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NFB | PRIVATE WEALTH MANAGEMENT

PROFICIO

NFB FINANCIAL UPDATE

View from the **Chair**

Finding opportunities during volatile markets

2022 began with enormous volatility across markets. Unusually, we saw equities, bonds and most investment types being sold at somewhat material discounts. From the approach taken by the Federal Reserve it became clear that central banks were going to wage war on out of control inflation.

As we predicted late last year, the inflation issue, explained as a temporary blip, was way more systemic and not at all the flash in the pan which would soon abate. The impact of dramatically increasing interest rates is always material. Previously bullish investors become urgent sellers and patient or conservative investors remain on the sidelines whilst mayhem prevails. Human behaviour, whilst often described as sophisticated and advanced is not typical of these times. Quality is disposed of alongside least valuable yet seemingly attractive investments. It is in these times that investors who have been patient or cautious can initiate investments which will deliver significant returns into the future.

We are living in interesting times. Conflict, inflation, pandemics, interest rates, politics and supply chains amongst other big moving parts combine to confuse markets and investors alike.

We remain steadfast in our belief that diversity across markets, assets and currencies remains the most robust and relevant approach to portfolio deployment. Good companies pay dividends, strong banks pay regular income and from time to time, those in need of income are rewarded with rather exceptional guaranteed rates which come from bond markets being at cyclical highs.

South Africa remains a unique and enigmatic market. Probably one of the nicest places around the world to live in, it remains very tricky politically and economically to be fully invested in.

Blending a portfolio to provide investors with sufficient secure income and complementing this with global growth facing investments has and continues to make a lot of sense. Logic tells us that one should invest in the currency in which you live. In our instance this does not hold true and looking at long term trends (trends are your friends), the Rand will continue on a volatile but weaker path.

Taking large amounts of capital abroad has us thinking and advising tactically. What this means is that one isn't forced to exit in one fell swoop. We can manage larger flows over time, averaging out the exchange rates. This is especially true when significant short-term weakness is experienced, as in recent months.

On the contrary, for younger investors, or those taking out regular, sometimes fairly large amounts, we tend to recommend sending funds out at prevailing rates, avoiding trying the impossible task of timing the market.

Our behaviour has become a major study at university and organisations around the world. Called behavioural finance, it references human biases which include the fear of missing out, loss and anchoring on the most recent occurrence as a harbinger of the future. Whilst sometimes these thoughts or fears materialise, they are often wrong and lead to knee jerk reactions and unfortunate and costly consequences. World renowned for the remarkable investment results over extended time periods, Berkshire Hathaway and their two key gurus have opined that when everyone else is panicking it is time to buy and when everybody else is displaying greed it is time to sell. Never have truer words been said.

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> ***"We remain steadfast in our belief that diversity across markets, assets and currencies remains the most robust and relevant approach to portfolio deployment."***

Mike Estment CFP®
Executive Chairman: Johannesburg
NFB Private Wealth Management

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.

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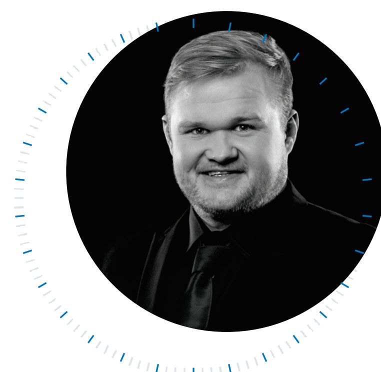
Jonathan Braans
Private Wealth Manager
NFB Private Wealth Management
Johannesburg



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.

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> ***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.***

Xolisa Funani CFP®
Private Wealth Manager
NFB Private Wealth Management
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View from the **Chair**

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Recently, the world of retirement cash flow funding has been positively impacted by a few developments. Firstly, institutions are developing guaranteed income solutions which complement growth-oriented parts of the portfolio. These can be for either compulsory (pension) funds or normal investments which we term discretionary funds. What makes this particularly interesting is the current heightened rates on offer from the bond market. We would encourage you to reach out to our advisory team and to investigate this opportunity which might suit your circumstances.

Finally, I thought it appropriate to mention structured products. For the correct investor, seeking equity like returns but with less of a tolerance to risk, these investments which we offer from time to time might be suitable. Structured products provide a blend of inflation beating probabilities with varying degrees of capital guarantee or partial protection. Again, I would suggest a conversation with our advisory team to see if this investment and its characteristics suit your needs and risk profile.

NFB is remarkably lucky. 37 years young, we enjoy remarkable relationships with clients, our staff, institutions who know and trust us, and the regulators. Thank you for your custom. It is the fuel which drives our engines. Thanks also to you for the introductions and referrals we enjoy from existing clients. ■

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

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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 **retirement reform two-pot system**

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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. ■

JOHANNESBURG OFFICE

Illovo Point Office No 1101
68 Melville Road Illovo Sandton

T: +27 11 895 8000
F: +27 11 784 8831
E: jhb@nfb.co.za

EAST LONDON OFFICE

NFB House 42 Beach Road
Nahoon East London

T: +27 43 735 2000
F: +27 43 735 2001
E: el@nfb.co.za

GQEBERHA OFFICE

106 Park Drive Building 2 2nd Floor
St Georges Park Gqeberha

T: +27 41 582 3990
F: +27 41 586 0053
E: pe@nfb.co.za