



**Last week I wrote about the importance of adding a few highly speculative investments into a balanced and diversified portfolio as part of the process of building a structured entity which will hopefully have the ability to grow long into the future while at the same time providing a decent income.**

However, while long-term investment security married to the highest possible long-term growth is arguably the single greatest defining view of a well-constructed investment portfolio, investors who are nearing the end of their lives and who might also have been buffeted by the ravages of monetary inflation, might have slightly different priorities. For the latter, a greater than average yield might well trump capital growth considerations particularly if greater than average security is possible.

That is why I explained last week that Pref Shares might just thus be of interest to this latter group. Most important to the small investor who is looking to enhance his dividend income, though Pref shares behave like interest-bearing bonds, the Tax Man treats them as dividends and thus taxes the income at a flat 20 percent instead of the taxpayer's marginal rate. This fact might thus considerably outweigh the superior long-term capital appreciation benefits of Ordinary Shares when looked at from the point of view of the elderly pensioner and it is the latter issue which takes me this week to the subject of Preference Shares, or "Prefs" for short.

So is there a case to be made for buying prefs? Investopedia sets it out rather well:

### **Advantages of Preference Shares**

Owners of preference shares receive fixed dividends, well before [common shareholders](#) see any money. In either case, dividends are only paid if the company turns a profit. But there is a wrinkle to this situation because a type of preference shares known as [cumulative shares](#) allow for the accumulation of [unpaid dividends](#) that must be paid out at a later date. So, once a struggling business finally rebounds and is back in the black, those unpaid dividends are remitted to preferred shareholders before any dividends can be paid to common shareholders.

### **Higher Claim on Company Assets**

In the event that a company experiences a [bankruptcy](#) and subsequent [liquidation](#), preferred shareholders have a higher claim on company assets than common shareholders do. Not surprisingly, preference shares attract conservative investors, who enjoy the comfort of the downside [risk protection](#) baked into these investments.

### **Additional Investor Benefits**

A subcategory of preference shares known as [convertible shares](#) lets investors trade in these types of preference shares for a fixed number of common shares, which can be lucrative if the value of common shares begins climbing. Such participating shares let investors reap additional dividends that are above the fixed rate if the company meets certain predetermined [profit targets](#).

## Disadvantages of Preference Shares

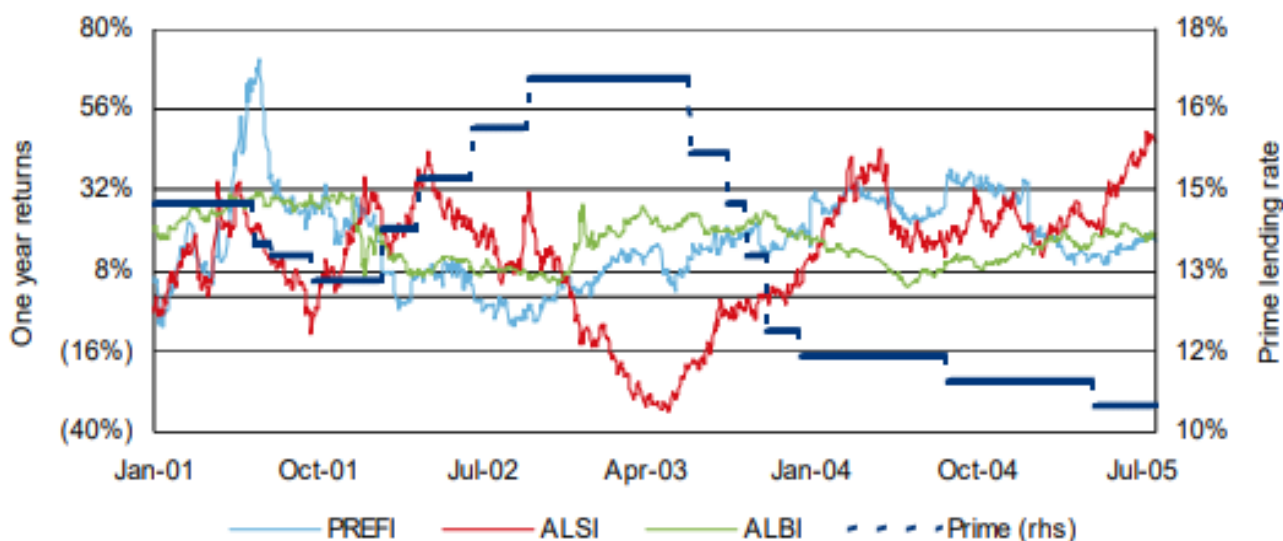
The main disadvantage of owning preference shares is that the investors in these vehicles don't enjoy the same [voting rights](#) as common shareholders. This means that the company is not beholden to preferred shareholders the way it is to traditional equity shareholders. Although the guaranteed [return on investment](#) makes up for this shortcoming, if interest rates rise, the fixed dividend that once seemed so lucrative can dwindle. This could cause buyer's remorse with preference shareholder investors, who may realize that they would have fared better with higher interest [fixed-income securities](#).

### Usually not the best option for the ordinary investor

For ordinary investors in the prime of their lives, pref shares are probably not the best option. The following graph from a research paper produced by Standard Bank eloquently explains why, as a general rule, Ordinary Shares, represented by the red graph trace over the period of great investment market fluctuation between January 2001 and July 2005, are the better long-term bet...provided you are able to get your timing right.

The preference share index, represented by the blue graph trace was, however, highly profitable to investors who bought into it in mid 2001 when the share market was peaking and by mid 2002 would have enjoyed significant capital gains. Overall, however prefs appeared to be less volatile but nevertheless very profitable if they are bought at a time when interest rates are declining:

**FIGURE 30: ROLLING ONE YEAR RETURNS ON INDICES vs PRIME**



Source: Standard Bank Group

There is a caveat however, though prefs are in general a hybrid name for a category of shares which might often behave like bonds inasmuch as they provide a guaranteed dividend at a set percentage, this is not always so. Some prefs might merely pay a profit-dependant dividend which might - or might not - be cumulative if corporate profits are constrained. In the former case the dividend might accumulate until such time as the pref issuer is in a better financial position but the advantage in this latter case is that the dividend will be paid to pref holders ahead of dividends to ordinary shareholders who are only entitled to what is left over!

Then there are non cumulative prefs and non-redeemable, non-cumulative and non-participating preference shares...the list goes on and so if you are thinking of investing in this category of shares, make sure you understand the terms before you get started.

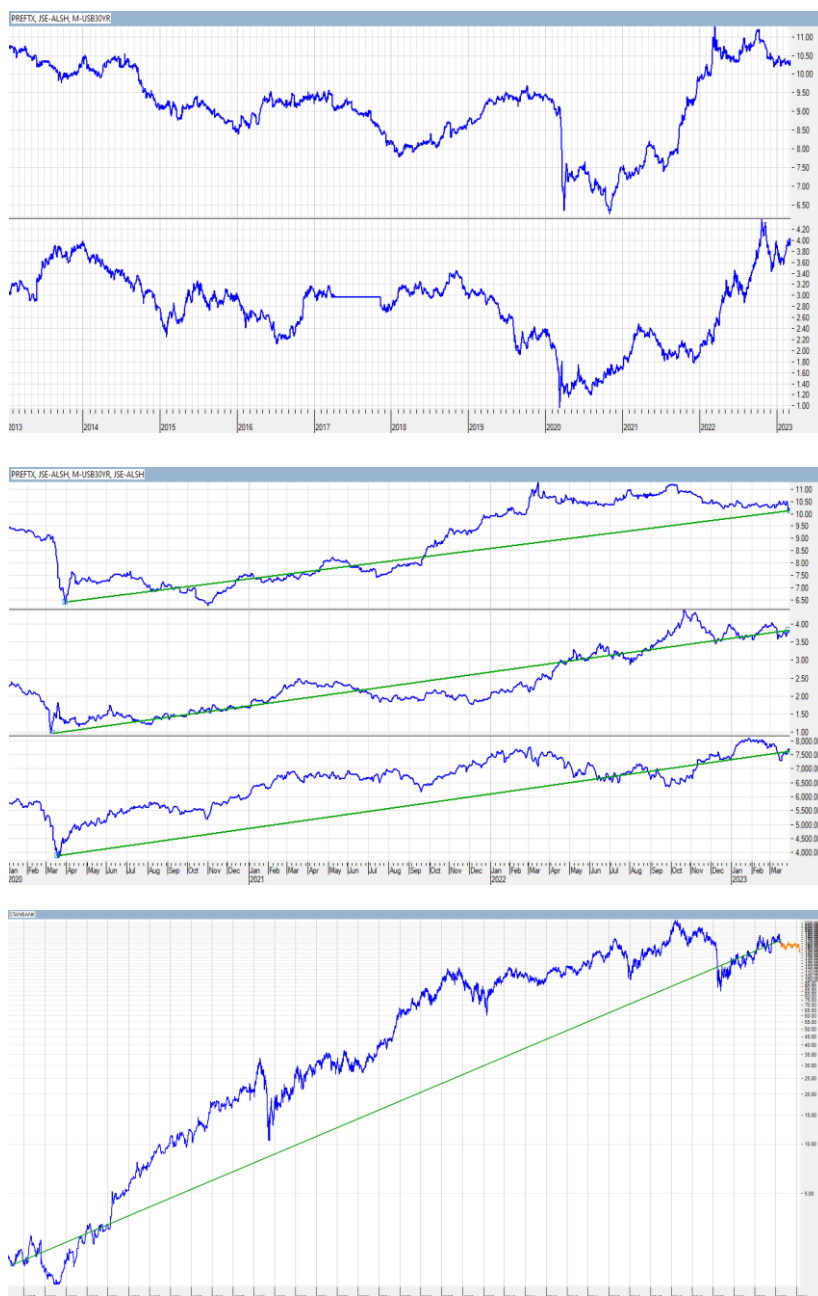
So, though prefs are in many ways similar to ordinary shares, in practice they are usually treated differently in the marketplace. While your money is theoretically safer if you hold prefs, in reality prefs behave more like bonds inasmuch as their movement is more closely allied to the movement of interest rates and so potential losses could be severe at times when interest rates are rising. Thus, as I have previously explained in my discussions about investment in sovereign bonds, the general rule that applies to interest-related prefs is that one should ONLY buy them at times when interest rates are peaking globally....which is arguably the case at present!

To emphasise this point, in the following graph I have contrasted the JSE Pref Share Index (Top Graph) with the US 30-year long bond to illustrate how closely the two have followed one another over the past decade. Readers will surely recall my cautionary note about central bank's struggle against global inflation rates, and in particular my observation that while in July 2020 the US Government was able to borrow money by placing 10-year notes at a yield of 0.62 percent, in February this year they were having to offer 3.75 percent. In simple terms, the **cost** of US debt has thus risen over six times over the past 33 months with a commensurate capital loss to current bond holders.

Now the two graph traces might look the same but in fact, since the bottom in March 2020, the South African Pref Share Index has risen at compound **18.1** percent from a yield of 6.8 percent to a current 10.22 while the yield of a US long bond has risen from 0.96 percent to 3.98 at a compound annual average rate of **58.3** percent. In my next graph composite I have accordingly blown up the recent period from March 2020 and put in green trend lines to illustrate the relative growth rates and you can thus see that, over the same period the JSE All Share Index rose by a compound annual average rate of **25.1** percent: Locally then, Ordinary shares were obviously a better bet during this period!

Furthermore, though the quality of prefs is obviously defined by the quality of the issuer, in practice, most prefs that are available to ordinary investors have such a quality underlay simply because in order to have made their way into the marketplace, this has to be so.

Accordingly, by way of contrast with the speculative option I dwelt with last week, I turn to a share which has over decades been one of my defining examples of a solid Blue Chip, Standard Bank ordinary shares. In the third graph on the right you can see why this share fits the Blue Chip bill: because it has delivered solid price growth over the past half-century at, as the green trend line so clearly illustrates, a compound annual average rate of 13.1 percent:



Now, in addition to its Ordinary shares, Standard Bank had in issue 8 000 000 6,5% first cumulative preference shares of R1,00 each which were this week standing at a dividend yield of 5.6548 percent. More to the point, the price of the shares has performed as if it was a normal share, having risen from a low of R56 in October 2020 to a current R93.69 ahead of a dividend payout due this week.

Contrast that with the performance in my second graph of the Standard Bank Ordinaries which have risen from a low of R98 in May 2020 to a current R169.79 at which price they are offering a dividend yield of 5.6823 percent resulting from an impending payment of R5.528 to be paid on April 11.

In June 2004, the bank also issued 5-million non-redeemable, non-cumulative, non-participating preference shares with a par value of one cent each at a subscription price of R100 per share together with 20-million identical prefs which were privately placed and which collectively provided the bank with R500-million in capital.

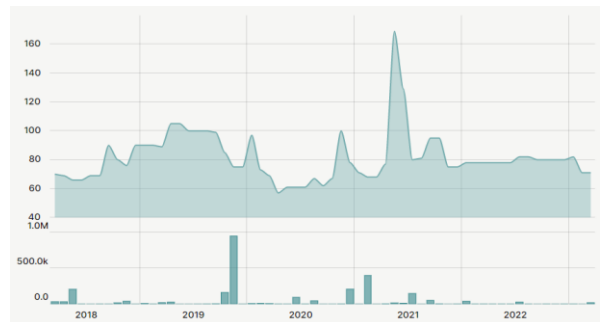
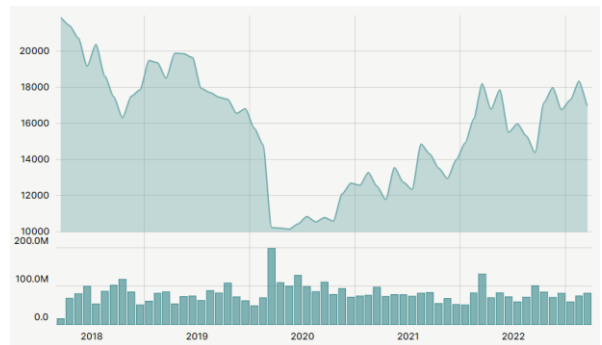
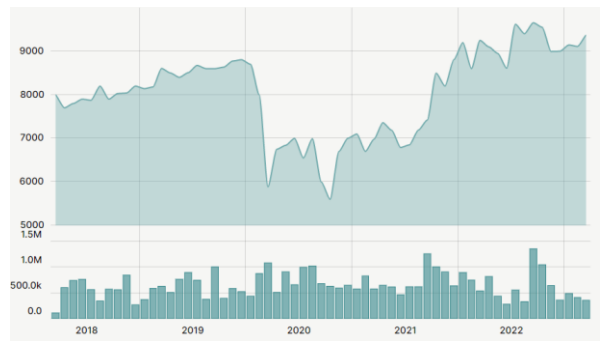
Currently offering a dividend yield of 7.3239 percent which implies a payment of 2.6 cents after tax calculated at 20%, the final, due for payment on April 3, was preceded by an interim payment of 2.6 cents paid on September 12 on a current price of R0.71, the shares have risen from a price low of 57 cents in April 2020 to a current 71 cents.

What is important to understand is that, like bonds, these 6.5% Prefs normally pay a fixed dividend and thus, as ambient interest rates fluctuate, the share price changes so that the dividend yield will remain competitive with the current market rate. Simply-stated, if interest rates are rising the share price must fall and vice versa. But to understand what a remote area of the investment market we are talking about, note that over the past eight months there have been only ten trades representing a total of 52 955 shares during which they rose to a peak value of 82 cents before falling back to a current 71 cents.

For what it is worth, Standard Bank's total 'authorised share capital' consists of 1 750 000 000 ordinary shares of 10 cents each, 8 000 000 6,5% first cumulative preference shares of R1,00 each and 1-billion non-redeemable, non-cumulative, non-participating preference shares of R0,01 each, representing a total authorised capital of 193 000-million of which 1 345 515 867 ordinary shares of R0,10 each have been issued, 134,55 8 000 000 6,5% first cumulative preference shares of R1,00 each and 8,00 25 000 000 non-redeemable, non-cumulative, non-participating preference shares of R0,01 each representing a total issued share capital of R142.8-million.

But what does all of this mean to would-be ordinary investors like you and me? Well let's start by noting that since their share price lows of 2020, the 6.5% Prefs have risen in value by a compound annual average rate of 7.6 percent and yielded an average dividend of 5.6548 making a Total Return of **13.25** percent, the non-cumulative prefs have risen by compound 18.7 percent which together with an average dividend yield of 7.3239 percent represents a Total Return of **26.02** percent while and the ordinary shares have risen by compound 27.5 percent and are yielding an average dividend return of 5.6823 percent making a Total Return of **33.18** percent.

Clearly then, if you are happy to live with the roller-coaster ride of being an ordinary shareholder, then Standard Bank ordinary shares are the clear winner. Over time, if history were to repeat itself they would offer you a two and a half better return than the 6.5% prefs.



But then you have to accept that in times like these sods law applies; i.e. should you need cash and be forced to sell your shares, chances are it will be a time when the price is down. Since the Silicon Bank dominoes began falling, Standard Bank ordinary shares have already lost a tenth of their value and, furthermore, ShareFinder's artificial intelligence system projects in red in the graph on the right that in the year ahead, the ordinaries will overall lose around 21 percent.

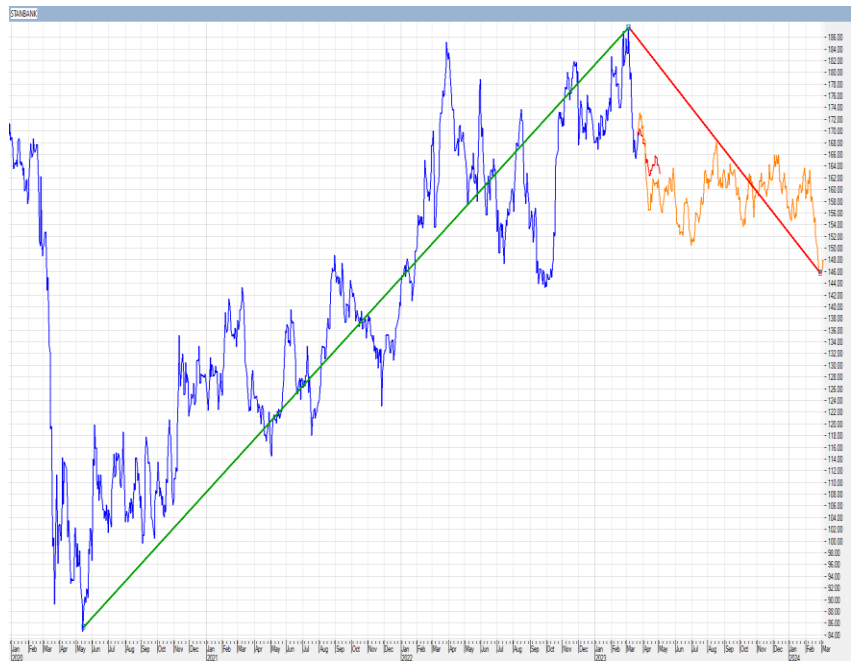
Indeed the bank's ordinary shares are quite volatile as you can see in the graph. Last year they lost 21 percent between their March high and September low while in 2021 they twice went through quite heart-stopping declines and subsequent recoveries losing 12.3 percent between September and the end of November and 16.9 percent between March and May.

Not that the prefs did much better. They fell 12.8 percent between March and July last year and ShareFinder furthermore projects a decline of 13.8 percent between now and mid-November as you can see in my second graph on this page.

So, the term "Preference" is clearly a little misleading in everyday market terms...but it would obviously have a very different meaning were South Africa to experience the very unlikely event of a Silicon Bank mismanagement and subsequent bankruptcy....though I hasten to stress that our bank liquidity rules imply that South African banks are infinitely safer than their US equivalent except in the case where politicians are able to circumvent the rules!

Now, if it is yield you are seeking, Barlows 6% Prefs are offering the highest at a current after-tax dividend of 9.6 cents on a current share price of 87 cents or, in percentage terms 11.0344 percent but, noting the green trend line which has been falling in price at a compound annual average rate of -6.4 percent, it is clear that as global interest rates have been falling over the years, investors who hold Barlows prefs have suffered a steady capital loss.

In the graph on the right I have tracked the Barlows Prefs relative to US 10-year bonds as a proxy for the global interest rate trend which has seen rates declining until the mid 2020s. But note that there seems to be a mismatch because the Barlows Prefs lost rather than



gained in value as global rates were declining and only since February this year have they begun an increase in value with a total of three trades since that date.

Barlows' involvement in Russia at a time when most international companies have been withdrawing in sympathy with the global call for sanctions has obviously worried investors. However, the latest company report dated February this year has been reassuring that trading figures remain positive: "Revenue, at R16.5 billion, increased by 14.9% compared to the five months ending 28 February 2022. This, together with other measures, drove an 11% higher EBITDA to R1.9 billion and an 18% uplift in operating profit from core trading activities to R1.5 billion. Total EBITDA and operating profit margins achieved were 11.5% and 8.9% respectively and in line with the prior period."

In summary, if you are attracted to Prefs because of their higher yield, you should not necessarily expect to receive capital gains commensurate with those of Ordinary Shares. Furthermore, as always, there remains a trade-off between yield and the long-term capital growth outlook of this category of investment.

## The month ahead:

**New York's SP500:** I wrongly predicted declines until April 13 but I am still expecting a down-turn until early May and then gains until early July when I see the next retraction until September.

**Nasdaq:** I wrongly predicted the end of the recovery last week but I think it has merely been delayed and now I see weakness until early May followed by a long-term rising trend for the rest of the year.

**London's Footsie:** I failed to predict this week's recovery which represents the start of a long-term recovery until the end of the year.

**France's Cac 40:** I correctly predicted the end of March would see the start of gains until the end of July.

**Hong Kong's Hangsen:** I wrongly expected a continuing decline until early May before the next long recovery begins. But the gain is likely to have been temporary and now I foresee declines to the end of May before a long recovery starts.

**Japan's Nikkei:** I did not foresee the brief recovery but now I see a retraction until early May before the next long but volatile recovery trend begins and is likely to last until the end of the year.

**Australia's All Ordinaries:** I wrongly thought the recovery should have ended. Now, however, I see a brief retraction until April 10 ahead of a long recovery to early June which should mark the start of a 5-month decline.

**JSE Top 40 Index:** I correctly predicted a very brief interim recovery followed by losses until mid-May and then modest gains until mid-July. But the overall trend remains down to mid-October.

**ShareFinder JSE Blue Chip Index:** I correctly warned that the current brief recovery is a chimera within a long trend of weakness which is likely to end in mid-May ahead of a long recovery into the New Year.

**Rand/Dollar:** I correctly predicted the start of a recovery which I expect to last until late May followed by another month of weakness and then continuing recovery until the New Year.

**Rand/Euro:** I correctly predicted gains which I now expect to last until May 18 followed by weakness until mid-June 4 ahead of a long recovery until next February.

**The Predicts accuracy rate on a running average basis since January 2001 has been 86.89 percent. For the past 12 months it has been 93.48 percent**

# ***HILARY JOFFE: Wage deal may not be as big a risk to budget framework as feared***

**BLPREMIUM**

Over the past three years the government has firmly bent the curve on public sector pay, halting a decade-long trend of above-inflation wage increases that had seen the payroll's share of public spending rise steeply.

The new two year wage settlement the government and public sector trade unions now seem set to sign would continue that trend, bringing an unexpectedly early end to the usual pay dispute. But it would add R35bn-R40bn of unbudgeted government spending over the next three years. And it leaves many unanswered questions about what level of personnel spending is sustainable, and what kind of public service the government wants and SA needs.

At the time of writing the settlement had yet to be concluded, but it provides for a 7.5% increase in the coming fiscal year, starting April 1, followed by an increase in line with consumer price inflation (as projected by the Treasury) for the next year, 2024/25.

But this year's increase is really 3.3% rather than 7.5%. That's because it includes the R1,000 a month after tax cash gratuity public sector workers were granted in 2021, and again in 2022, which was due to fall away once a new wage settlement was reached. So the increase for the first year is not that far above the 1.6% the Treasury had pencilled in — to avoid pre-empting a settlement. It's also below the projected inflation rate of over 5.3%.

The Treasury had long made it clear it wanted to end the trend of “automatic indexation” in government spending generally, and specifically in pay, where in each wage round the public sector trade unions automatically sought and won cost of living increases of inflation plus one or two or even 4%.

Over the decade before the Covid-19 pandemic public sector pay increased by an average 2% above inflation each year. And from about 2015 the headcount was declining, so most of the money went on higher wages and salaries, not more front-line staff. That drove the public sector wage bill up to more than 34% of government spending by 2019. At that level it was in line with the Scandinavian countries and higher than the US and many emerging markets. It was also crowding out government spending on medicines or textbooks or infrastructure and was one of the factors driving government debt up to unsustainable levels. The wage bill was also growing faster than the economy was growing, consuming ever more of the economy's resources.

The turning point came in 2020, when the government froze wages as Covid-19 pushed public finances into crisis. Then in 2021 it put the cash gratuity in place as a temporary measure, renewing this in 2022 when it also unilaterally imposed a 3% increase when no agreement could be reached. That intervention to bend the curve in 2020 ultimately saved the government hundreds of billions of rand, though it made for unhappy labour relations.

The new two year settlement would require that the majority of unions in the Public Sector Co-ordinating Bargaining Council (PSCBC) accept the employer's revised offer, but indications are that they will, despite fierce opposition from unions such as Nehawu.

Crucially, however, even once it does the Treasury also has to agree to the deal. It has an effective power of veto after 2022's Constitutional Court judgment that upheld the government's 2020 decision not to

implement the third year of the 2018 wage agreement. In theory, if the Treasury decided the government could not afford the new agreement, it could refuse to sign. Even if it does, the big question is whether it allocates new money to fund the extra spending, or requires departments to find the money — by shedding staff or reallocating money within existing budgets, or cutting whole programmes.

Finance minister Enoch Godongwana signalled in February that he might do just that: an unbudgeted wage settlement would mean funds must be clawed back in other ways, he said in his budget speech. “Mainly this will mean restricting the ability of departments and entities to fill non-critical posts. It will also mean achieving cost savings from major rationalisation of state entities and programmes,” he said. It would require trade-offs.

The trade-offs that have been forced on the government with a series of unbudgeted wage increases over the past many years are at the heart of the issues, not just about sustainability but critically about the structure of the public service and the quality of service delivery. The wage bill is the product of a bargaining process outside the budget, not of a deliberate policy debate about how money should be spent. The result in SA’s case is perverse consequences.

One of these is the extent to which pay increases have been at the expense of headcount, particularly in the police but also to an extent in teaching and nursing. Studies by the Treasury and Wits academic and former budget office head Michael Sachs have highlighted the extent to which the number of police, in particular, but also of teachers and nurses, has not kept up with population growth. Inevitably that has affected service delivery.

Another big issue is who gets the money within the public service — and the dynamic there, essentially, is that the increases have gone largely to junior and middle grades, at the expense of senior management and supervisory skills. The PSCBC negotiates wages only for the bargaining unit employees the unions represent, which is up to middle management level.

At senior and executive levels it is the Treasury that decides whether increases are affordable. And given the budget constraints, and the need to signal restraint, it has not been kind. Senior managers such as directors-general and their deputies and heads of departments had not had a cost of living increase at all between 2015 and 2022, when they were included in the 3% unilateral increase. Treasury figures show both salaries and headcount declining at senior management level since 2015/16.

Many departments are top heavy and there are plenty of deployed cadres who are less than competent. Equally, however, there are still good senior people in the government, and the pay structure has made it harder to retain them. The dearth of skilled and experienced managers and professionals has severely compromised the government’s ability to deliver services or spend wisely or implement government policy effectively. “Policy is personnel” as one Treasury official puts it.

Assuming it is signed, this year’s settlement will build on the shift to moderation of the past three years and may not prove as much of a risk to the budget framework as many in the market have feared. But it will do nothing for the quality of the public service unless it addresses the broader trade-offs.