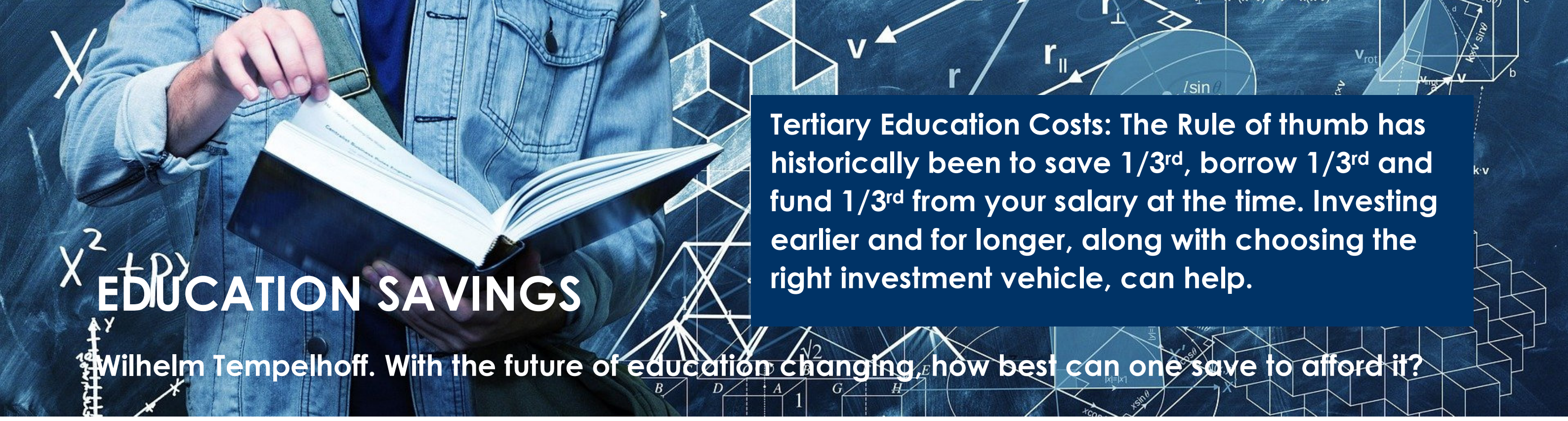
A change like prescribed assets will take time to implement and move through the normal legal processes. It is not something that is instated casually and not without substantial consultation and a robust review and discussion process. During this time, the financial industry at large will continue to weigh in and represent the interests of retirement savers. We continue to monitor the developments in this regard and will naturally assist our clients in any way to plan around the likely outcomes.



Snapshot: A cautionary tale. Namibia's pension fund act is very comparable to our own and similarly they share a budget deficit (albeit one that is much harder to finance). Credit-rating wise they are two notches below investment grade. Their fiscal situation deteriorated recently to a point where they amended legislation to ensure that retirement assets were brought back into Namibia.

They did this by changing their equivalent of Regulation 28. In 2017 the legislation required 25% of Namibian pensions to be invested locally, that number is now 45%. As a result, they are experiencing valuation inconsistencies in their financial markets. The increased requirement for pension fund managers to invest in local Namibian assets led to a bloating of returns on their government bonds as managers struggled to find attractive stocks locally and defaulted to bonds.

With the stroke of a pen they created demand for Namibian bonds and found much needed funding to the detriment of normal functioning financial markets and lenders alike. RSA does not have much room in this regard, but we do have a much larger pension fund pool, close to R6trillion vs. the N$168Billion of our neighbour.



EDUCATION SAVINGS

Tertiary Education Costs: The Rule of thumb has historically been to save $1/3^{rd}$, borrow $1/3^{rd}$ and fund $1/3^{rd}$ from your salary at the time. Investing earlier and for longer, along with choosing the right investment vehicle, can help.

Wilhelm Tempelhoff. With the future of education changing, how best can one save to afford it?

Could your education savings be tax-free?

We have recently been involved with many families that sought to start investing towards their children's education costs. Especially their Tertiary, and even Secondary, education. Education inflation (7.3% in 2020) is higher than normal consumer price inflation (+/-4%) and not far off the high levels of medical aid inflation in SA. This means that those seeking to save effectively for future education costs must consider using investments that are aimed at beating official inflation by a moderate to high degree. This to at least preserve the purchasing power of their education savings over time. Consider also that the trend of online learning has opened the whole world to students, with fees paid in a foreign currency as a result.

Conventionally parents made use of two educational savings methods:

1. Education savings accounts with the bank, and
2. Education policies with insurers.

They both have their own unique set of benefits and drawbacks. Savings accounts offer stable returns and very low costs, but they seldom provide returns well ahead of inflation. Education policies offer better long-term returns, but their fees are high and internal taxes can stymie returns even over the long term.

Traditionally education policies are based on endowment structures (term policies) because they are long term contracted vehicles that internally "take care" of the tax on the investment return. They offer fixed premiums and get you to commit to a specified term for saving, which can sometimes be a good thing. The more cynical observer would also add that a contract term allows for commission to be earned by the broker. The internal tax paid by these policies amounts to 30% on any interest or income, 20% on dividends (same as individuals) and 12% on capital gains/growth. For the wealthy this may be a bargain but for most parents these numbers are high and other investments offer lower taxes on returns when investing in their individual names (as opposed to via a policy).

Financial Planners and investors have therefore been exploring other vehicles such as direct unit trusts to lower costs and aim for strong returns ahead of inflation. While this approach is already much better than polices and bank accounts, they do kick up tax from dividends, income, and capital gains.

Enter the humble tax-free investment account. These accounts seem ideal for education savings although they can be used for many other goals. Think of a tax-free account as a shell that can be filled with a range of underlying investments to fit the need or objective of the investor. Need a place to invest long term? Would you like to build up additional retirement savings? Do you need to start investing offshore? Would you like to invest for your child's education? All these needs can be met with a tax-free account.

These accounts seem ideal for education savings because:

- They have zero investment limitations other than only using fixed-fee investments therein,

- They have zero tax, not even on dividends which is normally a flat 20% withholding tax for everyone,
- They have no contract period and no term,
- They have no withdrawal costs or limitations,
- They can cater for all risk profiles and a wide range of objectives,
- Some even allow for beneficiaries to be listed and fall outside your estate for executors' fees and the admin around the winding up of the estate.

Currently the legislation, of Section 12T of the Income Tax Act, allows one to invest R36 000 per annum into a tax-free account or a combination of accounts as long as you don't add more than R36 000 per person per annum. The lifetime limit is R500 000 in total contributions.

Tax-free savings can be as "sticky" as endowments because investors think twice before withdrawing from them. Taking a withdrawal is allowed and normally has no cost or penalties involved but it does mean that the amount remaining of your R500 000 limit remains unchanged.

As a parent of a minor you can create a tax-free account in either your own name using your own annual and lifetime limit OR you could open it in your child's name using their limits. The main consideration is that you may use up your child's lifetime limits on his/her behalf if the account is opened in their own name. Also consider that a minor will be able to handle his own account from age 18 whereas an account in your name will remain in your control past this point.

It is also useful to note that normally when a parent invests in a child's name, the returns of the investment are that of the parent for tax purposes according to Section 7 of the Income Tax Act. Which is why endowments were attractive in the past. Tax-free accounts eliminate this problem altogether.

Importantly there are other considerations, and more improved options, where grandparents save for their grandchildren's education. Here the investment can be in the grandchild's own name, under the parent's care, with tax accruing to the grandchild (who likely earns no other income). This does however fall outside the scope of this article, questions are welcome.

Our favourite tax-free providers at present are Nedgroup, Allan Gray and some selected direct offerings from life- and asset management companies.

Snapshot: Are Endowment Policies unseful? Indeed they are when used correctly and for the right reasons. Endowments are mainly used to wrap investments inside a life policy or add an insurance component to an investment.

This is done for several reasons which include: to obtain more beneficial tax rates, to avoid the administration delay of an estate, to avoid executors fees in an estate, to invest for a set period of time, to include certain insurance benefits, to emilinate the need for complex tax reporting and to enable the listing of beneficiaries on an investment.

Technically the investments inside the endowment are held on a life insurer's balance sheet and they are then taxed in the hands of the insurer according to the nature of the policy owner. For individuals and trusts this means a flat income tax rate of 30%, capital gains tax of 12% and the normal 20% withholding tax on dividends. The investor becomes the policy owner but not necessarily the beneficiary of the policy. These policies are therefore usefull for estate- and tax-planning.

FINANCIAL FAQ

*"It's best to sit tight. An investment is like a bar of soap, every time you touch it, it gets a little smaller." – **Recent client comment***

Our family trust has earned a lot of interest this year, is there some way to lessen the tax burden?

The short answer is yes. It does however depend on the nature and wording of the trust deed. Generally speaking trusts allow for the use of the "Conduit Principal" which allows the earnings of a trust to flow through to the beneficiaries thereof while preserving the nature of the earnings, i.e. whether it is income, dividends, capital gains or rental for example. The trustees could therefore decide to distribute the interest of the trust, to the various beneficiaries of the trust, and have them declare it in their own income tax returns as interest earned. This distribution must however be done during the same tax year that the interest is earned. The tax therefore does not have to pay the tax, because the beneficiaries do so in their private capacity. There are some pitfalls to be aware of such as the deeming provisions under Section 7 of the Income Tax Act and general anti-avoidance rules.

Do I pay tax on the returns inside my retirement investment?

No, you do not. Retirement based investments such as retirement annuities, pension funds, preservation funds and living annuities, pay no tax on the returns inside the policy. The compounding therefore remains high because nothing is sacrificed to tax withing the investment. Bear in mind that once you retire from these investments and/or start drawing an income, tax will come into play again by taxing the lump sum you elect and taxing your income taken. Importantly this has not always been the case: in the late 90's and early 2000's the rental and interest income of retirement funds was taxable (at low rates but still taxable). National Treasury may consider again imposing tax on certain income types earned in a retirement fund, to bring in easy tax revenue.

Who should I appoint as the executor of my estate?

A question we are asked often. Generally, you should appoint a professional or a person who is knowledgeable in the legal and financial details involved with winding up an estate. That said, we don't always know of a trustworthy individual to fit this bill and most people would like to appoint someone who they know will have their best interests at heart. One can also consider listing a trusted friend or family member as the executor and provide them with the ability to seek the assistance of a professional that they trust to help them with the decisions and administration burden when the time comes. We often see joint executor nominations where a family member (such as a spouse) is nominated along with a more knowledgeable person to get the best of both worlds. Nominations are however not binding, and the nominated person can turn down the responsibility should they feel uncomfortable with the responsibility.

What is the base cost value of a Krugerrand for Capital Gains Tax purposes?

Krugerrands are specifically excluded from being personal use assets and when selling a KR, one needs to pay tax on the proceeds. Generally speaking, capital gains tax is payable if the coin was held for longer than three years and income tax is payable if the coin was bought for speculation. For investors who had the coins in their possession before 1 October 2001, their valuation date value (base cost) would be R2750 according to SARS. For investors who bought the coins after the introduction of capital gains tax in 2001, the base value is the purchase price in Rand.