FinPlanCo

NEWSLETTER H1 Apr 2024

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1 DECISION MAKING: FACTS VS. OPINIONS

Behavioural finance plays a big role in your decision making. Identifying these can help with gathering the appropriate info.

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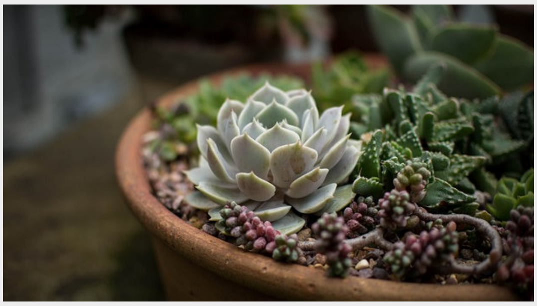
The two-component retirement system is set to be implemented in September of 2024. What does this mean and does this affect you?

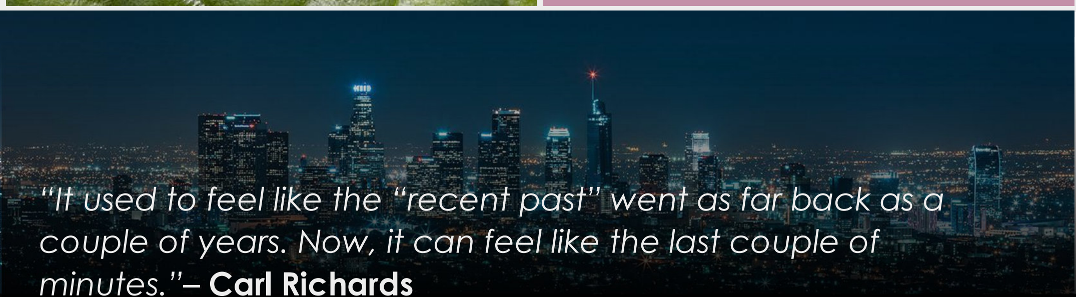
3 WHAT IS ESTATE PLANNING?

An article that expands on the estate planning principals and provides an overview of the process.



4 GROUP BENEFITS: APPROVED VS. UN-APPROVED

The wording sounds ominous but the differences are not.



"It used to feel like the "recent past" went as far back as a couple of years. Now, it can feel like the last couple of minutes." – **Carl Richards**

INTRODUCTION

This newsletter excludes the normal economic environment update and financial planning FAQ in favour of expanded FAQ articles. As introduction a short glossary of some staple financial terms from Investopedia:

Bond Coupon: *"… refers to the annual interest paid on a bond. Coupons are expressed as s a percentage of the face value and are paid from the issue date until maturity."*

Dividend: *"… is the total amount of money that an investor receives as income from owning shares of a company, or another dividend-yielding asset, during the fiscal year."*

Compound Interest: *"… is interest that applies not only to the initial principal of an investment or a loan, but also to the accumulated interest from previous periods. In other words, compound interest involves earning, or owing, interest on your interest."*

Effective Interest Rate: *"… the real return on a savings account or any interest-paying investment when the effects of compounding over time are taken into account. It also reflects the real percentage rate owed in interest on a loan, a credit card, or any other debt."*

DECISION MAKING: FACTS VS. OPINIONS

Carel Marx - There are various biases when it comes to the human psychology. As humans we tend to love a good story and we can believe it and convince others to do the same.

Perhaps we can highlight a few biases that we have picked up in ourselves and our clients.

Confirmation bias – this is the tendency to search for, interpret, favour and recall information in a way that confirms or supports one's prior beliefs or values.

False Consensus effect - refers to individuals' tendency to overvalue the prevalence of their own beliefs, values, and behaviours. It suggests that people often project their personal attitudes onto others, assuming these perspectives are more widespread than they truly are.

Bandwagon effect - refers to the tendency of people to adopt certain behaviours, styles, or attitudes simply because everyone else is doing it. The fear of missing out also ties into this effect as you hear about a product or event that sounds beneficial to others and you jump onto the bandwagon.

We are all familiar with Bitcoin (BTC). We think it would be a fair statement to say that most people, able and willing to invest, know very little about the functionality of the product and how to value it. We hear and read a lot about it, yet we cannot distinguish between fact and opinion because we have too little knowledge on the topic ourselves. Already we can see several biases coming into play. Most of us are probably just scared that we would be missing out on a chance to make a quick buck, so we jump onto the bandwagon. Others buy into the story that Bitcoin will be adopted by all countries worldwide and become the new global currency for payments, investments, and the pricing of assets (like the US Dollar at the moment).

The reality is maybe something we wish to ignore, and we desperately want to believe that the narrative is true. Bitcoin was invented in 2008 and used as a digital currency alternative in 2009. By 2011 it was trading at $1 a Bitcoin and +-13 years later it is trading at $64 000 a Bitcoin (+/- R1 200 000 per BTC at time of writing). Bitcoin has made some headway in terms of being a payment currency but nowhere close to be becoming the mainstream currency. Perhaps there are too many "reality checks" that prevents the narrative to realise. How would regulation work around one global currency and the payment systems proposed? Would tax authorities continue to have a clear view on transactions? What will a Big Mac cost once Bitcoin becomes the mainstream payment currency? Do we price it in US Dollar and then convert it to BTC? If we do that, is the US Dollar not again the actual pricing tool and BTC the secondary currency? Will a Big Mac cost the same in the US and in RSA because we both pay in BTC?

For interest's sake: a Big Mac currently (January 2024 price) costs $5.69 in the US and only $2.71 in RSA?

Let's bring our thoughts a little closer to home. We mentioned the price of a Big Mac in SA vs the US. The Big Mac index is based on the theory of purchasing power parity or PPP. This is the notion that prices should move towards the exchange rate that will equalise the prices of an identical basket of goods. Given an exchange rate of R19 on average, a Big Mac will cost you R51.50 in South Africa and $5.69 in the US. To get to the same price, the ZAR needs to trade at +-R9 to the Dollar. This is just one metric one could use to get an idea of where the Rand could trade. There are numerous other ways to also determine the approximate value to the Rand and yet all of them point towards a very weak or under-valued Rand at present.

The purpose however of this article is not to determine the actual value of the Rand versus any other currency but rather to the narrative that is playing itself out among everyday South African investors. The narrative is that one should invest offshore only as the Rand will forever continue to weaken and offshore stocks, mostly US stocks, will forever continue to move up. You either get onto the moving train or you will be left behind in the worthless Rand.

Could much of the Rand weakness actually not linked to our poor performance as a nation? Could it be that most of the Rand weakness is caused by other factors happening around the world and the Rand is merely reacting along with a basket of other emerging market currencies (high risk currencies)?

In the year 2000 we had the IT or tech bubble burst called the "dot-com crash", but we also had a little story doing the rounds, called the Y2K bug. At this point, few people understood software, the internet and how to program a computer; and as such few could distinguish between facts and opinions. Without going into a lot of detail, it ended up being a very low impact story.

This article was not written to discredit Bitcoin or to indicate that the Rand is moving back R9 to the Dollar. The idea is that we all need to train our brains to be more objective. Don't jump onto a moving train because you like the idea or you are scared you might lose out or perhaps think it's the last train, it's now or never. Try to distinguish between facts and opinions and perhaps rely rather on probabilities and try to get those in your favour. Make decisions on facts and not on someone's opinion unless that opinion is driven by professional understanding and fact. Always remember that news you read or hear would be priced into the asset you are considering at that point in time, only new information would move the price.

What is meant by an asset's valuation?

In South-Africa the asset managers generally agree that South-African growth asset valuations are low and attractive. They see a long term investment opportunity from these low valuation levels. But what is meant by the "Valuation" and what makes it "low", "fair" or sometimes "high"?

The easiest way to explain this is by considering the valuation of a company's stock. Here investors and asset managers have different techniques or processes to determine the true worth of the shares or the fair market value of the business. A value therefore seeks to determine the intrinsic value of the company and its shares.

There isn't a single formally to determine the valuation and there are various ways of estimating the value. Generally, you are trying to determine the assets, prospects, growth trajectory and financial strength of the company. Then you use these metrics to estimate a combined value. You can consider the assets of the company using the "Net Asset Value" or you can discount the future cashflows expected for the company to determine a value for today. You can also value the company relative to its peers or use valuation ratios such as the Price to Earnings ratio or the Price to Book Value ratio.

When asset managers or investors say that a valuation of a share or asset is low, it means that it is less than their calculated intrinsic value. When they say it is high, it is over their intrinsic value estimate. Fair would be close to or in line with their estimated value. At the core of investing lies valuation because you are always comparing the price of the asset to your estimated fair value thereof. If a bread is worth R20 to you because of the ingredients, time, energy and effort needed to create it and it is on sale for R10, it would be a bargain to you. Always bear in mind however that not everyone's calculated value is the same, some would be willing to pay more and others less.

UNPACKING THE TWO-POT RETIREMENT SYSTEM

Wilhelm Tempelhoff - South-Africans will again see a large shift in the rules governing their pre-retirement savings on the 1st of September 2024. Here we unpack new rules and the considerations in this regard.

From the 1st of September 2024 contributions made into a retirement fund (including provident funds, pension funds, retirement annuities and preservation funds) will be split between a savings component (1/3rd) and a retirement component (2/3rds).

The savings component can be accessed at any time prior to retirement via one allowable withdrawal per year with a minimum withdrawal amount of R2000. Importantly this withdrawal is taxed at the member's marginal tax rate. Marginal tax rate refers to the tax rate applied to any additional income a person earns above their current annual income. At retirement the only portion of your retirement fund that is accessible as a lump sum retirement withdrawal will be the remaining savings component value, taxed according to the retirement lump sum tax table. If you do not have any amount remaining in the savings component at retirement, you have no lump sum retirement withdrawal amount available.

The retirement component cannot be accessed until retirement. This component cannot be withdrawn at resignation and at retirement it must be fully used to purchase an annuity. No retirement lump sums are available from this component unless the combined value of the fund (savings and retirement component combined) is lower than the legislated minimum at the time of retirement (currently R247 500).

There is however a third component that needs to be discussed: the vested component. This refers to the amounts already accumulated in your retirement funds before the implementation date of the new rules. This component will follow the existing rules which for example would allow a member of an employer's provident or pension fund to still make a 100% withdrawal from this component at resignation. The current rules apply to this component and the growth on this section of your fund.

To make things more confusing your vested component will be categorised as either "vested rights" or "unvested rights". This refers to the nature of your accumulated benefits and whether it is pension fund, retirement annuity, or provident fund based. Provident fund contributions made before 1 March 2021, or for those who were 55 years of age or older on this date their continued contributions included, will be considered vested components with vested rights. In other words, the right to still access 100% on resignation or 100% at retirement remains in place. Contributions made to pension funds and retirement annuities before the 1st of September 2024 as well as contributions to a provident fund between 1 March 2021 and 1 September 2024 will be considered vested components with unvested rights. Meaning that the rules that applied between 1 March 2021 and 1 September 2024 will still apply to these benefits. Rules such as being able to access 100% at resignation for pension fund benefits or the fact that you can only access 1/3rd at retirement.

It is therefore fair to say that it is the "three-component retirement system".

Although not finally confirmed, the plan is that retirement fund administrators will have to "seed" the savings pot of all members with 10% of the vested pot at implementation date. This is however limited to 10% of the value or R30 000 whichever is the larger.

Those who were members of provident funds on the 1st of March 2021 and older than 55 on this date, are excluded from the new rules. They will have vested rights on their current fund and contributions going forward. These members may however choose to form part of the new system. What is called legacy retirement annuity policies, beneficiary funds and unclaimed benefits funds are also excluded from the new rules.

It is perhaps useful to consider a few examples:

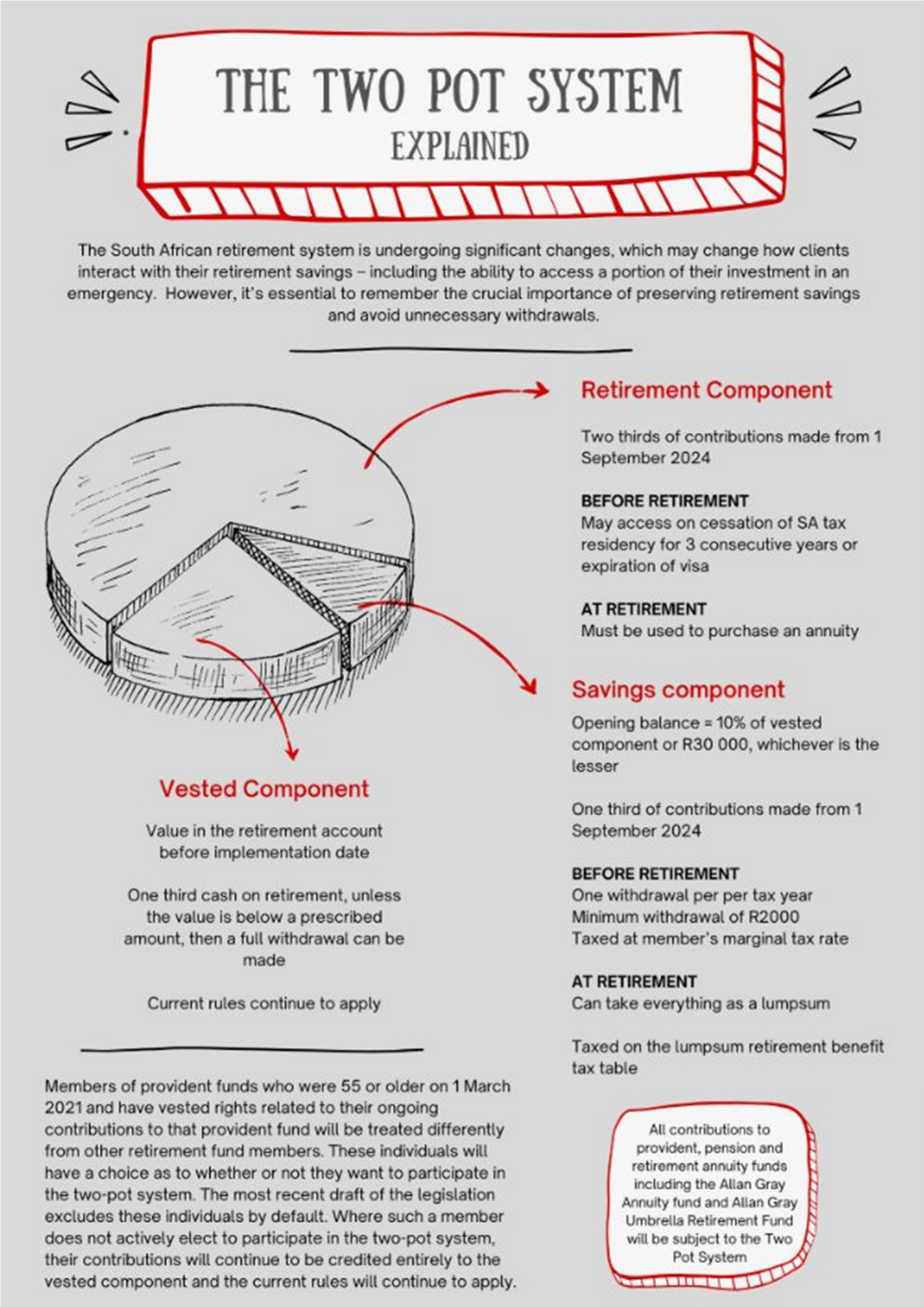
Cathy is 45 years old and currently lives in the UK. She has a South-African Pension Preservation fund worth R300 0000 which was created when she left her employer 6 years ago. She would like to study further in the UK and needs to free up her full preservation fund to fund her studies. In this example Cathy should think about making her one allowable pre-retirement withdrawal from her Pension Preservation fund before the new rules kick in. This is because under the current rules she would pay tax on her withdrawal according to the lump sum withdrawal tax table but if she waits 10% of her fund (up to R30 000) will be moved to the savings pot on 1 September which will be taxed more onerously using her marginal income tax rate.

Next, we have Martin who is 62 and is a member of his employer's provident fund. Martin has been working for the same company for decades. He plans to retire at age 65. Martin does not need to worry about the implications of the new rules because he was over 55 on the 1st of March 2021 so his Provident fund benefits are vested with vested rights and his monthly contributions would be too. Martin will still have the options he had before 1 March 2021 regarding his provident fund.

Thato is a young CA who started working for a large auditing firm after graduation in 2020. He joined the company's group retirement fund (a pension fund) and has been contributing to the fund for the last year few years. Thato would like to move to Canada soon. The new rules will apply to Thato's retirement fund although his accumulated benefits up to 1 September 2024 will be considered vested with unvested rights (pension fund rules). If Thato resigns before 1 September, he would be able to withdraw his full pension fund value and be taxed under the lump sum withdrawal tax table. If, however he works another year or two, Thato would only be able to withdraw his accumulated benefits up to 1 September 2024. He would only be able to withdraw the value of his savings component built up after 1 September 2024 and he would need to preserve his benefits of the retirement component until he either retires (min age 55) or breaks tax residence with SA and three years have passed.

Karin has a retirement annuity (RA) fund with Ninety One worth R1.5mil; she is 40 years old and contributing R3 000 per month to her RA. The new rules will affect Karin but benefit her as well. On the 1st of September Ninety One will allocate 10% or up to R30 000 of her RA value to a savings component, allowing her emergency access to her RA for the first time ever. Karin's monthly contributions after 1 September 2024 will be split between a savings and retirement component. If Karin plans to retire normally at age 65 for example and never makes any withdrawals from her savings component, the new rules should not affect her because she still has effective access to 1/3rd of her value as a retirement lump sum and 2/3rds must go to the purchase of an annuity post-retirement.

The infographic below, courtesy of Allan Gray Investment Services, provides a good summary of the working of the new rules.



MARKET TIMING IS IMPORTANT

Carel Marx – The price you pay for an asset and the timing of a cash flow affects return and risk

Returns

Consider the following scenarios:

Person A invests R120 on a Jan 2023 into the JSE All Share index which returned 10% for the period ending 31 December 2023. Person A ends up with R132 at the end of the calendar year.

Person B invests R10 per month in the JSE also starting on the 1st of January 2023; the returns however expressed in monthly terms were 10% in January 2023 and then 0% for every month thereafter. The JSE as is the case for person A returned 10% for the year but person B ends up with R121 or a 0.83% return in the same year.

We often receive or look at 12 month return numbers in the same light as an investor like Person A. We forget the fact that in many cases we have multiple cash flows during the period under review and this could have a massive impact on the return outcome.

In a period where performance is positive, the earlier you have all your money invested the better. In periods of downturn, something like a debit order investment will reduce the pain and you will receive an average price lower than the initial starting point.

Sequence of returns

Let us assume a person is retiring today at the peak of their financial wealth with R10 mil. The person would be taking R500 000 per annum as an income but paid monthly R41 666. The income equates to a 5% withdrawal per annum of the starting capital value.

If we assume this retired person invested in an investment that returned -0.5% per month or -6% for the year. Their holding period return based on capital values is -10.7% but the internal rate of return was -5.7%. So, return wise you are down only 5.7% but capital wise you are down 10.7% (negative market movement plus the withdrawal).

The following year you want to retain at least the same income but to receive R41 666 per month on a lower capital value of R8 929 751, you need to withdraw 5.6% of the capital amount.

In order to get back to the original R10 mil capital investment, you would need to earn 1% per month for 20 months in a row or cumulatively 20% over this period or alternatively if your investment could return 12% in month 13, it would also put you back on the R10 mil original investment amount.

The point here is that returns in your initial retirement years make a difference and income withdrawals amplify any negative market movement. Again, timing matters here and your investment and risk approach in the formative years can have a large bearing on your retirement success.

Risk (Margin of safety)

We might not be able to perfectly time the market but it is possible to buy an asset at a price below its perceived market value. Without getting stuck into too much of the details, if an asset it considered to be worth R100 and the price comes down to R80, the price has dropped 20%. If you believe that the price should move back to R100 then it might be an investment opportunity but what if we are wrong? If the price now moves even lower to say R60 then we lose 25% since our purchase price was R80. If we bought however at R100, our loss would be 40%.

Asset managers use price to reduce future risks of losing money. Think about Nvidia shares currently trading at $824 per share. The price at the start of 2024 was $481 and the peak of the share price was $950. Perhaps we can assume the "fair price" is somewhere between $481 and $950? The market currently is saying a "fair" share price is $824 but to get this price we need to assume certain growth projections into the future. If these projections are unsustainably high then chances are, they will disappoint the market and the price would need to come down, but the opposite is also true, and the price could go back to $950. The point is, you know where the share price started and you know the peak price, the closer you can buy to the $481 level the more protection you build into further stock price losses. Risk in our view is the chance of permanently losing capital and by being price sensitive, you can enter a position at a lower price reducing your capital at risk.

Conclusion

When we refer in the title to the importance of market timing, we are by no means suggesting that we have the ability to do market timing by buying securities or assets at the bottom and selling them at the top. The key take aways from the above should be the following: 1) cash flows make a difference to your return outcome so be mindful when comparing a holding period return versus an internal rate of return. 2) Your starting point when entering into an investment does matter and is especially important for newly retired individuals that doesn't have the time and the income to recover from a bad investment start. 3) If you know the history of an assets price, then you know the highest, lowest and perhaps the average price. Avoid paying the price at the top (example buying Nvidia at $950). The lower the price you pay, the lower the risk of having large losses in the future.

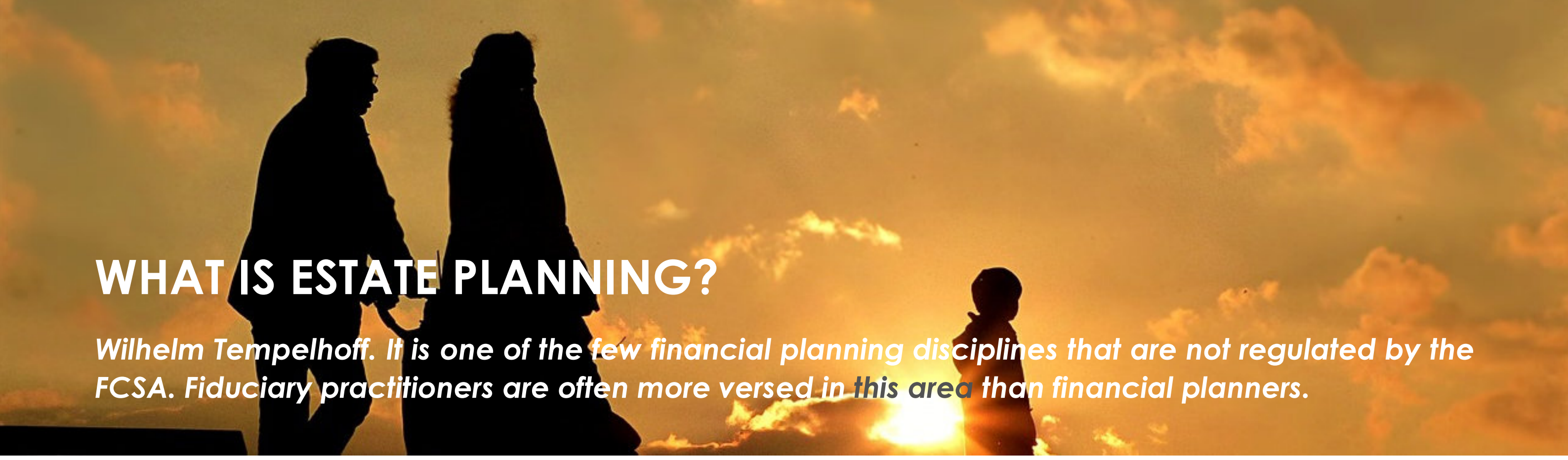
What is a Living Will?

A Living Will is a document that details your preferences for medical care in the event that an illness or accident prevents you from communicating your choices. It is written at a time when you are "compos mentis" and the prescriptions therein can persist even when you are no longer "compos mentis". This differs to a power of attorney which falls away when the person providing the POA is no longer compos mentis.

A Living Will acts as a guide for your loved ones and medical professionals, letting them know which treatments you support or oppose and making sure your beliefs and preferences are provided. It is addressed to your family and personal doctors who may need to implement or ally to the court for enforcement thereof. Living Wills are however not yet recognized by SA statutory law. Each person has a right to reject or accept medical treatment and the SA Constitution supports this. In practice however, if there is the slightest chance of a person's recovery, Doctors or family members do not have to comply with the Living Will.

When you draw up a Living Will you can dictate your preferences on matters such as tube feeding, life support systems, and pain management. The South African Medical Association (SAMA) provides guidance, and an example of a living will at the following link:

https://www.samedical.org/files/guideline_living_wills_and_advance_directive.pdf
It is a good idea to approach a qualified fiduciary specialist or financial planner to assist you with drawing up a Living Will.



WHAT IS ESTATE PLANNING?

Wilhelm Tempelhoff. It is one of the few financial planning disciplines that are not regulated by the FCSA. Fiduciary practitioners are often more versed in this area than financial planners.

It is inevitable that we will all pass away. We hope to all be blessed with a long and happy life but sometimes this is not the case. While we do not know when our time comes, we can make plans to ease the burden of doubt and uncertainty our passing causes our loved ones.

This is where the practice of Estate Planning comes in. Investopedia defines Estate Planning as "*…the preparation of tasks that serve to manage an individual's financial situation in the event of their incapacitation or death.*"

South-African estate plans all following a basic structure or flow:

Step 1 is usually to consider your current situation by gathering the details of your assets and liabilities and understanding your familial structure in general.

Step 2 considers the liquidity in your estate and seeks to quantify the estate duty, executor's fees, Master's fees, other liabilities, and the income needs of your spouse and/or dependents.

Step 3 then contemplates strategies to improve your current outcome by for example minimising estate duty, improving the structure of investments, pegging the value of the estate, or transferring wealth to your spouse.

Step 4 then looks to testamentary planning which covers a valid, up-to-date Will, distribution plans for the assets including bequests, guardianship and maintenance of minor children and ensuring the financial security for the spouse and dependents. This can include a living-will which dictates your wishes when you are on life support.

Each person's situation is different, and their asset and liability bases are also different. There is no one-size-fits-all solution with estate planning and more complex estates need more complex estate planning. For example, where a person has large business interests, estate planning may need to be supplemented by continuity planning as well.

If you pass away without a valid Will your estate is distributed in terms of the Intestate Succession Act where your spouse and descendants share equally in the estate. The spouse must however receive at least R250 000 and if you have no descendants the spouse will inherit your full estate. If you have no spouse and no descendants, your parents will inherit and failing them your siblings.

South-Africans have freedom of testation which gives you the freedom to dictate how your estate should devolve and dispose of your assets as you deem fit. You are therefore not obligated to bequeath your estate to anyone (forced heirship).

A Will must be in writing, and it can be written by hand, typed, or printed. The testator/testatrix must sign the Will at the end and if there is more than one page, each page should be signed. The Will must also be signed in the presence of at least two competent witnesses. All participants must sign in the presence of each other. In the meantime, it is important to "live your best life" as Gen Z says. To do this you need three simple things: someone to love, something to look forward to, and something to do (a reason to get up in the morning).

GROUP RISK BENEFITS: APPROVED VS UNAPPROVED.

Wilhelm Tempelhoff – approved and unapproved benefits have different tax consequences and considerations for your estate and beneficiaries. We take a look at the general differences here

Often employees will have group risk cover as part of their group benefits with their employer, providing them with benefits like life- and disability-cover. Group risk benefits can either be approved or un-approved, referring to how these premiums and benefits are treated from a tax and claims perspective.

The principles are best illustrated by way of an example: Consider Dana who has a pension fund benefit of R500k and a life cover benefit of R1mil with her employer's group scheme. How are these benefits treated at her death?

Approved group life benefit: Dana's pension fund is an approved fund and if her life cover part of the fund with premiums paid by the fund, it is also considered an approved benefit. Dana's monthly premiums for the life cover would be tax deductible against her salary (subject to the normal retirement contribution limits of 27.5% of her taxable income or remuneration, maximum R350 000 per annum) because they are part of the contributions to the retirement fund. The retirement fund then pays the premium for the life cover component. There would be no tax consequences as a fringe benefit for Dana.

The R1mil proceeds from her life cover will form part of your retirement fund value making her total retirement benefit R1.5mil. This R1.5mil will not form part of her estate for estate duty purposes and her executor will also not charge a fee on this asset if the proceeds do not pay into the estate. If Dana nominated beneficiaries on her benefits, the trustees of the retirement fund will consider her circumstances and dependents before allocating the benefits according to Section 37C of the Pension Funds Act. Although they will consider her beneficiary nominations, they have the final say and will favour dependents. This decision can take 12 months as the trustees request detailed information. Dana would only have one set of nominated beneficiaries.

Once the allocations have been confirmed the beneficiaries will need to decide whether they convert the benefits to an income providing annuity (income is subject to income tax in their hands) or take the benefits as a retirement lump sum withdrawal (subject to retirement lump sum tax using Dana's history) or a combination of both.

Un-approved group life benefit: Dana's pension fund is approved but her life cover does not form part of the fund, it is a separate policy completely. In this case the life cover benefit is un-approved, and her monthly premiums will not be deductible against her income. If Dana's employer pays the premiums, this will be a fringe benefit and added to her salary for her income tax calculations. Seeing that Dana will not receive a tax deduction for these premiums, the proceeds from the life cover are free of income tax and lump sum retirement tax.

The proceeds from Dana's life cover benefit will be paid to her nominated beneficiaries in a reasonably short timeframe (requirements are usually a simple form, a copy of the death certificate and other supporting documents) or to her estate if no beneficiaries are listed. Dana's beneficiaries on the approved retirement fund will claim according to the approved section above subject to

Section 37C. Dana would have two sets of nominated beneficiaries, one for the retirement fund and one for the life cover policy.

Although the retirement fund section is still not an asset in her estate, the life cover benefit is and will form part of the estate duty calculations (excluding the benefit paid to her spouse) and executor's fees will apply unless beneficiaries were listed on the life benefits.

The example above only considers a life cover benefit, but group risk benefits can include dread disease cover, disability cover, income protection and funeral cover.

You will notice from the above that the wording of "approved" and "un-approved" does not indicate that one alternative is better than the other, they are just different with their own pros and cons. If you are unsure whether your group risk benefits are approved or unapproved, just reach out to your HR department and they should be able to provide you with more detail.

It is always a good idea to keep your beneficiary nominations up to date on all the group benefit components and to understand what the after tax benefits could look like.