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PROFICIO

NFB FINANCIAL UPDATE

View from the **Chair**

Don't ignore the present, but maintain your long-term focus.

There is a lot going on in our lives right now - politically, socially, economically, and personally. I thought I would reflect a little on several of these, focusing on markets and investments and reminding us of the importance of balance, enjoyment, and the long game. While they are somewhat dull, getting investments right makes life a lot easier and safer.

Advisory firms, like NFB, earn income by providing advice and service to thousands of (predominantly) South Africans. We are all living through a once-in-a-lifetime experience: Vax versus anti-vax, work from home, calls for compulsory returns to offices, fundamental changes in real estate and office rental markets, the dramatic revolution in online “everything” - all of which are impacting on people's perceptions and their approach to life in general.

The realisation of mortality, and our vulnerability to a disease that seems to continuously morph into a new strain, are everyday discussion points. Loneliness, cabin fever, and sometimes a sense of hopelessness are ever-present and probably need us all to be watchful, both for ourselves and others about whom we care. I've seen some rather hilarious memes of dads being escorted back to the office by their young kids, with the kid suggesting that the dad not worry, and it'll be OK! Families, communities, and circles of friends have become more important, which is a great positive out of what has otherwise been an annus horribilis.

Onto markets and investments. Some say we are just at the beginning of an upward correction as the world comes back from Covid. I would argue that the developed world has extended (having recovered from Covid) one of the longest and strongest bull markets in recent history. SA largely missed this and remains reasonably attractive in terms of SA Inc stocks, some of which are still offering good value. However, we are part of the global village and remain sensitive to developments and trends.

Inflation is a hot topic. While it serves the political agenda to have the Fed, BoE, and other monetary authorities suggest that this inflationary experience is a passing phase, it seems that housing, commodities in general, labour in developed countries, and other important determinants of sustained inflation are way above trend, and in some cases radically higher. This can be disregarded but will eventually lead to a steeper correction in rates when the authorities relent and act. As investors, this means that this one-way bet on continuous growth in stocks and other assets is fast approaching a point where more scrutiny of the downside is needed. The impact of rates increasing is twofold - it gives investors an alternative to holding riskier shares and earning dividends and also makes borrowing more expensive.

Another issue for all of us South Africans is the debate about the rand. Recent years have endowed SA with some wonderful demand for our resources and other goods, even more so during this Covid period. When the world is growing or repairing itself, as has been the case, resource-based economies thrive. In SA, this has not only materially improved our balance of payments, but it has also provided SARS and Treasury with massive, unexpected tax revenue. This also overflows into other areas of the broader economy, both directly linked to mining and resources, but even broader. Like all good things, these tailwinds don't last

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> *... we need significant long-term capital investment rather than "hot flows" into our share and bond markets.*

Mike Estment CFP®
Executive Chairman
NFB Private Wealth Management JHB

Investing **tax-efficiently**

Considering the tax implications of your investments is critical when building your portfolio.

Investment returns serve as the fundamental metric by which to measure performance. Whether invested in equities, bonds, property or alternatives, people become fixated on the percentage growth of their money. However, many people do not consider the material manner in which these returns are compromised by poor tax planning. Essentially, certain investment vehicles are more tax-friendly than others, while some come with certain restraints, such as liquidity clauses and maximum lifetime contributions.

Unit trusts

Unit trusts are one of the most common and well-known investment vehicles in the market. They are highly flexible in that they are not confined to any regulation regarding their underlying asset allocation. Furthermore, these investments are fully liquid, with the proceeds from the redemption returned to the investor within five working days from submission. However, this flexibility and liquidity comes with a drawback in terms of a lack of tax efficiency (for those with a higher average tax rate).

A capital gains event is triggered where you decide to sell or switch part or all of your investments (units in a unit trust). Currently, 40% of any capital gain is included in your annual income; this equates to a capital gains tax (CGT) rate of 18% for individuals paying the maximum 45% marginal tax rate. Also, note that each individual is allowed a R40,000 annual capital gain exclusion. As a simple example, suppose an individual with a marginal tax rate of 45% invests R1,000,000 into a unit trust. The investment then grows to R1,500,000. At this point, the investor decides to terminate the investment. The CGT payable by the individual would be R82,800 (growth less the R40,000 exclusion, multiplied by 18%.) Therefore, the individual's real profit on the investment of R1,000,000 would be R417,200.

Tax-free savings accounts

Tax-free savings accounts (TFSA) allow you to invest without paying any tax on the growth (capital gains, interest or dividends) of the investment. Individuals are permitted to contribute R36,000 per tax year, up to a lifetime limit of R500,000, into a tax-free savings account. Generally, TFSA's are best suited to long-term investments so that the tax benefits compound over time. Furthermore, it is important to remember that this annual or lifetime contribution does not "reset". For example, if you put R36,000 into a TFSA at the beginning of the tax year but then withdraw R20,000 from this investment vehicle three months later, you will be unable to make further contributions until the start of the next tax year.

TFSA's are great savings vehicles for young people starting their investment journeys. Aim to max out the R36,000 allowable annual contribution. Remember, you can do this by way of a single lump-sum contribution or by smaller amounts on an ad-hoc basis. You can also achieve this by starting a R3,000 monthly debit order at the start of the tax year.

Retirement annuities

Retirement annuities (RA's) are tax-efficient investment products used by individuals to save for retirement either when an employer does not provide a pension fund, or when they wish to maximise allowable deductions by saving more than the amount contributed by the employer. The incentive to save using a retirement annuity lies in the fact that any contributions, up to the lower of 27.5% of your gross income or R350 000, are tax-deductible. The amount contributed to the retirement annuity reduces your taxable income for the year.

Any capital gains, dividends or interest income received within the product are not taxed. Switches between funds within a retirement annuity are also free from tax, thus enhancing the overall flexibility of the investment.

Although the growth within a retirement annuity is not subject to tax, withdrawing from one is (to an extent). When retireing, individuals can make one tax-free lump-sum withdrawal up to the lower of R500,000 or one-third of the total value (there is a discrete tax table used to calculate the tax on lump sum withdrawals above R500 000). The remainder must be transferred to a compulsory living annuity, where an annual drawdown rate of between 2.50% and 17.50% is set to sustain your income needs during retirement; the income is taxable.

Retirement annuities are subject to Regulation 28, limiting the extent to which retirement funds may invest in a particular asset or asset class. Although this is for protection purposes, it may come at the expense of growth within the portfolio.

Ensuring that your investments are structured tax-efficiently is arguably just as important as their performance.

Endowment policies

Endowment policies are tax-efficient investment options for individuals with an average tax rate greater than 30%. These investments are subject to liquidity constraints during the first five years (the restricted period), during which time investors are allowed one interest-free loan and one surrender of the policy, limited to capital invested plus 5% per annum. After the restricted period, the endowment becomes fully liquid, allowing for ad hoc and regular withdrawals.

Offshore endowments tend to differ slightly in their liquidity and offer multiple surrenders during the initial five-year period. This provides the investor with the benefit of extra liquidity during the initial five-year restricted period. Interest income within an endowment is taxed at 30% instead of 45% for top income earners, and capital gains are taxed at an effective rate of 12% instead of 18% for investors in the highest tax bracket.

Ensuring that your investments are structured tax-efficiently is arguably just as important as their performance. Getting the balance right between tax efficiency, liquidity and flexibility of the underlying assets is the key to a successful investment portfolio that can help fund your retirement, pay for that overseas holiday, or pay for your child's education. Always seek advice and consider the tax implications when looking to invest your hard-earned money. ■

> “… *many people do not consider the material manner in which these returns are compromised by poor tax planning.*”

Jonathan Braans
Private Wealth Manager
NFB Private Wealth Management JHB

View from the **Chair**

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forever. Looking at high-grade iron ore as an example, the remarkable price increase was followed by the price halving in a very short period. This price change, together with those of other goods, might leave SA's rand high and dry should this demand weakness persist. Let's hope I'm over pessimistic and the global demand for "stuff" resumes and continues!

Politics and economics remain very fluid in SA. The indecision and lack of action following the Zondo process, the recent unrest, and the continued exposure of crooks we all know exist leads to anxiety. This makes us all very nervous. We worry about when to take allowances offshore, get very excited when the rand goes to 13 something, but quietly panic when it is back at 15, and we delayed buying dollars in the hope that it was on its way below 13 (ring any bells?). Interestingly, overseas investors see things differently. They continue to trade the currency. However, we need significant long-term capital investment rather than "hot flows" into our share and bond markets.

In summary, I am beginning to consider deferring new, riskier investments in the belief that we are closing in on a time where the market will display better value.
This does not suggest investors bailing out of portfolios, but rather careful consideration of the markets, changing circumstances, and choices available.

NFB offers structured products from time to time. These allow one the advantage of exposure to equity returns while providing downside protection should markets soften. I often use a phrase that refers to the tree and the fruit. This suggests taking some of the profit (fruit) off the table while leaving the original portfolio deployed (tree). Investments and portfolios are most often unique to individuals.

We would be delighted to discuss this content, your portfolio, and the market at large with you. Please reach out if we can help. As always, we thank you for your support and for the many referrals we receive from you. ■

Investment properties: **should I pay cash or make use of a bond?**

While growing up, many of *us have probably been told that "bricks and mortar are good, and debt is bad"*. While there is some merit to this statement, it's based on the perception that debt is acquired for consumption purposes rather than acquiring an investment property – an asset that can generate a passive income while also benefiting from long-term capital appreciation.

The financing decision generally follows the decision to purchase an investment property. Will it be more beneficial to acquire the property by using a bond or paying for it through a single cash payment? This would only be a question for investors with sufficient liquid capital to cover the purchase price and the related acquisition costs, generally ranging from 8% to 15% of the purchase price.

For this comparison, we will assume that the investor has access to the required liquid capital to purchase the property outright and cover all the associated costs. The investor, therefore, only needs to weigh up the costs and benefits of each financing option.
The table below presents a summary of the pros and cons of acquiring an investment property by way of cash or a bond.

It is not a given that an investor with sufficient liquid capital to purchase the property through a single cash payment will elect to do so. An investor should weigh up the pros and cons of each financing option and decide based on what they view as important.

For most individuals looking to acquire an investment property, the decision to purchase the property through a single cash payment is not an option. Bonds allow individuals with access to smaller pools of capital to become property investors and reap the rewards of such an investment.
If used prudently, debt can assist individuals in building investment portfolios that generate passive income streams well into the future. ■

Cash Pros	Bond Pros
• No interest payments on a 20 or 30 year home loan. • Avoid exposure to potential rises in interest rates. Avoid the worry about being approved for a loan and having to pay bond registration costs. • Cash buyers are more attractive to serious sellers - may even enable you to negotiate a better price.	• Tax deductibility of interest. • You maintain a more liquid position by only funding the deposit and paying bond registration fees upfront. • You have additional liquid capital available to invest in other income-generating investments. • In the event of an emergency, you still have access to a cash reserve.

Cash Cons	Bond Cons
• In an emergency, you don't have access to a cash reserve as your capital is tied up in the property. • In terms of portfolio management, you are heavily exposed to a single asset/asset class.	• Exposed to potential rises in interest rates. • Risk of defaulting tenants and having to cover repayments out of your pocket. • If you repay over the bond's lifetime, the total amount paid is considerably higher than the original purchase price.

"If used prudently, debt can assist individuals in building investment portfolios..."

Jason Smith
Private Wealth Manager
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