FinPlanCo

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1 TAX IMPLICATIONS OF INVESTING

Different investment assets provide different types of return each with their own tax consequences to consider.

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When planning for retirement one should not forget about investment property and the advantages it can bring to your portfolio.

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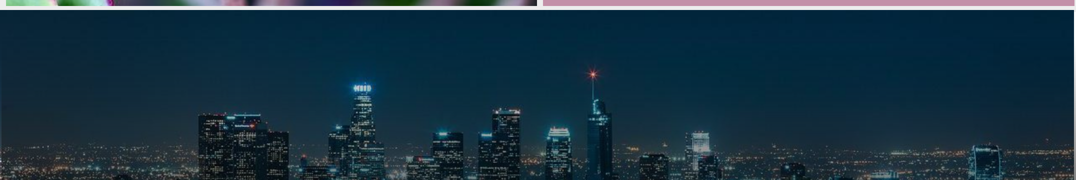
We discuss the "goldilocks" amount of offshore allocation in a diversified portfolio from an SA perspective.

4 UNDERSTANDING BENEFICIARY NOMINATIONS

Where can beneficiary nominations be helpful and prudent. Followed by our **FINANCIAL PLANNING FAQ.**



"If you don't find a way to make money while you sleep, you will work until you die."– **Warren Buffet**

INTRODUCTION

This newsletter excludes the normal economic environment update in favour of an extra article. As introduction a short glossary of some topical market terms from Investopedia:

September Effect: *"describes a phenomenon in which stock market returns are often negative during the month. Depending on the period analysed, historical data reinforces this concept's legitimacy, but past performance isn't necessarily a predictor of future returns."*

Santa Claus Rally: *"describes a sustained increase in the stock market that occurs in the week leading up to Dec. 25. However, there seems to be some disagreement over whether these rallies happen in the week leading up to Christmas, or if it's the week after Christmas until Jan 2."*

January Effect: *"A perceived seasonal increase in stock prices during the month of January. Analysts generally attribute this rally to an increase in buying, which follows the drop in price that typically happens in December when investors, engaging in tax-loss harvesting to offset realized capital gains, prompt a sell-off."*

CONSIDER THE TAX IMPLICATIONS WHEN INVESTING

Wilhelm Tempelhoff. Investors are often surprised when the tax man comes knocking for a piece of their investment returns pie. Understanding and considering how your investment returns are taxed, can help avoid surprises and often allow you to plan more prudently to enhance your after-tax outcome.

High-net-worth individuals are particularly acceptable to large tax bills that diminish their returns, but most investors can benefit from a little investment- and tax-planning.

Let us consider the following two scenarios to illustrate. Joe and Jane both have R1mil in a fixed deposit with a large bank. They earn 9% interest on the deposit for the tax year 2023/24. Joe's salary is R12 000 per month before tax while Jane earns R70 000 per month before tax. Both Jane and Joe are under the age of 65.

Detail	Joe	Jane
Total Salary Income	**R144 000.00**	**R840 000.00**
Marginal Tax Rate	18%	39%
Total Interest Income	R90 000.00	R90 000.00
Less Interest abatement	-R23 800.00	-R23 800.00
Taxable Interest Income	**R66 200.00**	**R66 200.00**
Taxable Income	**R210 200.00**	**R906 200.00**
New Tax Rate	18%	41%
Tax rate on taxable Interest	18%	39% for R17 900 and 41% on the rest
Tax Payable	**R11 916.00**	**R26 784.00**
Interest After Tax	**R78 084.00**	**R63 216.00**
Return After Tax	**7.81%**	**6.32%**

You will notice that the investment is much more lucrative for Joe and less so for Jane because of the tax liability. Joe and Jane should also bear in mind that the tax is payable even if the interest is reinvested, and therefore inaccessible, in the fixed deposit.

Interestingly Jane and Joe can each invest R264 444.44 (as per the example above) in a fixed deposit without incurring any income tax because of the R23 800 interest abatement.

Jane could consider an alternative investment which may provide a lower return but in a more tax friendly manner. An example would be a dividend yielding investment with an 8% dividend pre-tax which would be 6.4% after tax without any cashflow issues. Often investors compare the gross returns of the options at hand, and go for the higher return, but one should compare the net outcomes to find the better alternative.

Your marginal income tax rate is not the only factor to consider here. One must also compare the different types of return that your investments earn because each asset class produces a different return stream which in turn causes different tax types to apply. Consider the table of asset classes and the returns they produce on the following page.

Asset Class	Return produced
Cash and Money Market instruments	Interest based
Bonds, Debentures and Debt Instruments	Mainly interest but some price movement
Equity, Shares and Stocks	Price appreciation and dividends
Property	Rental income and price movement
Foreign Currency	Currency appreciation

For interest the first R23 800 (those under 65) or R34 500 (those over 65) is tax free, the rest is taxed at your marginal income tax rate.

Price appreciation gives rise to a capital gain and R40 000 of your triggered capital gains will be tax free in any given tax year. The remainder is included at a rate of 40% into your taxable income and then taxed according to your marginal tax rate. That effectively means that capital gains tax is between 0% and 18% depending on your marginal tax rate. Capital gains accumulate over time, and they are only taxable when triggered, in other words when you sell your investment or change it.

Dividends are taxed at the source and the investor receives them after the Dividend withholding tax of 20% has been deducted.

When investing in Rand, gains provided by the currency exchange rate are capital gain based. In hard currency investments the conversion gains, between when you externalise and when you repatriate funds, are ignored.

<u>How can one improve the taxability of your investment returns?</u>

SARS encourages taxpayers to structure their affairs to best benefit within the Income Tax Act framework, this is called tax avoidance. It is tax evasion that is illegal. During the drafting of your financial plan, you and your financial planner will consider a whole host of factors when deciding upon your investment approach, tax is but one of these. That said, you may start by considering the following:

Try to avoid earning too much interest, yes, it is a predictable and dependable type of return, but it leads to a lot of tax compared to the other return types.

When investing for the long term, try to focus on shares and assets that appreciate in value considering that capital gains tax is one of the friendlier taxes on the list.

Maximise the use of any tax concessions, abatements, and rebates before you look at more restrictive investment structures or products that can improve your after-tax outcome. Consider options like retirement annuities, tax-free investments, Article 18A donations, etc.

For those who can part with their funds for at least 5 years, endowment policies are useful considering that the Life Insurance Company pays the tax on the investment returns internally at flat rates of 30% for income, 12% for capital gains and 20% for dividends.

For a married couple it may be prudent for the spouse who has a lower tax rate to do most of the liquid investing.

It may be tempting to use structures or products that promise some tax benefit or shelter. It is however important that investors understand the drawbacks and potential pitfalls of such, to make an informed decision. You might be avoiding one type of tax just to be caught by another tax net.

RETIREMENT PLANNING, DON'T FORGET ABOUT PROPERTY

Carel Marx. Investment Property is an important building block in a retirement plan. Leverage allows you to broaden your retirement asset base and then re-evaluate at retirement.

Traditionally we all have some sort of pension, provident or retirement annuity that we contribute towards every month. These contributions are anything between 5% and 15% in most cases of one's pensionable salary.

Pension funds then typically employ an asset management business to manage the investments. Those pension funds will consist of the standard asset classes such as stocks, bonds, listed property and cash, both locally and offshore. In SA we have an added layer of constraints called Regulation 28 which regulates the amount invested into each asset class. Irrespective of Regulation 28, these assets are all listed on some exchange and is "marked-to-market" daily. This means that the price of the asset is set by the market every day.

Listed financial assets in a balanced portfolio can move in various directions depending on a vast number of factors. The factors are typically imposible to predict and you can do very little about it.

How successful are people at retiring using a pension/retirement fund as the sole source of income at retirement? We think it is public knowledge that most people are not able to retire comfortably when only depending on their employer's retirement fund provision. Why? They don't contribute enough throughout the term of employment and people tend to take lump sum withdrawals when they resign or move jobs. This is not only public knowledge, but we can also confirm that in reality, this is the case too.

Most successful retirees are those that have physical property in their portfolio. It is worthwhile to dig deeper into why. Property in most parts of South Africa hasn't performed well and more recently, property has become an out of favour asset for most investors. Out of favour because property is not very liquid and South Africa seems to be in a spot of bother to put it lightly. The areas that performed well in the past, took a knock in Covid and are struggling to recover. If property is not a great investment, why is it so important for retirement? The answer is leverage.

Buying an investment property is something you can do with the Bank's money. That is refered to as leverage. Without going into the detailed numbers, what if we are able to finance the property value, repay it over twenty years and the rental income you receive approximately equals your costs (bond repayment, levies, maintenance ect)? This would effectively end up as a paid-off asset after 20 years without impacting the investors cash-flow. You can still contribute the same amount to your retirement fund plus have a property at retirement. Imagine now, you've purchased four investment properties pre-retirement? The outcome is obvious, your asset base is larger at retirement whether you keep or sell the properties.

Let us unpack the retirement strategy a little more. We are not for one moment suggesting that property is a great investment and everyone should own as many as possible. In most cases we see clients with property with an income yield between 4% and 9%. How do we calculate this? We take the gross monthly rental income, subtract all expenses, multiply by 12 and divide by the market value of the property. Think about it this way. If you purchased a property cash for R1 mil and receive after all costs R5 000 per month in rental, your income per year is R60 000 which is a 6% yield. As an alternative you can invest the R1 mil in a money market fund and earn +-8%. For the property investment to make sense, you need at least 2% market value growth on the investment. In most cases, the market value growth on property prices, is where investors came up short. This figure in some cases turned negative over the last couple of years which means your end result is even lower than the 6% income yield.

Irrespective of the investment case for property, the leverage part is what makes sense. Once the property is fully paid, one should evaluate the investment case and consider selling if it is a weak performing investment compared to listed alternatives.

We use property as a proxy for any asset that you can purchase with a lender’s money. This could be an Uber vehicle that you buy via the bank and rent it out to a driver. It could be a loan to purchase a business of some sort. Property is just the most common asset that banks would be willing to finance on fair terms to any investor earning disposable income.

The importance of a Last Will and Testament.

A Last Will and Testament (“Will”) is a legal document that sets forth your wishes regarding the distribution of your property and the care of any minor children. If you die without a Will, those wishes may not be carried out. Furthermore, your heirs may end up spending additional time, money, and emotional energy to settle your affairs after you're gone.

What are the requirements for a valid Will? Since 1954 all Wills must be in writing. They can be written by hand, typed, or printed. The signature of the testator/testatrix must appear at the end of the Will. If the will consists of two or more pages, the testator/testatrix must sign each page. This signature must be made in the presence of two or more competent witnesses who also sign every page at the same time.

Here are a few points, why you should have a Will:

- Specifies how your assets are distributed
- Names guardians for minor children
- Protects unmarried partners
- Prevents family conflicts
- Facilitates charitable contributions
- Minimizes taxes
- Guides end-of-life decisions
- Addresses business succession
- Distributes personal and sentimental items

In summary, a valid will is a written document signed by you and witnessed by two or more competent individuals (who don’t stand to benefit from the Will over the age of 14). Having a Will is crucial as it ensures your assets are distributed according to your wishes, appoints guardians, minimises conflicts, and provides peace of mind. It's a vital part of estate planning to protect your legacy and loved ones.

THE RIGHT BLEND BETWEEN LOCAL AND OFFSHORE

Wilhelm Tempelhoff. How much offshore is the goldilocks amount? (not too much but not too little, just right)

We are often faced with the question of how large the foreign investment portion of portfolio or investment plan needs to be. When reading a politically charged headline or sitting through a particularly long load shedding stint, our emotions may dictate a higher allocation. Alternatively, after spending some time in the countryside and enjoying the quality of life in SA we may be tempted to keep more assets close to home. Ultimately however the answer lies in a more measured and logical approach.

If you type the question into a search engine, opinions vary between 20% and 100% depending on the writer and their personal views. Rules of thumb exist to say that you should have about 30% of your investable assets offshore and some advocate the use of the "Martian approach"; meaning that a Martian coming to earth would likely not invest any more than 3-5% in South-African assets when he has the whole world to choose from.

We find that the answer is less a rule of thumb and more a consideration of the investor's cash flow requirements, term, objective and risk profile.

M&G asset management recommends that you should start by considering how much offshore exposure you already have. *"In South Africa, surveys show the typical investor has approximately 80% of their total equity exposure in locally listed companies. However, it's important to note that local equity in SA isn't as local as it used to be. Over 50% of revenue from JSE-listed companies is now sourced from outside of South Africa. So, the first question to ask, when you're thinking about moving money offshore, is: how much exposure do I already have? It could be higher than you think if you're invested in JSE-listed stocks or in a typical "balanced" unit trust fund."*

The main argument is that one needs to include foreign assets as a diversification element and to gain access to the much deeper and wider investment set that foreign markets provide. After all South-Africa is only one country out of almost 200 alternatives. This clearly makes sense, and it is the main driving force regarding foreign diversification.

Another motivation is that the Rand's exchange rate weakens over time and given enough time it benefits the foreign investor irrespective of the entry point. In a recent article Ninety One explains that on average, "*the rand has depreciated by approximately 6% p.a. over rolling 5-year periods, contributing to an offshore investment's overall rand return*".

Interestingly when evaluating long term orientated foreign investments their finding was that your entry level exchange rate has little bearing on returns. This may be because, simplistically, the rand appreciates in a risk-on environment and depreciates in a risk-off environment, this is often the opposite of asset valuations during these periods. *"So, what the rand may give you in terms of a potential offshore investment entry point, offshore asset valuations (and asset price momentum) tend to take away, and vice versa."*

The concept of asset-liability matching is important. In general, you should mainly invest in assets that match your expected liabilities. If you expect that your expenses or liabilities will mainly be in Rand, it is likely best to mainly invest in Rand. If on the other hand you expect to travel abroad often or need to pay study fees offshore or "swallow" between two countries in retirement, you should have more assets offshore.

Consider a situation where you are a South African retiree, and you need most of your income in Rand. Having most of your investment offshore means that a currency appreciation (strengthening Rand) could have disastrous effects on your monthly income.

The more income you need from your investments, the less offshore exposure you should take. This is because foreign investments can be very volatile. Ninety One has done some detailed research regarding the failure rates of living annuities based on their foreign exposure and income withdrawals in Rand. They showed a strong correlation between the failure rate, the income drawdown rate and the foreign exposure. In other words, the more income you need to withdraw from your living annuity, the lower your foreign exposure should be to decrease your risk of failure.

Naturally investment term also plays a role here. The longer you can part with your funds, the more offshore investments you can include.

Lastly one needs to consider your growth goals or return aim. For those who seek conservative returns, offshore exposure should be limited. The opposite also holds true, the higher your return aim, the more offshore you should include.

Most asset managers who run return targeting funds (eg. inflation targeting funds) recommend that if your aim is to beat inflation plus 6-7% you need 35-45% offshore. If your return aim is more modest at 3-4% above inflation, you may only need 30% offshore and for more conservative aims of inflation plus 1-2% the ideal may be 10-20% offshore.

Bringing it all together you can start to form a picture of the ideal offshore exposure levels. Personal preference will also have bearing, but one needs to be careful of letting emotion cloud one's judgement.

FinPlanCo's opinion is that the foreign investment returns of the last decade are not a good indication of what is likely to happen over the next decade. We prefer to steer well clear of the argument that "*foreign investments have done so well and that is why we need to include more of them in a portfolio*". The starting prices/valuations simply don't support this argument.

Rather consider your objective circumstances and goals to determine your ideal offshore exposure.

Investment Approach: Let your Term guide you.

When you contemplate setting up an investment or decide between various investment options, one of the most important considerations is your investment term. This is also known as your time horizon and it refers to the length of time that you plan to invest before you make any withdrawals. This can be for the short-term (days, months, or a few years) to the very long-term (up to decades). Often, we tend to first consider the risk profile of the investor or their objectives before we look at the term. Objectively however, the planned investment term can easily dictate the risk profile and objectives.

If you can only part with your money for a short period of time, it is best to keep it safe and minimise the volatility of the investment outcome. If, however, your timeframe is longer, say 10 years, a safe investment with a high certainty of outcome but a lower compounded return, would not be appropriate. Shorter periods need more investment stability, longer periods have the benefit of time to smooth out short term bumps in the road.

Consider a retirement fund investment for a 40-year-old individual retiring at 65 who has a conservative risk tolerance level. Intuitively it makes sense that this long-term investment, needs to take a longer-term view, and invest in the assets that produce the best outcomes over the corresponding term. The investor may be a conservative person, but the term is long enough to take on more risk and aim for a better outcome compared to using conservative investments that may match the risk tolerance but not the risk capacity.

Your investment term is very important and often indicative of your risk capacity. Mismatches can lead to unintended consequences and may bowl over the best laid financial plans. Let your objective term guide your investment planning and then tilt the plan in the direction of your subjective preferences.

Understanding Beneficiary Nominations

Wilhelm Tempelhoff. Beneficiary nominations are a critical part of estate planning. Here we consider the details.

When deciding to nominate beneficiaries on in your Will, on your policies or retirement fund, it is important to consider the importance and implications of doing so. In this short article, I aim to highlight the considerations and provide an overview of the options.

In South-Africa we enjoy the freedom of testation, which allows you to nominate whomever you like in our Will, and to also disinherit family members. Bear in mind that you may have a duty of support which could lead to a maintenance claim against the estate.

Your Last Will and Testament will dictate your wishes to your nominated executor and allow you to make bequests, nominate your heirs, and list beneficiaries. These terms are however not interchangeable.

A bequest is a gift of a specific item to a specific person. Generally, you only make a bequest if you are sure the item will still be around when you pass away. An example would be where you bequeath your grandmother's diamond ring to your eldest daughter.

In terms of your Will, your beneficiaries are the people inheriting from you by way of your Will while your heirs are the people who inherit the residue (or remainder after the bequests) of your Estate.
Be mindful of the implications of nominating a minor as a beneficiary or heir. Minors don't have contractual ability by themselves, and movable benefits (investments, cash, etc.) usually fall to the Guardians fund for administration until the child reaches majority. Minors can however inherit immovable property but in practice this creates practical problems.

Where minors stand to benefit from your death, it is best to rather set up a testamentary trust and vest the benefits in the hands of your nominated trustees for the benefit of the minors. You can dictate your wishes to the trustees in this regard and for example allow them to administer the benefits on behalf of the child until they reach a set age.

Importantly your Will is not the only mechanism available for dictating your wishes. You can, and often should, nominate beneficiaries directly where possible because this allows you to save on both administration time and executors fees. Some structures allow you to also nominate secondary beneficiaries to create a hierarchy.

You can nominate beneficiaries on the following types of investments, funds or policies:

1. **Life insurance policies** – nominations of beneficiaries are important to save executors fees and time, be mindful however of the liquidity needs of your Estate to avoid cash shortfalls.
2. **Living annuities** – often allow primary and secondary beneficiaries to be nominated; allows flexibility to the beneficiaries, and avoids the default lump sum payment to the estate which can cause heavy tax.
3. **Retirement annuities, Preservation funds and Retirement funds (Pension and Provident)** – although the final decision is made by the trustees of the retirement fund, beneficiary

nominations are important to relay your wishes. Retirement regulations dictate that your dependents take precedence above beneficiary nominations.

4. **Certain Tax-Free accounts** – Tax-free accounts created on a life licence allow you to nominate beneficiaries. This saves on time and executors fees.
5. **Endowment policies** – allows you to nominate beneficiaries for proceeds and in some cases beneficiaries for ownership to continue the policy. This saves executors fees.
6. **Profit share investments** – PPS's profit share account allows you to nominate both primary and secondary beneficiaries in a hierarchy. This saves executors fees.

It is also worth noting that your group benefits at work should also be reviewed. Take note of whether your benefits are "approved" or "unapproved" as this has bearing on how they are taxed in the hands of the beneficiaries.

If you would like to confirm, review or update the current beneficiaries on any of your policies or investments, please do not hesitate to contact us. We would be happy to confirm the current nominations and assist you with amending them where necessary.

Can taking on more risk lower your loss potential?

How can taking more risk mean you lower your risk of losing buying power over time or permanent loss of capital?

Let's start with setting the scene on two potential investments. The first is a fixed deposit with the biggest bank in South Africa on a 5-year fixed basis earning 9.77% nominal. The second is a global company listed on the JSE with a dividend of 8% per annum. Inflation we can guess would be between 5% and 6% over the next 5 years. For this example, we will use inflation at an average of 6%.

The first investment option is a fixed deposit earning you 3.77% above inflation and the latter 2% above inflation. A fairly good outcome in terms of real returns. Return is however just the one side of the equation as we need to consider risks. For most investors this will be an easy decision as you earn more on the fixed deposit, and it has "no risk". Is this however a true statement or does fixed deposits have risks we don't even consider?

Advantages

Fixed Deposit	Global Share
Certain outcome	Inflation can be passed onto consumers
No capital fluctuation	Global business means currency protection
	Not reliant on the consumer and habits of one country
	Could see price increases above inflation over time as the business perform well
	Dividends taxed @ 20%
	Capital gains tax is lower than interest and dividend tax

Disadvantages

Fixed Deposit	Global Share
No protection against rapid rising inflation	Outcome is not certain
No protection against a weakening ZAR	Capital fluctuation on closing market prices
Mainly reliant on SA consumer market which is fragile	
No chance for capital appreciation	
Interest income is highly taxable	

The advantages and disadvantages which we don't mention above, would be applicable to both investments. Something like interest rates coming down after making a fixed deposit means you are earning a higher rate than what is available on the market after the rate drop. An interest rate cutting cycle, in turn, is also good for global stock prices as the cost of capital decreases.

Just by looking at the advantages and disadvantages of the above-mentioned investment one would need to think a little harder in terms of your investment allocation. It is particularly important today in the South African context as the increased probability on a default, high inflation and a continued weakening of the Rand, are factors that will bode ill for cash deposits.

Understanding the risks is very important. It is imperative that one has an overarching view of your assets to see how the bigger picture looks and how diversified you are. The answer is never simple, and a diversified approach is almost always the answer. Cash deposits are very useful as short-term parking bays or for liquidity purposes in case of emergency but not they falter at protecting the buying power of you money in global terms or in case of state (or bank) failure.

FIANCIAL FAQ

"When times are tough, it is tough to invest but I know it is the right thing to do what seems counterintuitive."– ***Recent client comment.***

Which assets fall outside my Estate?

For South-African residents, their worldwide assets are included in their estate for estate duty and administrative purposes. Some assets are specifically excluded from your estate. An example is any retirement fund or living annuity, considering that these assets are taxable according to the retirement tax lump sum tables. Some assets also fall outside the estate for admin purposes and executor fees, buy fall inside the estate for estate duty purposes, these are called "deemed assets". An example here would be an endowment or life cover policy with beneficiaries nominated thereon because the beneficiaries receive the benefits directly without it flowing through the estate and executors' hands. Assets that are held in separate entities are also excluded from your estate (for example family trust assets) but be careful when dealing with a company as assets in a company are excluded but the share value falls inside your estate if you are a shareholder of the company. This list is not exhaustive but it provides a good overview.

My investment includes an asset class called "hedging/derivatives", what does this mean?

Most modern investments allow the incorporation of hedging and/or derivatives to some extent. Hedging refers to an investment that is intended to offset potential losses or gains that could occur on an investment component. A well-known hedge would be to protect against the weakening of a currency. Derivatives are not so easy to explain. The textbook would say that a derivative is an instrument, contract or security that *derives* its value from an underlying asset or assets. That is a very wide explanation. Sufficed to say it is a contractual agreement that dictates terms between two parties depending on the movement or outcome of a particular asset. An example would be an Option to buy 100 Sasol shares for R300.00 each in 12 months' time. One party would sell this option for say R10 per share, and the other would buy it. An option is only that, the option to buy or sell, so it could be useless if the share price is R265 in 12 months' time coining a profit of R10 per share for the option seller. However, if the share price is R395 in 12 months' time, it would be a bargain to be able to buy at R300 plus the original option price of R10 per share.

When do I cancel my life insurance?

This question comes up often when clients retire. Life insurance's main purpose is to fund outstanding debt and to fund living expenses for your dependents should you fall away. Some use it to fund a liquidity shortfall in their estate and some might want to leave it for their family as a boost in life. The answer however on when to cancel life insurance is simply when you don't need it anymore. For example, when you have no debt remaining, enough liquidity for your estate, and your dependents are self-sustaining. Most of us cannot afford to pay life insurance when we retire because the premium increases are normally too steep, and your retirement term might be 25 to 35 years. A gradual reduction in your life insurance benefit over time, as your liabilities decrease and your dependents fall out of your budget, is a good approach. It is however best to consider your objective situation carefully.