



Taking stock of your portfolio

by **PIETER KOEKEMOER**



PIETER KOEKEMOER is head of the personal investments business. His key responsibility is to ensure exceptional client service through a combination of appropriate product, relevant market information and, above all, strong investment performance.

We associate the start of a new year with reform, fresh starts and the revisiting of our personal goals. While the short-term bias inherent in all of us makes it difficult to stick to lifestyle-oriented resolutions, just a little bit of effort once a year can make a huge difference to enhancing the outcomes from your investment portfolio. In this article, we have posed some questions for you to ponder that will hopefully inspire you to look after your own money better.

Some important assumptions underpin the information set out below – all of which we have detailed in previous issues. In summary they are:

- All local asset classes produced significantly above average rates of return over the past 10 to 15 years. We do not expect this to be repeated in the current decade.
- Offshore assets, especially international equities, were the worst performing asset class over the last decade, disappointing many investors. However, we believe that this is currently the asset class offering the most value to a patient long-term investor.
- The outlook for the world economy remains subdued as many countries work through a painful, drawn-out balance sheet recession. This requires austerity (higher taxes, lower benefits) and depresses confidence, investment and consumer spending. The need to deal with the developed world's debt problems will keep interest rates below average for an extended period and may eventually fuel higher inflation.

Taken together, this means that a low double digit annual average return from an asset allocation fund – such as

Coronation Balanced Plus – will be a great outcome over the next decade, compared to an annualised return of more than 15% over the past decade. If you compound at 11% rather than 15%, your final capital value will be 30% less after 10 years.

Do you know what you want to achieve?

It is very difficult to assess whether you are investing successfully if you have not given careful thought to what you want to achieve. The most important elements required to setting an appropriate investment framework are to define your objectives and time horizon(s), and understand your ability to take risk – then stick to it. A long-term perspective is the best defence against suboptimal investment decisions. You may find it useful to split your portfolio into multiple buckets defined by time horizon, as this is the most important determinant of the level of risk that you can take. To illustrate the point, let's look at two examples.

If you are around 45 or younger and employed, you are likely to be most concerned with optimising the value of your portfolio for retirement in 15 – 30 years' time. With time on your side you can take on more risk in the quest to optimise returns. This allows you to own more of the growth assets that currently offer the best expected returns over time, as you are able to stomach any short-term market fluctuations. Currently, we believe that selected international equities present the best 10-year plus growth opportunities. These assets can be accessed through funds such as Coronation Global Managed and Coronation Optimum Growth. You may also have a shorter-term objective, such as accumulating a deposit for a new home in two or three years' time. For this part of your portfolio, it does not

make sense to take on too much risk. In this case, funds which emphasise short-term capital preservation – such as Coronation Strategic Income and Coronation Balanced Defensive – would be more appropriate.

For those who are 65 and depend on your investment portfolio as a primary source of income, your objectives are a little more complex. You need to balance a current income with long-term growth that will protect your purchasing power in the second half of retirement. To meet these objectives, you need a portfolio that can still keep pace with inflation and provide protection against short-term capital losses. This can best be achieved in a fund that balances growth assets and income assets while retaining a strong focus on capital preservation, such as Coronation Capital Plus.

Are you dealing with uncertainty appropriately?

The year 2011 confirmed that the world is not in a good state of health. This was reflected in fairly mediocre returns produced by most asset classes, and there is not much reason to think that 2012 will be much better. All the major intractables remain, especially the developed world's sovereign debt problems compounded by decidedly underwhelming politicians. And it may get worse. The BRICs' continued super-growth may finally start to slow down, the economic recovery in the US may underwhelm and the European debt crisis may not be resolved in an orderly fashion. In addition, 2012 will bring its own market-rattling events equivalent to last year's Japanese triple scare (earthquake, tsunami and nuclear meltdown) and popular protests against the status quo from Algiers, Egypt and Damascus through Athens, Madrid and Santiago, to New York and London all the way to Moscow.

A focus on all this negative newsflow makes it much easier to make poor investment decisions. Arguably the easiest way to destroy value is to make big 'risk on/risk off' switches informed by the current mood of the markets. Moving everything into growth assets as soon as there's a bit of positive news or switching all your assets into cash at the hint of negativity is in most cases a sure way to lose money – inevitably resulting in buying high or selling low. Part of the problem is that the market rarely moves in a straight

line – today's despair-induced losses are often followed by tomorrow's hopeful gains.

For most people poor timing decisions can be avoided by setting clear objectives, buying appropriate asset allocation funds and finding a trusted adviser with whom to discuss investment decisions. It is important to remember that one of the few investment certainties in an uncertain world is that market declines are inevitable. Unfortunately, no one has ever been able to call market declines or recoveries consistently. But that is no reason to despair – the best opportunity to acquire quality assets below their long-term fair value is most often when sentiment is at its most negative.

And this leads us into the next point – make sure you are invested in the right mandate managed by the right manager, then stick with it.

Do you own the right mix of assets?

Investment is not speculation. Your goal is to consistently accumulate returns rather than hit a string of successive sixes. This is best achieved by carefully considering your needs before attempting to decide on the right fund/s. If you do enough homework to give you conviction, it is a lot easier to commit for the long term. Investing in asset allocation funds with clear objectives that are aligned to your personal goals is a very efficient way to implement an appropriate investment strategy, as long as you are comfortable to rely on your investment manager to make most day-to-day decisions on your behalf. (Review the objectives of our flagship range on page 26).

How tax-efficient is your portfolio?

The following considerations should be taken into account when optimising your portfolio for tax:

- **Capital gains and dividends are more tax-efficient than interest or rental income.**

Investors can earn a return in the form of income (interest, rental income or dividends) or capital gains. Income and rental income are taxed as part of normal taxable income. For most investors with a regular source



of income, this means tax at the maximum marginal rate of 40% (at the time of writing) on these forms of investment income. Dividends are taxed at a lower rate of 10% because the company declaring the dividend has already paid company tax on the profits which made the dividends possible. Capital gains are also currently taxed at 10%.

From a tax perspective, it is more efficient to receive dividends and capital than interest or rental income. Table 1 indicates how funds with more equity exposure (Coronation Balanced Plus and Coronation Capital Plus) – where dividends and capital gains represent a larger component of the total return – have historically been significantly more tax-efficient than a fund investing primarily in fixed income and property assets such as Coronation Strategic Income. Note that this is not an argument to only be invested in equity assets – the asset allocation decision should primarily be driven by your risk profile and time horizon as previously mentioned.

TABLE 1

Fund	Typical equity exposure	Before tax	After tax	Gross return converted
Balanced Plus	65%-75%	15.8	14.8	94%
Capital Plus	40%-45%	13.6	12.5	92%
Strategic Income	<5%	10.7	7.3	68%

Note: The calculations above assume an individual taxpayer paying the maximum marginal rate of 40% and does not take into account the general interest rate exemption (R22 800 at the time of writing). If the latter is taken into account, an investment of up to R350 000 in Coronation Strategic Income (assuming a yield of 6.5%) will achieve similar tax efficiency to the two asset allocation funds listed above.

- **Frequent switching between funds reduces the tax-efficiency of your portfolio.**
Investing in a unit trust is relatively tax-efficient, especially if you hold your investment in the same fund/s for the duration of your investment horizon. In this scenario, the payment of capital gains tax (CGT) is deferred to the end of your investment horizon. Table 2 compares the before and after tax outcomes for two investors earning a before tax return consisting only of price appreciation (i.e. capital gains) of 8% p.a. over their 10-year investment horizon. The first investor remains in one fund throughout the 10 years and therefore only pays CGT at the end of the 10-year term. The second investor switches to a new fund

at the end of every year, pays the CGT due and reinvests the balance. This calculation indicates that investor one, by deferring CGT, increased the final value of his portfolio by 7%. It should also be noted that frequent switching may lead to you being deemed a speculator rather than an investor. In this case you will pay the higher income tax rate on your gains.

TABLE 2

	Before tax return	Investor 1 After tax, no switches	Investor 2 After tax, 1 switch per year
	100.0	100.0	100.0
Year 1	108.0	108.0	107.2
Year 2	116.6	116.6	114.8
Year 3	126.0	126.0	122.9
Year 4	136.0	136.0	131.4
Year 5	146.9	146.9	140.4
Year 6	158.7	158.7	149.8
Year 7	171.4	171.4	159.6
Year 8	185.1	185.1	169.8
Year 9	199.9	199.9	180.4
Year 10	215.9	204.3	191.3
Decline in final value as a result of tax		11.6	24.6
Tax efficiency ratio		95%	89%

Assumptions:

The full 8% return is earned consistently in the form of capital gains only.
The effective CGT rate for individuals paying maximum marginal rate (10%) has been used.
The calculation assumes that tax rates will remain unchanged for the duration of the investment. The efficiency ratio equals after tax return divided by before tax return.
No primary CGT allowance is taken into account.

- **Product wrappers (retirement annuities, living annuities, preservation funds and endowments) can increase the tax-efficiency of your investment.**

When you invest in a retirement savings vehicle (such as a retirement annuity), you obtain two tax advantages at the cost of restricted liquidity. Your investment (up to a limit set by government, currently 15% of earnings) is deductible from tax in the current year. You also do not pay any taxes on income earned within the fund, and CGT is not applicable to your investment. You will eventually pay normal income tax on the pension withdrawn from your retirement savings, but this will in many cases be at a lower marginal rate than applicable while still employed. The deferment also enables your money to grow faster, as you get additional compounding benefits on the portion of the portfolio that would otherwise have been taxed.

Are you saving enough?

Lower expected returns unfortunately mean that you need to commit more capital to achieve the same outcomes. At a 15% annual rate of return, nominal capital doubles roughly every five years, while it will take six and a half years for capital to double at a rate of return of 11%. The real world impact of this is significant. If you invest R10 000 for 30 years and earn 15% p.a., your final capital value will exceed R660 000; if your rate of return drops to 11%, your final value will be R229 000 which is just more than a third of the former value. The implication of this is that it is probably necessary to increase savings rates by 3% – 4% of income to achieve a similar level of retirement capital than would have been available in a higher return environment.

Another way to contextualise this question is to consider the amount of capital required at retirement to purchase a sustainable income that can keep pace with inflation. Histori-

cally, around 15 times of the required pre-tax income level was typically quoted as a rule of thumb for someone retiring at 65 in reasonable health. This multiple implies a sustainable income withdrawal rate of around 7%. Given our more muted outlook for returns and the likelihood that inflation may be somewhat higher, we think that an initial income withdrawal rate of 5% is more appropriate. This implies that you would require around 20 times your required income level in retirement capital, or 25% more than the 'old normal' rule of thumb.

Do you have access to good advice?

If some of these questions appear daunting, it may mean that you need to consult your financial advisor. It is important that you make the right choices to ensure that your investment plan is still appropriate given the outlook for the markets and your own changing personal needs and circumstances. 