FinPlanCo

NEWSLETTER H2 Nov 2022

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The current financial environment is dynamic. We provide a short update relating to markets, regulations, and the financial planning milieu.

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With Treasury's new Two-Pot retirement savings suggestions making headlines, we summarise what we know so far.

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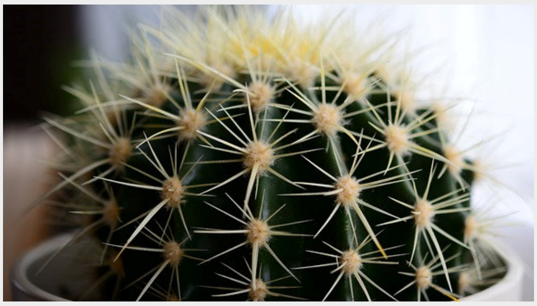
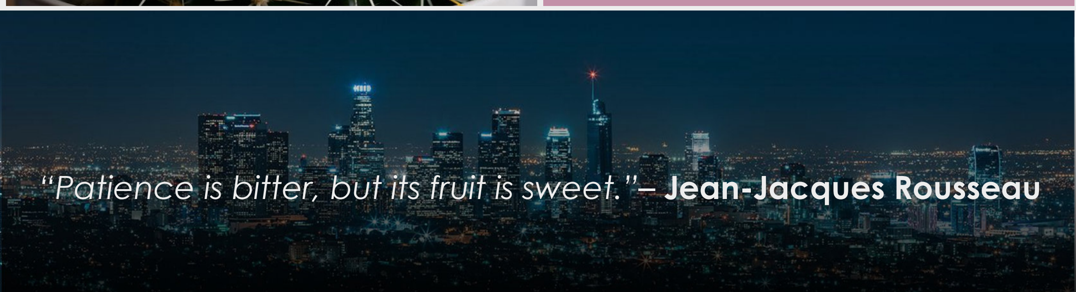


4 RISK/REWARD PAY-OFF

We ask whether the risk/reward pay-off still in place after some thin investment years. Followed by our **FINANCIAL PLANNING FAQ.**



"Patience is bitter, but its fruit is sweet." – **Jean-Jacques Rousseau**

INTRODUCTION

It is not easy writing about the financial environment when the current atmosphere is feeling a little depressing to say the least.

We can again mention the risk of a worldwide recession in 2023 for various reasons such as higher interest rates to fight inflation, a global energy crisis, and a potential world war, but we think most people have read or heard something along these lines. South African residents have also dealt with intermittent electricity, corruption cases, strikes, a taste of unstable coalition politics, poor or no service delivery from the state, poor economic conditions for business and most recently a water crisis.

In our quarterly statements we wrote *"There will always be problems and uncertainties and it is therefore hard to find the motivation to invest. It is human nature to be nervous when uncertainty is high, but it is often during these periods that value can be found. We hold fast to the concept that when the risks are high, asset prices are low"*.

Continued on the next page…

FINANCIAL ENVIRONMENT UPDATE

Carel Marx. Global investors grew accustomed to low interest rates and economic stimulus. A return to normality feels abnormal.

It is therefore important to note that risks or problems tend to come and go and something like high global inflation is likely to improve drastically in 2023. The energy crisis will also end at some stage as new production comes online (both in SA and globally) and you can expect that the Russia Ukraine war will end (let's hope not in nuclear war).

It is however extremely difficult to see light at the end of the tunnel while you are in the thick of things. Global equity prices are down and price metrics like PE (price/earnings ratio) ratios are looking more reasonable and, in some areas, very cheap in fact. Let's have a look at some performance numbers on actual investments (especially referring to indexes to mid-October 2022):

Investment Name	1m	3m	6m	1yr	Ann. 3yr	Ann. 5yr	Ann. 10yr
ARK Autonomous Technology & Robotics ETF in US	-16,43%	-17,71%	-33,99%	-48,07%	8,77%	5,15%	
ARK Innovation ETF in US	-20,23%	-23,00%	-42,33%	-70,62%	-7,45%	-0,37%	
iShares Global Technology ETF TR in US	-9,27%	-12,14%	-21,83%	-28,66%	11,26%	12,43%	15,15%
iShares Healthcare Innovation UCITS ETF USD in US	-5,25%	-8,46%	-16,70%	-31,38%	4,60%	3,16%	
Index: Nasdaq 100 GTR in US	-9,81%	-10,58%	-22,70%	-28,85%	11,32%	12,83%	15,71%
Index: Nikkei 225 in US	-6,66%	-6,87%	-16,34%	-29,36%	-4,49%	-1,07%	4,87%
Index: S&P 500 TR in US	-7,42%	-6,97%	-17,95%	-18,99%	7,34%	8,30%	10,89%
Vanguard FTSE 100 UCITS ETF Acc GBP in US	-6,57%	-8,00%	-20,80%	-19,67%	-2,47%		
Vanguard FTSE Developed Asia Pacific ex Japan UCITS ETF Acc USD in US	-7,65%	-8,48%	-22,60%	-24,72%	-1,12%		
Vanguard FTSE Developed Europe ex UK UCITS ETF Acc EUR in US	-6,79%	-8,31%	-21,87%	-30,14%	-1,96%		
Vanguard FTSE Emerging Markets TR in US	-8,86%	-9,63%	-19,82%	-28,42%	-2,21%	-1,82%	1,05%
Vanguard FTSE Emerging Markets UCITS ETF Acc USD in US	-8,09%	-8,67%	-19,77%	-28,17%	-2,66%		
Vanguard Long Term Bond TR in US	-7,68%	-13,08%	-16,27%	-29,78%	-7,76%	-1,91%	1,10%
Vanguard Mid Cap Value TR in US	-7,52%	-5,53%	-16,96%	-13,82%	5,37%	5,19%	9,94%
Vanguard Russell 1000 Value TR in US	-6,26%	-4,97%	-15,62%	-13,52%	4,19%	4,43%	7,86%
Vanguard Total World Bond ETF TR in US	-3,69%	-6,22%	-7,86%	-14,86%	-4,01%		
Vanguard USD Emerging Markets Government Bond UCITS ETF Acc USD in US	-5,56%	-3,88%	-11,88%	-21,35%	-5,92%		

We've highlighted some of the one-year performance numbers. The ARK Innovation ETF (exchange traded fund) which is an actively managed ETF that invests in disruptive innovation businesses. This was a massive theme in 2020. If you invested in the ARK Innovation ETF on the 17th of March 2020 and you kept it until 10 Feb 2021, you would have been up 300% in USD over this period. Bitcoin over this same period went from $5031 a coin to $44 870. That is up 790%! Fast forward to today, you have wiped out all your returns in the ARK Innovation ETF over the last 5 years and your gains in Bitcoin are reduced to 290% (still great however).

European stocks depicted by the Vanguard Developed Europe Ex UK ETF are down 30% in USD over 12 months and down 2% per annum over the last 3 years. Europe has more problems to deal with compared to the US and possibly a lot of other places in the world. A quick recovery is maybe less likely as opposed to the US or China.

Global bonds have taken the worst beating in decades after having one of the longest bull runs in history. Depending on the choice of bond or combination of bonds investors dropped between 20% and 30% over the last year. The Vanguard Long Term Bond ETF showing a mere 1% per annum now for investors staying invested over the last 10 years.

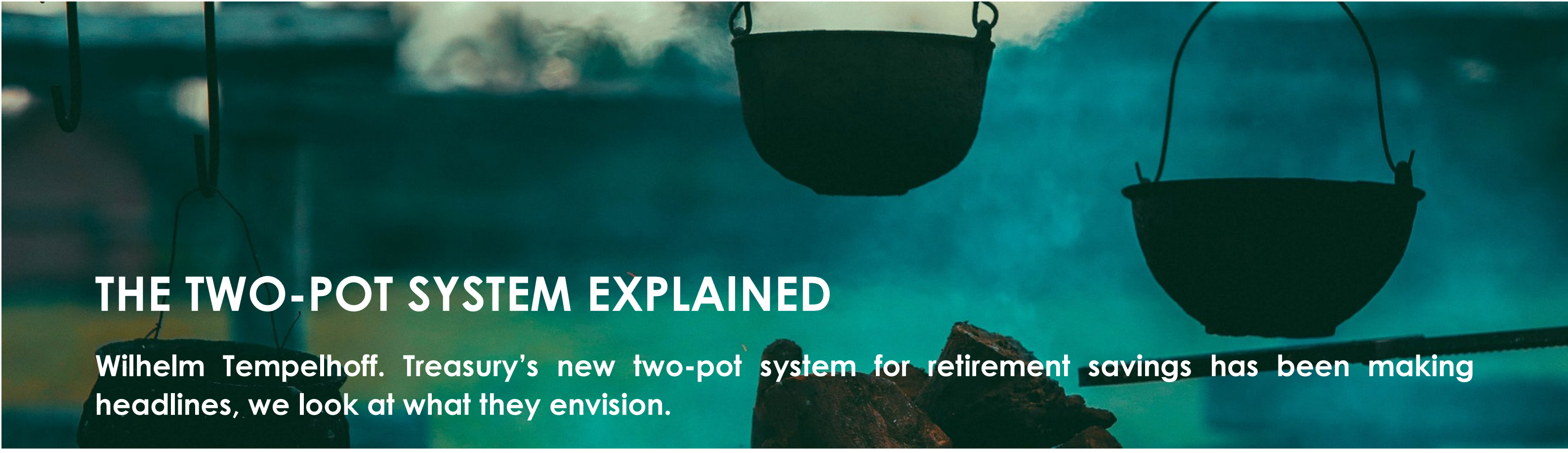
Why do we show the negative numbers? Because something like global bonds could be part of your future portfolio soon and contribute positively to its performance. This was in most cases non-existent over the last 15-20 years as active managers did not hold these assets. Arguably the risk return payoff didn't make any sense. The valuations on disruptive technologies were eye wateringly high but some active managers are now considering these companies. Again, the risk return payoff did not make sense before, but it is starting to do so now.

Some interesting data points.

- UK inflation now at 10% (the highest in 40 years since 1982)
- A 0,75% interest rate hike in the UK is the biggest in 33 years (benchmark rate now 3%)
- R2.2 billion: the amount of imported solar PV panels into South Africa in the first 5 months of 2022
- US Government debt now $30 trillion ($30 000 000 000 000)
    - My calculator has space for 3 billion which is 4 digits short
    - It will take you +- 950 000 years to count to 30 trillion
    - If the US re-paid $1mil of their debt every second, it would take them 1 year to clear it (or $86 billion every day)
    - Or they can ask every taxpayer for $250 000 (R4,5 mil)
- The 5-year US Treasury yield was 0.3% in August 2020, the yield is now above 4% on the same instrument

With great turbulence comes opportunity and keeping a level head in times of asset price dislocation with asset value, can lead to better investment outcomes in the long run. Sentiment can shift quickly and markets can rally in the absence of good news (we saw this in October). All you need is better tan expected bad news and that usually follows the point of highest pessimism.

The remainder of this newsletter is mainly focussed on Investment Planning topics considering the very topical nature thereof at present. In future we will again write about the other financial planning components such as risk planning, retirement planning, tax planning, etc.



THE TWO-POT SYSTEM EXPLAINED

Wilhelm Tempelhoff. Treasury's new two-pot system for retirement savings has been making headlines, we look at what they envision.

Many of our clients have asked us about Treasury's proposed Two-Pot retirement fund system and how it would impact their retirement savings and planning. Although much change will likely still take place in this regard, we thought it best to include an article on the topic to provide some insight on the current available information.

On a high level, the proposed changes to the retirement legislation aims to improve the preservation of long-term retirement savings while allowing emergency access to a portion before retirement.

The Covid-19 pandemic caused such upheaval that some retirement fund members had to resign to get access to their retirement fund savings. Others could do nothing, having saved into RA's where access is only available at retirement. Treasury's amendments seek to address the need for emergency withdrawals from retirement savings but still limit this access to ensure that some retirement provision remains in place.

While it is called the Two-Pot system it is actually Three. Accumulated savings in retirement funds (Pension fund, Provident fund, Preservation funds and Retirement Annuities), up to the implementation date, will be seen as the "vested pot" and the current rules will continue to apply to these benefits. We will not go into detail on the current rules.

The new two-pot system is then used for all future contributions into a retirement fund from the implementation date forward. One pot for the long-term investment component for retirement (min 2/3rds of the contribution) and one pot for the emergency access section (up to 1/3rd of the contribution). We call these the "retirement pot" and the "savings pot" respectively.

Your full contribution to a retirement fund will qualify for the tax deduction (subject to the current 27.5% and R350 000 annual limits) even though up to 1/3rd will go to the "savings pot". Once you access money from this savings pot you will however pay tax according to your marginal tax rate (tax rate for every additional Rand of income you earn) on the withdrawal. This differs from the current use of the pre-retirement lump sum withdrawal tax table.

Importantly the savings pot will be the only pot (apart from the vested pot) where a retirement lump sum can be taken. The retirement pot will not allow any lump sums even at retirement, it must be used to fund a retirement income. If there is nothing left in the savings pot, then there is no withdrawal available at retirement.

The changes will also allow those who save into a Retirement annuity to also accumulate a savings pot and withdraw from it prior to retirement; a pre-retirement withdrawal from an RA was never an option before.

To avoid excessive withdrawals from the savings pot and using the funds for anything other than an emergency, the suggestion is that the minimum amount for a withdrawal from the savings pot should be R2000 and that a withdrawal is only allowed once per year.

There are many questions that still need to be answered, including:

- Could one "seed" your pots with transfers from your vested benefits?
- Should the pots be managed differently from an investment approach?
- How would transfers between the same type of pot work?
- Should the existing retirement lump sum tax tables not remain in place?

Importantly, if you were 55 years or older on 1 March 2021, you do not have to conform to the new three-pot system and you can continue according to the old rules. The Implementation date is set for March 2024 but a lot needs to still happen between now and then. Including public comments, amended draft legislation, administrative changes at SARS and pension fund administrators, significant communication to members, etc.

There is no need for retirement savers to panic or be concerned about the changes. It will still take years to implement, and the proposals above are only drafts which will likely still change. For the time being retirement savers should continue investing for retirement and focus on their long-term goals. When these amendments do come into effect, we will assist clients with the new considerations and amend their financial plans accordingly.

As Leon Schuster said when preparing a prank on singer Bless Bridges: "*We will double-cross those Bridges when we come to them…*"

The importance of something to aim at

Its fair to say that, as urinals go, Airport urinals are not the cleanest even though much effort is made to keep them neat and clean. It's a high foot traffic area and because passengers are often in a rush, the whole process can be a bit messy.

In the 1990s an economist and cleaning manager from Schiphol International Airport, suggested a solution to the problem: etch a fly into the urinal bowls. By giving men something to aim at, the outcomes of their urinal visits would hopefully be improved. The Victorians had the same idea when they painted a picture of a bee in their chamber pots. In Latin the word for bee is *Apis*, a clever play on words… Similarly Islandic urinals sported pictures of banking officials during the Great Financial Crisis.

This technique of providing people with a choice that alters their behaviour in a predictable way without forbidding any options or significantly changing their incentives, is also useful in the financial planning word. Providing clients with a benchark or an objective as part of their financial plan helps to improve their investment aim and hopefully their outcomes.

Is alternative energy an investment or expense?

Carel Marx. How much is having uninterrupted energy worth to you?

Very topical now is energy, not only in South Africa where we are experiencing the worst round of load shedding, but we now see talks about possible “blackouts” in Europe and some states in the US. Individual households, apartment blocks and businesses must consider alternative energy sources such as solar power with battery storage, wind turbines (if you have wind) or generators.

Most of us are unsure if the financial sacrifice today is effectively paying your future expense upfront or perhaps it’s an investment due to you having a future cash flow saving, making it an investment. When doing the calculation, it is impossible to monetize the luxury of uninterrupted power supply, but it is a factor to consider.

We’ve managed to obtain some quotes on a solar system with battery storage to cover a household use of 800kwh per month. The cost thereof ranged between R170 000 and R250 000 all inclusive (installed with a Certificate of Compliance). Depending on your choice of quote, the annual Eskom tariff escalation and the interest rate used, the payback period is in the region of 5 to 10 years. The aim of the calculation was never to be 100% correct as the inputs to the calculation have too many variables that require a guess. All we wanted to see is if it makes sense from a cash flow and investment perspective.

All the quotes we received did have a battery warranty of 10 years, solar panel warranty of 10 years and an inverter warranty of 5 years. If your payback period is 10 years, then you do run the risk of only regaining your capital but importantly you do get the advantage of load shedding not affecting you. Any payback period closer to 5 years makes a lot of sense financially and obviously the advantage of uninterrupted electricity supply.

Financing the capital outlay is a great idea if you can use your home’s access bond. We used Prime minus 0.75% (Currently 9%) as our financing cost. Secondly, if you are paying cash and this money is currently idle in your bank account, then definitely use it as the opportunity cost is low. If you need to withdraw the funds from an investment, then you need to know the after-tax opportunity cost of doing so. We used a 9% before tax rate and a 5% after tax rate. The lower your finance cost and the lower your opportunity cost, the better the result.

The picture could look a lot different if NERSA/Eskom allows consumers to also become suppliers of power. Meaning that an individual/independent can feed into the grid any excess power generated and be credited for these units. Another big factor is the pace at which electricity prices will increase into the future. We said 15% for the next two years each and then 7% each year after that. There is a lot of talk that electricity prices might double over the next 5 years. That would be close to 15% each year of the next 5 years.

There was a lot of talk about prepaid users versus post-paid users and the fixed charge for having access to electricity. Currently as a post-paid user you pay +-R900 a month for the luxury of having access to power. Can this fee be scrapped by becoming a prepaid user? At present it seems like you only pay as you use. This would be another significant saving on your monthly municipal bill, bringing the payback period down drastically. In fact, it becomes a “no brainer” if you don’t have the fixed cost expense.

What did we learn about solar power and the calculations behind it?

1) Becoming a prepaid user of electricity if you can, to eliminate the fixed costs, is a significant saving and a huge reduction in the payback period,
2) We cannot rely on a sunny day every day so you might need an electricity back-up system of some sort (Eskom or Wind or a generator),
3) Don’t overpay for the solar system as it makes a huge difference to the payback period. In our example, you need to pay closer to the R170 000 mark. You cannot over capitalize at this stage as additional units are worthless if you cannot use them,
4) The longer your solar equipment lasts the more you venture into investment territory (longer than 10 years, for example the solar panels can last 20+ years with minimal loss of generation capacity)
5) To reduce your payback period, you need to reinvest the cost savings each month. You need some financial discipline here as you will need the capital again at the end of the period or after +- 10 to 15 years to reinvest again into new batteries, inverters and or panels. The old equipment will be worth very little if anything.

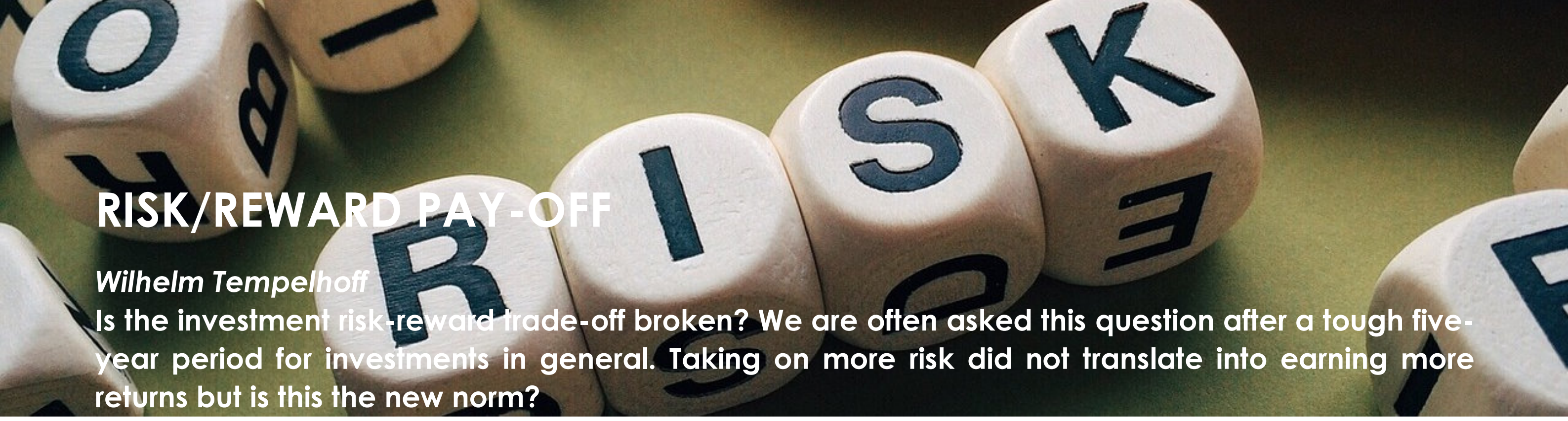
At this point in time, given the information we gathered, it seems that you are paying your expense upfront rather than it being an investment. The advantage is however that you have uninterrupted energy (if the sun shines) and you are adding to a greener world. The situation can change drastically depending on various factors as mentioned in the above points.

Quick take: What is financial leverage and when does it make sense?

Financial leverage is the term used for someone that borrows money to deploy it in some shape or form to generate a return. The “some shape or form” we are referring to could be borrowing money to buy a short-term security or share that you think will go up in price, you might be able to find an investment offering a higher return than the cost of borrowing or it could be money you use inside your business to generate additional income. Financial leverage is also what you do when you borrow money from the bank to purchase an investment property.

No matter what the investment case might be, it is important to generate a return similar or higher than the cost of capital. The current prime rate in South Africa is 9.75% (October 2022) which is a fairly high “hurdle rate”.

Why would you want to use leverage? On paper it works perfectly. You borrow money to buy an asset that generates enough revenue to pay for itself and after the repayment period, you own the asset. From a personal cash flow perspective, you haven’t spent any money but expanded your balanced sheet potential. The reality is that most people cannot save enough money from their income to retire comfortably. Financial leverage is an option to reach your retirement goals, but it should be approached with caution as it could set you back just as easily.



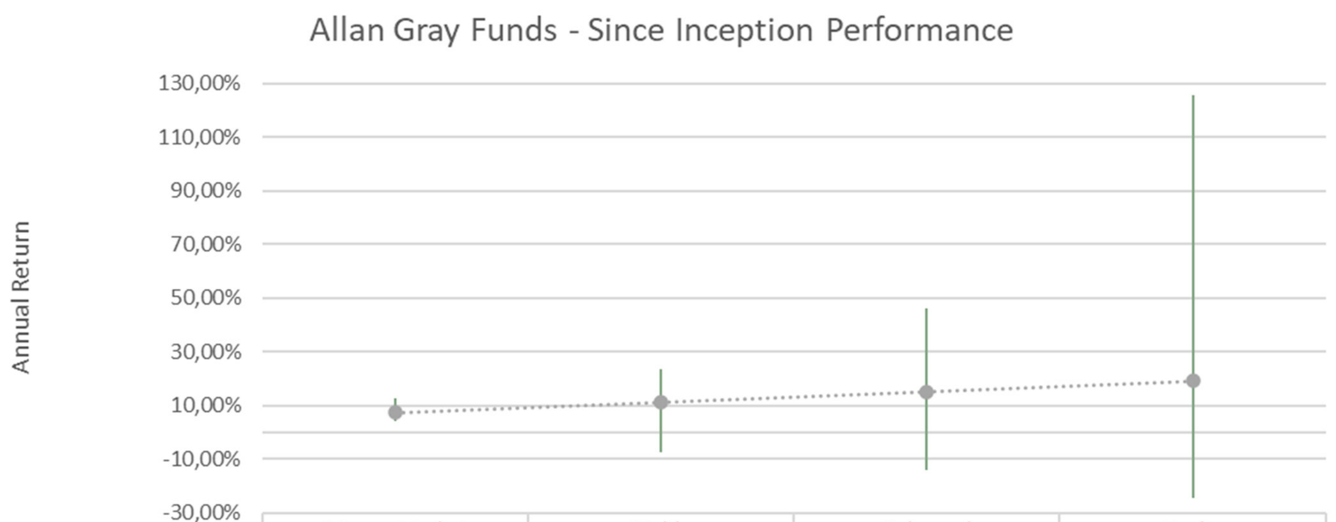
RISK/REWARD PAY-OFF

Wilhelm Tempelhoff

Is the investment risk-reward trade-off broken? We are often asked this question after a tough five-year period for investments in general. Taking on more risk did not translate into earning more returns but is this the new norm?

I have been working as a financial planner for 15 years and I have seen a range of investment planning outcomes over this time. On average, returns since 2015/16 have been disappointing and seldom rewarded clients appropriately for taking on risk. Certainly, investors who started to invest mid-2010's would have been disappointed by the rewards for their chosen risk profile unless they were very conservative on the local side or very aggressive in the offshore context.

By way of illustration let's consider the four main Allan Gray unit trust funds, each representative of a different risk profile: Money Market for low risk, Stable for Conservative, Balanced for Medium-High risk, and Equity for Aggressive risk. The chart below illustrates their annual returns since the funds' inception (which ranges from the late 90's to early 2000's up to October 2022). This provides a very long-term picture with returns of 20 plus years. The vertical lines represent the range of the 12-month investment periods, while the dots provide the annualised return since inception. Allan Gray Balanced managed an annualised return of 14.90% p.a. but its lowest return over any 12-month period was -14.20% and its highest return was 46.10%. The higher the risk, the wider the disbursement of short-term investment outcomes but the better the average return over the long term.



	Money Market	Stable	Balanced	Equity
Highest	12,80%	23,30%	46,10%	125,80%
Lowest	4,30%	-7,40%	-14,20%	-24,30%
Long Term Annualised	7,60%	11,10%	14,90%	19,20%

As one would expect the more conservative funds on the left have a narrower range of outcomes but a lower long-term annualised return; while the riskier funds have a wider range of outcomes but a higher annual return over the long term. Now contrast this to the returns of the last 5 years:

	Money Market	Stable	Balanced	Equity
5 year Annualised return	6.3% p.a.	6.4% p.a.	5.8% p.a.	4.9% p.a.

Investors have clearly not been rewarded for taking risk above a conservative level for some time. The question is: can one still trust that taking on more risk will lead to higher returns?

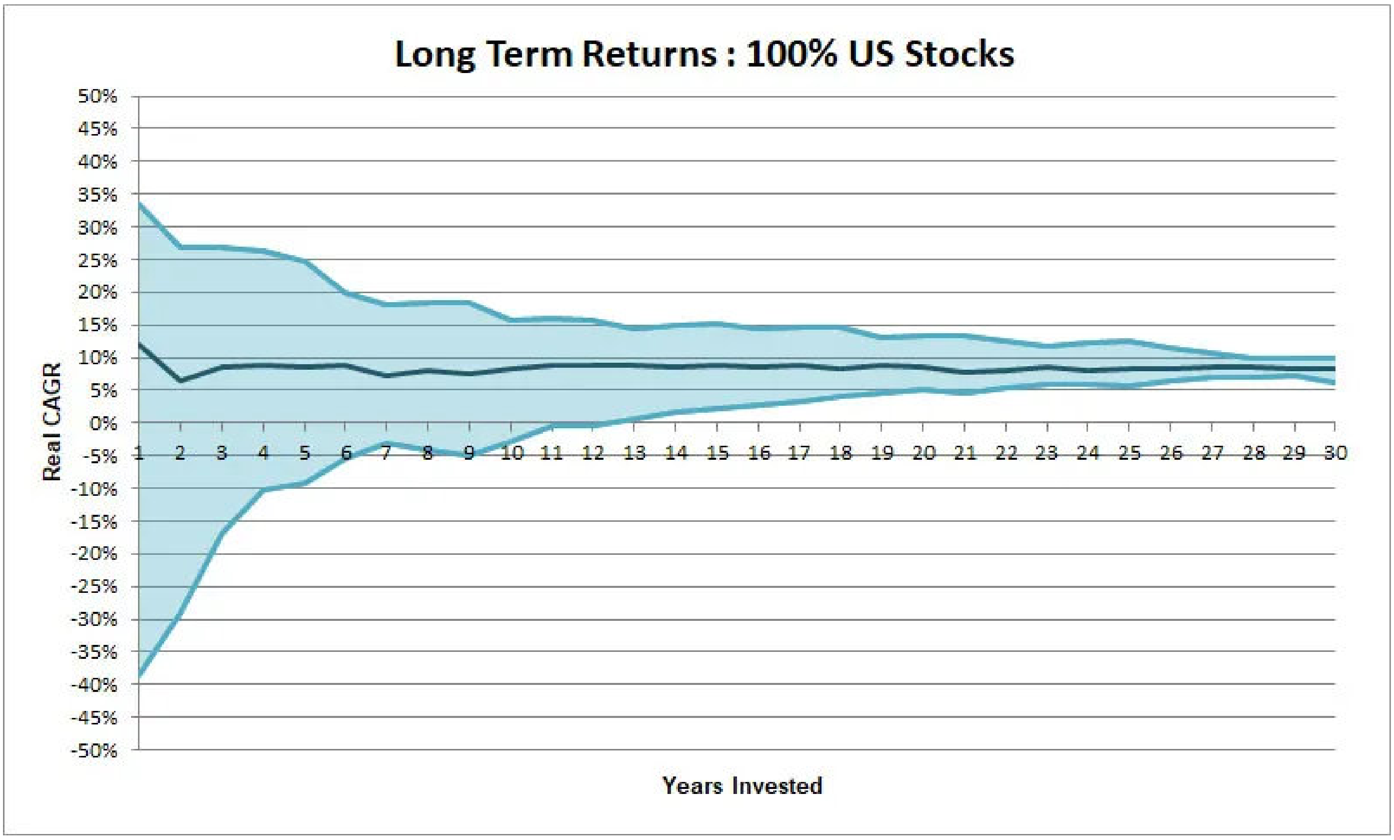
Although it may not seem like it, the short answer is "Yes", the risk/return trade-off still exists. Over the short- to medium-term it may not play out perfectly, but history has shown that investments tend to disprove the idea that you can "*have your cake and eat it too*" and affirm the idea that "*all good things come to those who wait*". There is no such thing as "risk-free returns" but there is such a thing as "return-free risk" (over short investment terms especially). Over the last few years, it seems the risk/reward gods have been slack in their application of the rules however.

You must assume some risk to earn a return, it can be a very low risk level (like depositing funds with the bank) or a very high-risk level (investing in a Russian fracking company's shares) or any level in-between. While even low-risk investments can turn out to be risky if something goes wrong, the relationship generally holds true that more risk should lead to higher returns and vice versa. The linchpin here is that **time is also a factor**.

The relationship should therefore be expanded to the risk/reward/time trade-off.

More conservative investments are suited to the short investment term during which their outcomes are more dependable. For longer investment terms, higher risk investments are more suitable because their outcomes become more dependable given time.

Here is an example of how a risky investment can become more dependable given time. The chart below illustrates the investment outcomes for a portfolio that is 100% invested in US shares over various investment timeframes. The horizontal axis shows the investment holding period and the vertical axis the range of investment outcomes since 1970. Real CAGR refers to the inflation adjusted compounded annual growth rate for the investment.



For example, an investment of 1 year may have provided a return as high as 35% or as low as -40% while an investment of 6 years provided outcomes ranging from -5% p.a. to +20% p.a. You will notice how the cone narrows with time, meaning the investment outcomes start to narrow as time goes by. For all the 11-year holding periods the worst outcome was 0% p.a. and the best +15% p.a. For a 30-year investment period the outcome is as narrow as +5% to +10% per annum. These are real returns (i.e. after taking inflation into account).

This clearly shows how time is a great equaliser that can improve and smooth outcomes.

This does not stop one from investing into a risky investment for a short period of time or into a conservative investment for a very long period. Logically however short-term investments need short term certainty of outcome, while longer term investments can hold through the high short-term volatility in anticipation of longer-term outperformance. In the context of the chart above, a conservative investment will have a much narrower range of outcomes which is why one needs to always consider your timeframe along with factors like your risk preferences and objectives.

The key to reaching your investment planning goals is to understand your **risk tolerance and investment time horizon**. This unlocks the **risk/reward trade-off** and allows your financial planning to be as efficient as possible in its aim to meet your goals.

We therefore believe the long-term risk/reward relationship holds true bearing the time scale in mind.

FIANCIAL FAQ

"There is nothing wrong with Vanilla, its straightforward and does the job, but sometimes I yearn for some Rum and Raisin."– ***Recent client comment about venturesome investment alternatives.***

What is the one key financial planning concept that will make the most difference to my wealth?

If we had to boil it down to just one concept, we'd say: Expand your lifestyle slower than your income expands. That means when you receive a promotion, salary increase or another source of income, don't fully expand your lifestyle to take advantage thereof.

In this way your disposable income grows faster than your expenses and you become wealthy. Cash-flow is king and being able to invest this additional disposable income allows you to get ahead in your financial planning. A simple concept but hard to implement when concepts like "YOLO" and "FOMO" constantly beat us into submission.

Why should I allocate more money to an investment that performed poorly?

Clients often balk when we suggest that they consider selling from their best performing investment/fund to buy into their worst performing investment (referred to as rebalancing). The principle behind this move is "selling high and buying low". You will find that all investments, with risk attached to the price, will underperform at some stage. It doesn't necessarily mean you have a bad long-term investment, it means your investment is facing short term headwinds. If something performed poorly, you need to analyse the reasons and decide if this is permanent or temporary. If it's the latter, then it represents a buying opportunity.

Interest rates have moved up, but my income fund under-performed. Why?

Fixed income investments aren't all made equal. You can invest in short term debt paper or long-term debt paper. You could have a fixed investment rate or a floating investment rate. There are multiple structures within the interest paying arena. Income funds typically hold various types within this asset class and part of the holding would be fixed rate longer term debt, referred to as nominal bonds. When the reserve bank hikes interest rates, it affects the short-term interest rate market directly. For example, if you have a money market fund, you will see the interest rate move up (there is a lag before this happens).

The increase in interest rates does not however increase the fixed long-term bonds rates, as these bonds were issued at a fixed coupon. However, if investors are demanding higher yields on these bonds to compensate for increased interest rates, the only mechanism to facilitate this is a lower bond price. While the interest rate yield curve moves upwards, income funds typically struggle with negative price movements, but it does mean that future return prospects improve.

What is the role of an investment platform?

Investment platforms started due to the need to have access to multiple investments from one administrator. Platforms then enhanced their ability to also provide valuation reporting, tax certificates and multiple product types to host the underlying investments. The platform facilitates all transactions between the client's bank account and the chosen investments.

Going back to the days before platforms, investors had to open accounts with all their preferred investment companies individually which meant that changing your investment or rebalancing your account was a tedious exercise.