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TheInvestor

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Is it best to pay off the bond or rather go for shares?

By Richard Cluver

Kathy is 45 and beginning to worry about making an adequate provision for her retirement. She is able to save a tenth of her income but wondered what was the best way to use the money. Friends have urged her to use it to pay off her house bond but, as a long-time reader of The Investor, she is tempted to opt for Blue Chip shares. What, she wondered, were the respective merits of both?

The most heartening aspects of her story is that she is only 45 years old in a society when folk are continuing to work well into their 70s and also that she is able to save a tenth of her income. That is enough to guarantee that if you invests well she will be able to retire very comfortably. But which investment route is best for her?

There is a lot of merit in the argument of her friends. Bearing in mind the often unappreciated fact that if you opt to pay off a mortgage over a lengthy period like 50 years you will actually end up paying something of the order of five times the original purchase price. Furthermore, with home prices rising in the long-term at a compound annual average of 11.5 percent, you obviously do a lot better than you would if you simply put your money into a savings account at a current rate of + – 6 percent. Furthermore, whereas interest receipts are taxable as income at your marginal rate, the effective gain you receive on the investment in your home is tax-free until such time as you come to sell at which stage you will pay capital gains tax. But capital gains tax only applies to private houses that sell for over R2-million and so, for the vast majority of South African home owners; this is effectively a tax-free method of investing.

Few people appreciate, furthermore, the real impact of compound interest over long periods of time. So, for example, Kathy currently owes R550 000 on her bond. When she reaches retirement age in 15 years time, that portion of the value of her home will have increased to R2 815 047 if her property continues increasing in value by the current 11.5% average. And this is considerably better than would be the case if she had instead opted to put her money into an average unit trust which has over the past decade delivered an average gain of 9.06 percent. So, for example, the same money into a unit trust over the next 15 years, assuming the same growth rates apply, would see her investment grow only to R2 008 886: some 30 percent less.

Finally, however, although property prices are just as cyclical as any other commodity, it is simply not as obvious as other sectors of investment because there are no daily listings as, for example, the stock exchange provides for its listed shares. So property investors are not subject to the same gut-wrenching price tumbles as are stock exchange investors and this tends to provide a modicum of peace of mind. But this is in fact a delusion which can trap the unwary. Though you might have, from scrutinising estate agents' sales boards, some comfortable impression about the worth of your home, reality only sets in when you actually try to sell.

However, if you want to understand why property is not the best investment around, you need to consider the graph composite below. Compared with the red line which illustrates the average growth of domestic property, the green line traces the mean growth rate of a portfolio of shares selected by my ShareFinder computer programme for the portfolio that I maintain on a monthly basis for readers of my Prospects newsletter. With dividends reinvested it has been delivering 36.1 percent annually since it was first launched in January 2011.

Admittedly this is a far superior growth rate than is achieved by most commercially available portfolios and so it carries with it a greater risk of value reversal whenever those periodic market reversals occur, but it does demonstrate what can be done with the savings of ordinary investors. Here the point to take to heart is that every rand that you devote to the stock exchange is growing over three times faster than the rands you devote to paying off the bond on your home.

Just one further point before I leave the case for investing in property, it makes sense to increase your mortgage repayments steadily as your income grows over the years because this can dramatically reduce the period of the loan. I have always argued for gradually increasing the monthly amounts you pay towards your bond in a like ratio to the annual increases that you usually receive at work. That way you significantly reduce the period of the loan without increasing the percentage of your income that is employed as "rent."

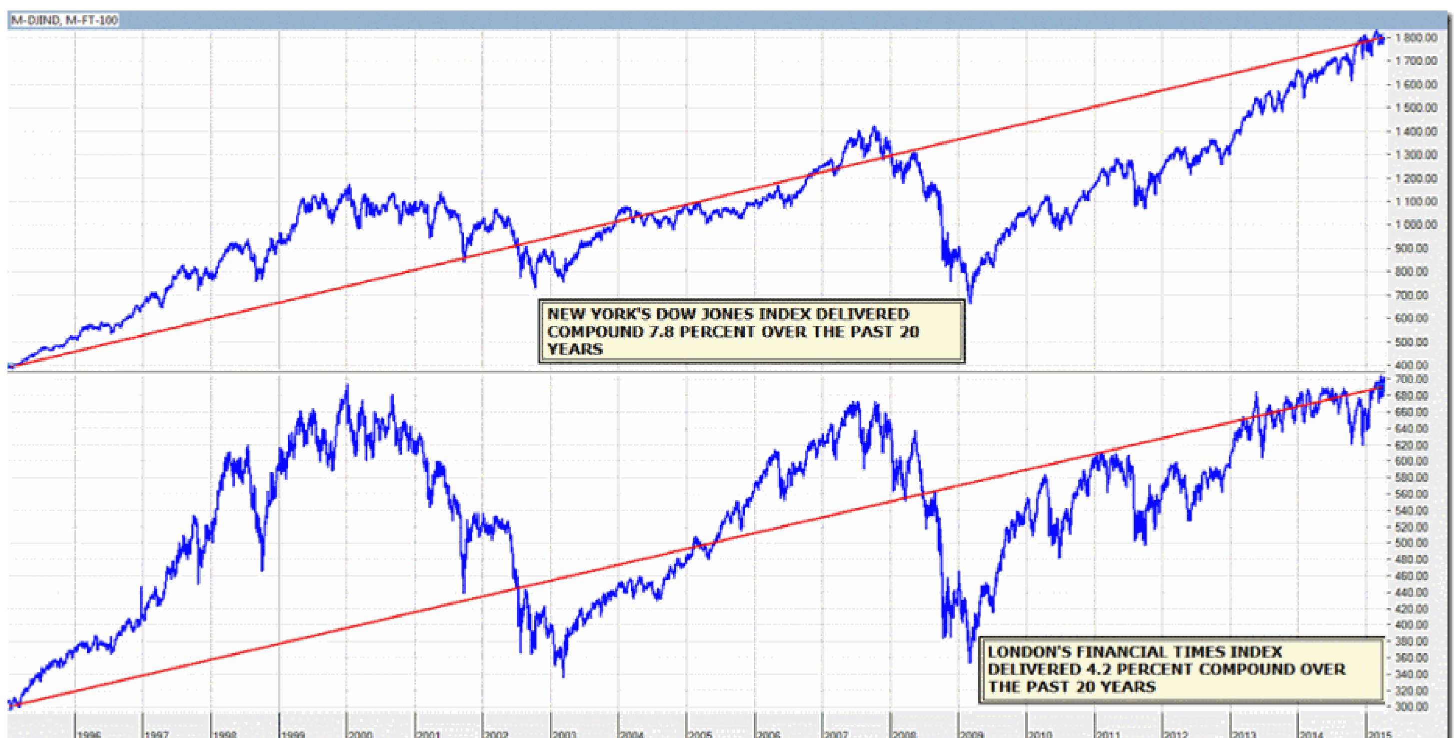
Zuma era Rand weakness threatens foreign investment

Since the onset of the Zuma administration in South Africa, the rate of Rand weakness has accelerated threefold with the drastic implication for local investors that in the longer-term our investment markets are unlikely to perform as well as they have in the past.

In my composite below you can see how, for the first 17 years of our new democracy the Rand was losing value at compound 4.7 percent relative to the US dollar and 4.9 percent compound relative to the British Pound. Then came the Zuma administration and the beginning of the collapse of nearly everything that the ANC administers. Thus for the past four years the Rand has been losing value three times faster at a dramatic 14.8 percent compound relative to the Dollar and 15.2 percent compound relative to the Pound.

Now, Blue Chip shares as selected by my ShareFinder computer programme Blue Chips are incomparably the best and safest performers on the JSE and they have collectively delivered 20.4 percent compound since the dawn of democracy in 1994 as illustrated by the graph below, but from the point of view of the US investor, once you take the slipping value of the Rand into account the return is a mere 5.6 percent and for the British investor a mere 5.2 percent.

As my final composite on this page shows, US investors who stuck to their own Dow Jones Industrials would have done better in Dollar terms than they would have had they invested in South African Blue Chips. British investors would have done marginally better in the long term if they invested in South African Blue Chips. But both categories of investor would have fared significantly worse in South Africa during the Zuma years. And that is a sobering view for the future.



Of course both categories would have scored handsomely had they instead chosen to copy the 2011 Prospects Portfolio which has been delivering compound 33 percent since its launch in January 2011. For US investors in Dollar terms the portfolio would have delivered 28.3 percent compound in the long term and 18.2 percent during the Zuma years. That is 3.6 times better than the Dow Jones Index would have delivered them in Dollar terms. Similarly British investors would have achieved 17.8 percent in Pound terms which is nearly twice as good as they would have achieved in Pound terms at home.

Of course, had the same overseas investors put their money into an average South African unit trust they would have achieved just 8.97 percent compound. Below I have depicted the performance of top unit trust management company Coronation's Capital Plus fund which has achieved precisely that figure over its lifetime. Of course such investors might have been lucky and chosen Sanlam's Industrial A which has achieved 21.73 percent compound since its launch in January 1999.

But they might just as likely to have opted for the Stanlib Inflation Beater that has barely managed to average 2.49% or the PSG Alphen fund that has averaged 1.18% or a score of others with similar returns which have in real terms been burning money for their investors.

Hopefully I have made my point, however, that it is preferable to do your own investing choosing shares that have delivered measurable high long-term dividend growth which has translated into high price growth. If you leave it to blind hope that some random professional portfolio manager can do it for you, you risk losing heavily down the years.

Learn from my Old Mutual disaster. Take another look at your old RAs

by Nic Oldert, **Active equity investor and co-founder of the Profile group.**

Not all retirement annuities are born equal. A far cry from bygone years, these days we can take our pick from a rather sizeable range of not only companies offering RA products, but of the products themselves. What are those exactly – and why should they matter to those who began paying into their own annuities years ago? Nic Oldert tackles, in his experience, why to be wary of the enticement of income tax deductions, and why it may be a very good idea to take another look at your old RAs. – Caitlin Hogg

RAs (retirement annuities) are contractual savings plans set up under South Africa's pension legislation. Up to certain limits, contributions to an RA are tax deductible. In other words, you save pre-tax money.

This seems like a good idea. The more money you save, the bigger your nest egg when you retire. Although the proceeds of an RA are taxable on retirement, the investment growth on all the extra savings over 30 or 40 years should, in theory, far outweigh the tax payable as a retiree.

For example, R1 000 a month invested for 30 years at 12% per annum turns into R3.5m. This yields about R20 000 a month *after tax* if you retire now age 65.

If instead you pay tax on the R1 000 every month and invest the after-tax amount (around R700) at 12% for 30 years you end up with only R2.5m. Today that would give you about R15 000 a month after tax. The RA pre-tax investment, in other words, should give you a significantly better retirement income – about 33% better in this case.

This doesn't always work out so well in practice.

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Unfortunately for South Africans, it is difficult to compare retirement products. It is easy to get performance figures for unit trusts but the similar numbers are usually not available for old-style RAs. Based on the poor returns of retirement products, one might conclude the performance is deliberately suppressed.

This is a strong statement, but if you look at my experience on an actual product from Old Mutual you may come to the same conclusion.

My attempts over the years to get performance data out of Old Mutual on this particular product were always unsatisfactory. It would take months to get a response. When a letter finally arrived the growth information would be months out of date. With shares or unit trusts, by contrast, you can see the prices and calculate up-to-date returns every day.

Before getting into the facts and figures, I must emphasize that the product in question is a "life house" RA (referred to in the industry as an underwritten RA or an insurance-based RA). This is very different to the RA "wrapper" offered by many companies today. The RA wrapper allows you, the investor, to choose the underlying investments (ie, unit trusts) which means that fees, pricing and performance are transparent. This sort of product was not available in 1990 when I was persuaded to take out an RA with Old Mutual. But old-style "life house" RAs are still sold by the big institutions. The underlying fund is an opaque black box. The moral of this tale, as you will see at the end, is to avoid life house RAs.

Let me add that my objective here is not to knock Old Mutual. I have no reason to believe the performance of other "life house" RAs is any better. This is precisely the problem with these products – objective, up-to-date performance data is not available.

I had already decided by 1990 that equities were the best long-term investment option. The RA I chose would invest, I was told, the maximum allowable in equities. So far so good. The RA, in theory at least, would give me JSE-linked growth on money that would otherwise simply go to the taxman.

Fast-forward 24 years and the question is: what went wrong?

Here are the facts. The policy ran from February 1990 to October 2014, a period of 297 months. I started with a lump sum of R4 500 in February 1990. From March 1990 to December 1996 I contributed R750 a month. From 1997 – shortly after I realised just how poor the RA's performance was – I reduced this to a R100 a month. I would have stopped contributions altogether but his would have triggered significant penalties (the penalties for reducing the contributions were less severe). As an aside, it remains incredible to me that, six years into a product, one can be *penalised* for reducing or stopping contributions.

My contributions (over just under 25 years) amounted to R213 600 (including some February top-ups). Old Mutual's marketing people would make this look good. R213 600 turns into R1.6m, growth of 700% in under 25 years. But this is exactly the kind of misinformation that enables life houses to keep misleading investors. It's not wrong, it's just not the right information. Because the correct question, of course, is: how did this investment perform against appropriate benchmarks?

That's another R1.5 million I could have had…

Old Mutual paid out R1 583 058 (one third in cash, two thirds transferred to a living annuity).

Here's the rub. The same cashflows invested in Old Mutual's oldest unit trust, the Investors' Fund, would have produced R2.4m. The unit trust performed roughly in line with the JSE's All Share Index but underperformed Investec's Equity Fund by around 2.5% p.a..

For the calculations in this article I set up a spreadsheet with every monthly payment made to Old Mutual over the 297 months. I imported pricing and dividend data for the JSE All Share index, the Old Mutual Investors' Fund and the Investec Equity Fund. I deducted fees that would have been payable. I reinvested dividends.

Old Mutual's RA underperformed their own unit trust by a distressing 34%. It underperformed Investec's Equity Fund by a massive 52%. Investec's Equity Fund, on the same cash flows, would have returned R3.3m, more than *double* the amount paid out by Old Mutual.

Old Mutual's RA is probably the worst investment I have ever made.

I began this article by describing the benefits of pre-tax investment. The incredible reality is that I derived absolutely no benefit from the tax-saving structure of the RA. Had I paid more tax every year since 1990 and invested the after-tax equivalent in Old Mutual's Investors' Fund I would now have about R100 000 *more* than the RA paid out. And bear in mind that this R1.7m would be completely unencumbered, mine to do with as I please, whereas two-thirds of the RA money has to be used to buy a pension.

Had I paid my tax and invested the *after*-tax amounts in the Investec Equity Fund I would now have R2.3m.

Let me restate this for emphasis. Every month for 24 years Old Mutual invested, on my behalf, 43% *more* money than I would have had available to invest had I first paid tax (I assumed an average tax rate of 30%). Yet had I instead taken the *after*-tax amounts and invested them in Old Mutual's unit trust I would, today, have *more* money than I got from the RA (and the cash would be freely available to me). How is this possible? It's almost inconceivable.

Of course, the RA fund has the disadvantage that it is forced by legislation to invest 25% of its cash in so-called low-risk securities (ie, not equities). This is meant to protect investors but over the long-term it does exactly the opposite – it penalises investors. This is because equities are

consistently, over the long term, the best performing asset class. They are riskier in the short term, but this volatility is usually not a problem over 20 or 30 years.

This is one reason the Old Mutual RA would have underperformed their unit trust. It could be argued that I should be comparing to a balanced fund (a Reg 28 compliant fund) rather than an equity fund – the problem is that no such unit trust has enough history. The performance of Investec's Managed Fund, which started in 1994, is roughly in line with the Old Mutual Investor's Fund – in other words, much better than the Old Mutual RA.

But here's an interesting figure: even if the Old Mutual RA enjoyed a *zero* return on the 25% that it could not invest in equities the expected return (based on their unit trust) would be about 14% *better* than they actually paid out. In other words, *three-quarters* of my monthly contributions invested in the Old Mutual Investors' Fund (the unit trust) would have produced over R1.8m (compared to less than R1.6m paid out by the RA). On the most conservative calculation (using interest rates), the remaining 25% should have produced another R100 000. Based on the unit trust, therefore, R1.9m is the minimum one might have expected the RA to have produced.

It's hard to imagine where the surplus went. Institutions tend to follow similar investment strategies across related products. In other words, it is likely that the Old Mutual RA fund held a similar equity portfolio to the Old Mutual unit trust. What, then, happened to the extra R300 000 which the investment should have produced? If this all went in fees my RA must rank as the most expensive financial product of all time. (Bear in mind that the Investors' Fund figures are already net of fees recouped by Old Mutual.)

And now the tax pain…

In addition to poor investment performance, the post-retirement tax treatment of the RA is unfavourable. Had I invested in Old Mutual's unit trust (or any unit trust) I would be in a far better tax position. Cashing in a unit trust today would mean paying CGT at a maximum effective rate of 13.3%. Using the weighted-average method of establishing base cost for CGT purposes, the actual CGT on the investment would have been 10.1%. This would be a once-off tax event.

By contrast, I will pay income tax (up to 40%) on all amounts I receive from the two-thirds of the RA I have been forced to invest in a pension. The one-third cash payout attracts 30% tax off the top (assuming the R500 000 lifetime exemption is used elsewhere).

In view of the above – apart perhaps from the "enforced saving" created by an RA contract – it's hard to imagine why anyone invests in these products.

As I said at the outset, the rationale for investing pre-tax income is sound – provided decent investment returns are achieved. RA wrapper funds which allow you to choose the underlying unit trusts are transparent and cost-competitive. And you can monitor how your investments are performing. But "traditional" RA products sold by life houses are, based on my experience, best avoided.

The bottom line is this: if you are contributing to "traditional" RA products, consider converting these to RA wrappers. In theory life houses are no longer allowed to charge onerous penalties when you make an RA paid-up or reduce contributions, although this needs to be scrutinised on a case by case basis – penalty disputes remain a headache for the Ombud. But if you can do so without crippling penalties, make your old RAs paid up and switch your contributions into RA wrappers. Or abandon the false allure of income tax savings and invest directly in unit trusts, you may well find yourself better off in the long term.

Nic Oldert, an active equity investor, co-founded the Profile Group and served as MD for 20 years. He continues to serve as editor of Profile's Unit Trusts Handbook in between other consulting work. He holds an MA in psychology which has proved advantageous in making sense of stock markets.

SA’s youth represent a time bomb

by Clem Sunter

Here are some interesting statistics regarding the youth, their numbers and their unemployment. The article is not really about race – it’s actually about numbers of the youth – but thanks to Stats SA who do still base their reports on race this is the way it comes out.

I have extracted and condensed the figures to highlight the youth – the future of the country, the figures being courtesy of Statistics SA, 2014:

Age Group	0-4	5-9	10-14,	15-19,	20-24,	Totals:	Ratios:
Black	4,936,601	4,541,523	4,303,892	4,357,984	4,417,106	22,557,106	84,6%
Coloured	420,171	428,867	444,983	451,117	427,547	2,172,685	8,2%
Asian	99,256	96,953	93,863	101,609	109,668	501,349	1,8%
White	263,301	269,367	280,988	306,851	312,797	1,433,304	5,4%

Comparatively the ratios for the entire population are
80% Black,
9% Coloured,
2,5% Asian and
8,5% White

Total population being 54m. If one had to plot the birth rate of the youth, dating back to 1990, from the above table, one would note the following: The figures for White, Coloured and Asian youth have remained fairly static since 1990, whilst those for the Blacks have increased steadily since 2005 to a point where they now account for almost 85% of their age group. Since 1990 the numbers of Black youth – aged 0-24 – have increased by 11% whilst those of the Coloureds, Asians and Whites have decreased by 1%, 9% and 15% respectively. Simply put, the Black birth rate is increasing fast – steadily – that of Coloureds is decreasing slowly, that of Asians decreased between 1990 and 2005 but is now increasing slightly again and the White birth rate is declining rapidly – and steadily – and has been doing so since 1990.

We can thus estimate that by 2030 – based on current growth – for the age group 0-24 there will be 91 Blacks, 7 Coloureds, 1 Asian and 1 White in every group of 100 youngsters. Those who thus keep harping on about driving the Whites into the sea should not bother anymore as we’re disappearing fast anyway and by 2030 are liable to account for less than 2% of the total population. The bad news of course is that starvation, unemployment and misery are likely to still be present, but they’ll apply generally only to Blacks – their being over 90% of the population by that stage – and generally to young Blacks. At present there are in fact 4,9 million Black youngsters aged 0-4 whereas the total white population is 4,5 million.

Consider also that there are another 4,5 million Black youngsters aged 5-9, another 4,3 million aged 10-14 and another 4,3 million aged 15-19 – hopefully all at school – and you begin to see the enormity of the challenge facing the country and the government in attempting to feed, house, educate and otherwise sustain such numbers. Regarding unemployment amongst the youth – calculated at 48% across the board by Stats SA – it would seem that of a total population for this group of 10,4 million, 5 million are thus unemployed, and even more disturbing is that at least 4,2 million of these are Black.

Considering that the entire White population is about 4,5 million this is a figure that should worry all with regard to education, crime, service delivery, government expenditure, job creation and socio-economic woes.

The above all give us pointers to where the country is going and most importantly what problems can be foreseen. The youth – aged 15-24 – currently account for 20% of the total population, some 10 million of them, whilst the young – aged 0-14 – form 30% of the population and number some 16 million. Add these two groups together – 50% of the entire population and 26 million in number – and you see the size of the problem facing us unless jobs are created, fast, or the Black birth rate is slowed.

Quite noticeably, AIDS hasn't had the effect it was claimed it would have and as a result the young Black population is exploding way beyond what the country can cope with, now or in the future. Unfortunately it would seem that the government, AKA the ANC, are either unaware or uncaring of this growing problem when they should be seriously worried for grants, subsidies, education, housing, services – all things relating to this age group in fact – are going to eat an increasingly larger portion of their budget, regardless of what they do now.

The South African economy needs to grow fast, starting now, if it is going to absorb another 26 million job seekers over the next 15 years. We can't export them, we have to create jobs for them! For this reason alone the government should be actively creating an environment wherein jobs can be easily created, they should be attempting to slow the Black birth rate and they should be concentrating on creating capitalistic solutions for hungry mouths, rather than attempting to instil socialistic ideas in an exploding population of young hopefuls.

If they are not doing so, and to all intents and purposes it seems they are not, then SA is heading for a huge problem, notwithstanding Eskom and the rest , in that there will be more young people than there will be enough food, drink, housing, education and services to cater for them. Socialism is definitely not going to feed that many mouths and grants and subsidies will eventually cripple any future government.