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NFB FINANCIAL UPDATE

View on the Horizon

Are your investments bearing fruit?

In this article I take inspiration from NFB's last "View from the Chair" editorial in which Mike Estment mentioned that as he approaches retirement, he has begun to "leave the tree but trim the fruit".

This is similar to an analogy that I have been using for some time with my clients in which I explain how fruit from an orchard can be compared to the yield from your investments. Both require time and patience but once your "tree" is fully grown, the amount of fruit you can harvest depends on how well you care for your tree.

How are investment returns made up and how is that important to the shorter- or longer-term investor?

Interest rates and yields have been low for a while but recently, with inflation pushing higher after years of stimulus yields from certain assets classes are starting to look attractive.

Investment returns are often made up of two components, namely an income and a capital growth component. Some asset classes such as cash or bank deposits consist only of interest or yield, while some equities don't pay dividends and are all about growth in the asset price. For the younger set or those still working, the income component is not important for day-to-day expenses, so these yields (or fruits) are re-invested. These investors want their tree to grow and want more trees in their portfolio orchard so that one day there is sufficient fruit/income that can be borne by the portfolio. This ensures the portfolio can continue to grow whilst the yield covers the income requirement.

So, are our markets (and your investments) currently bearing fruit?

Cash rates are now close to 6% for money market, with rates as high as 8% over 2 years and more than 9% for 5 years.

Longer-term Bond yields are looking particularly attractive with earnings north of 11%. Bonds are not without risk but the coupon on offer should more than compensate. Rates have moved out to levels last seen during the Covid sell-off.

Income Funds, which focus on shorter dated bonds, fixed interest, and bank instruments as well as property, are yielding around 8%.

Property has long been a provider of a solid income stream along with some capital growth prospects. Covid exposed the risks in property, but this battered and bruised asset class has recovered strongly and is starting to present some good opportunities. Yields or rental distributions are back on track and providing double digit returns. Capital valuations have not yet returned to pre-Covid levels and there is still room for this to re-rate, giving investors an opportunity to lock-in on a good income stream with some capital upside.

As equity markets have been under pressure, equity prices have fallen. This does not only provide capital growth opportunities with some reasonable entry points, it also makes the dividend yields look more attractive. Simply put, dividends are the share of profits not re-invested into the company but instead, is paid out to shareholders. Many companies have restructured through Covid and have been able to release more capital to investors by the way of dividends. A good example is the mining companies that have benefited from the recent commodity boom. Rather than dig more holes in the earth, they have paid out these profits in the form of dividends, some of which have been as high as 8%.

Our own equity partners, NVest Securities, manage specific mandated equity portfolios that have an income focus.

An example of this would be their Dividend Growth, Income Growth and Living Annuity portfolios where yields are between 5% and 7%.

continued on page 4

> ***"With inflation pushing higher after years of stimulus, yields from certain asset classes are starting to look attractive."***

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The market has crashed. Now what?

Why you need to sit tight and let the market recover.

This time it is different. These, in my opinion, are the most dangerous words that can be thrown around during a market correction or crash. Whether it was the dot com bubble burst, the USA subprime crisis, the COVID crash, or the current inflationary environment and turmoil in Eastern Europe, people tend to panic when markets go down. This in spite of the fact that history has shown that markets (over the long-term) are resilient and invariably bounce back.

As financial advisors, one of our primary jobs is to assist clients in staying unemotional and help them navigate through times of volatility in the market. This is often easier said than done. At the time of writing, the MSCI ACWI (All Countries World Index) is down 18.80% year to date in ZAR. SA Equities have fared slightly better but are still down roughly 8.50% as per the All Share Index. With this in mind, it is important to ask the question of what to do when volatility is prevalent in the market and what the best course of action really is.

Invariably, when markets are down, nobody is happy. Clients, fund managers and financial advisors all want to see markets running and growth in clients' investments. However, this is simply not how markets work. One of my favourite quotes on market volatility comes from Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's right-hand man: "If you can't stomach 50% declines in your investment, you will get the mediocre returns you deserve." Corrections and crashes are fundamental components of any healthy market.

What can we learn from historical market performance?

First, that the stock market is naturally cyclical, with major falls of around 20% to 50% every 8 to 10 years on average. However, despite these crashes, the market has still produced returns of 12.90% on an annualised basis. This means if you invested R1 000 in 1976, you would have R265 412 today. However, it is important to go one step further and consider the real return the market has provided since 1976 (i.e. over and above inflation). Average inflation in South Africa over the last 46 years has sat at around 8.70%. This means that R1 000 in 1976 would be the equivalent of only R46 737 today. This tells us how the market over the last 46 years has substantially outpaced the rate of inflation.

The behaviour gap is a type of behavioural bias that is widely spoken about in investment circles. Put simply, it is the difference between the rates of return that investments produce when an investor makes rational decisions and the rates of return investors actually earn when they make choices based on emotions. Now that we've seen evidence of the resilience of markets, we should look at how investors can utilise certain strategies (or behaviours) in order to minimise the impact of a stock market crash on their investments and mitigate the adverse effects of the behaviour gap.

Resist the urge to panic sell

During a market downturn, selling your investments might seem like a good idea. However, historical data shows us that in 10 of the last 20 years, the gap between the best and worst performance days of the S & P 500 was less than 40 days. This is the key reason why the strategy of timing the market does not work well and results in investors selling their investments at low prices. Rather sit tight and give the market time to recover.

Create an emergency spending fund

A great way to protect yourself from the effects of a market crash is to ensure you have an emergency fund that is protected from market volatility. In reality, a stock market crash impacts a lot more than the value of your portfolio. It can have an impact on things like inflation, consumer spending, and employment. Having a 'nest egg' that you can use for emergency spending needs as they arise is therefore of paramount importance as it negates the need to drawdown on any equity investments you may hold during times of volatility.

continued on page 4

> ***"The behaviour gap... is the difference between the rates of return that investments produce when an investor makes rational decisions and the rates of return investors actually earn when they make choices based on emotion."***

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Understanding the retirement reform two-pot system

How will the proposed legislation impact your retirement savings?

At the end of July, the National Treasury released several Draft Tax Bills for public comment. This article unpacks the proposed 2022 Draft Revenue Laws Amendment Bill which contains key amendments on retirement reform, specifically the move toward a "two-pot" retirement system.

First raised in Finance Minister Enoch Godongwana's Budget speech in February this year, as the name suggests under the proposed "two pot" system, retirement savings will be divided into two pots. The savings pot (one-third or 33.33% of their retirement savings) will be accessible for emergencies and the second "retirement" pot – containing the remaining two-thirds – will be ringfenced until actual retirement.
Longer standing members in retirement funds will have access to a third pot – a "vested" pot or the amounts accumulated before the implementation date.

Members will, however, only be able to access their savings pot once a year with the minimum withdrawal being R2 000. All or part of the amount accumulated in the savings pot up to the allowable withdrawal date each year can be taken out.

Treasury also proposes that individuals will only be taxed at their marginal tax rate on these withdrawals, unlike the current situation where tax rates are higher if pre-retirement withdrawals are made before retirement age.

The changes will affect all forms of retirement funds including company funds, umbrella funds, retirement annuities, provident funds and the Government Employees Pension and Preservation Funds.

Why now?

The amendments aim to enable South Africans to save not only for retirement but also for emergencies and unforeseen circumstances. This comes on the back of the COVID-19 pandemic, which saw many individuals receiving reduced salaries and having to resign so they could access their retirement funds.

The amendments would negate this situation and provide greater flexibility as it enables South Africans to access their retirement funds during their working life for non-retirement purposes, like emergencies.
This cash injection will definitely help alleviate unforeseen financial pressure, yet ensure the preservation of the bulk of the individual's retirement savings.

The planned implementation date for the new retirement system is March 2023 although Treasury says this is probably optimistic given the changes to fund rules and systems as well as the need to educate members about the reform and its implications. In addition, SARS also has some work to do as it needs to create capacity to cater for the new pots and be able to track withdrawals.

The Rationale

Treasury says that the new retirement system allows for far greater flexibility.

The present system has not been without its weaknesses, the greatest of which is the lack of preservation before retirement. When changing or leaving a job in most instances, individuals can access their pension funds or provident funds in full and despite the introduction of higher tax rates for premature savings withdrawals, individuals continue to leave viable employment as it is the only way they can access these funds in the short-term.

This not only puts their long-term retirement savings at risk but also impacts their ability to maintain their standard of living at retirement. When there are no retirement savings in place, the burden falls on the government to look after its ageing citizens. The need, therefore, to ensure that individuals when retiring have access to some financial means, is critical.

Seeking a solution, the government published a discussion document, "Encouraging South Africans to save more for retirement" in December 2021, which proposed a new retirement fund regime aimed at providing individuals in financial distress some level of access to their retirement funds. This would be in the form of a "two-pot" system for retirement savings as outlined above.

continued on page 4

> ***"Treasury says that it has recognised that in allowing for a withdrawal option, many funds may face liquidity risks on implementation whilst the required changes to systems and fund rules may also result in new and higher costs."***

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View on the **Horizon**

continued from page 1

The investment vehicle used can make a big difference

The problem with the income component is that most of it is taxable. It is therefore important to understand the after-tax return of these yields. Depending on the investments vehicle in which these are housed, this can make a material difference. Remember, there is no tax applied to your Retirement Annuity, Preservation Fund, Living Annuity and Tax-Free Savings Account.

There are certain products that still offer guaranteed rates that are tax efficient. These are often in the form of 5-year guaranteed endowments where the return offered is an after-tax rate. At the time of writing, these rates were in the region of 7.5% p.a. which equates to a 14% pre-tax return assuming the top marginal tax rate.

The next time you get your statement or sit with your Advisor take note of the distributions on your statement. Coupled with the market or price movement, this will give you your overall return. For those drawing an income, it is good to have your distributions cover your income, leaving the market growth to hedge against inflation.

Understanding how the distributions in your portfolio work and how these are used or re-invested are an important component of your retirement planning. ■

The market has crashed. **Now what?**

continued from page 2

Invest in (the right) equities

A stock market crash provides you the perfect opportunity to increase your equity allocation at a reasonable cost and, if appropriate, allows you to switch to a more aggressive asset allocation from a comparatively conservative allocation. This is because equity investments, especially when purchased at low valuations, have an unmatched ability to boost your investment returns for long-term goals such as retirement. However, just as point 1 above warns against panic selling, it is also important that you do not make panic buys during a market crash. Remember to stick within your own risk parameters and not just blindly purchase equities because of their relatively low valuations.

Adopt a long-term view

Perhaps the most important strategy on this list. The stock market does not go down to zero. While short-term volatility is inevitable when you are investing in equities, markets should bounce back and discover new all-time highs. If correctly positioned in terms of your ability to withstand volatility, the short term change in value becomes less relevant.

It is perfectly normal to feel anxious or nervous when markets are suffering. However, it is imperative that you block out the short-term noise and focus on the long-term goal. A stock market crash provides an opportunity to grow your wealth. Get in touch with an advisor and make sure you have a solid long-term plan in place that provides you with peace of mind even when markets are volatile. ■

Understanding the r**etirement reform two-pot system**

continued from page 3

Treasury believes this system will allow for financial resources to be available when needed but at the same time, it will also increase the overall level of savings dedicated to retirement.

Impact on Retirement Funds

These amendments are the culmination of several years of consultations and engagements that took place between the National Treasury, labour unions, fund administrators, industry and other experts. The new system, however, is not without its risks. Treasury says it has recognised that in allowing for a withdrawal option, many funds may face liquidity risks on implementation whilst the required changes to systems and fund rules may also result in new and higher costs.

The two-pot system proposal does not, therefore, include allowing immediate access to retirement funds. It proposes that contributions to the savings pot would start with the proposed implementation date (1 March 2023) and members would only be able to make withdrawals once sufficient funds have been accumulated.

Delaying members draw down on a substantial part of their retirement savings could still leave them vulnerable when they retire, not to mention the even greater risk to the overall fund. As more funds are withdrawn, there will be lower investment returns for members as less of their savings are invested.

The two-pot system presents a pragmatic approach to an enduring issue in our society. Survey after survey has shown that only 6% of South Africans can afford to retire comfortably so the draft retirement reforms will provide low-income earners relief from short-term financial pressures without impacting the preservation of their retirement funds.

The draft rules were open for public comment and had until 29th August 2022 to submit comments to Treasury. ■

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