

Optimising asset allocation for tax efficiency



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Marriott Asset Management assesses the current economic environment and how retirees should invest to maximise income and minimise tax.

The inflation outlook is critical as it has an important impact on the value of assets. It also provides us with clues regarding monetary policy decisions and, ultimately, interest rates. We expect inflation to steadily increase. We believe that it is likely to average at least 7% over the next decade, and possibly be higher.

Although we have seen inflation ticking up through 2011, it has to some extent been masked by the strength of the rand, which has kept imported inflation at bay, particularly rising food and fuel prices.

Consumers are reeling from higher electricity, fuel and food prices and retail sales are under pressure. The manufacturing sector – essentially a leading indicator of both retail sales and the economy – is struggling, with output down by 6% year-on-year for the month of July. With household debt at a historic high of close to 80%, the savings-to-disposable-income ratio slightly negative at -0.2% and house prices falling in real terms, the outlook for the consumer is bleak. Raising interest rates will exacerbate this.

The million dollar question? How does the Reserve Bank combat inflation without raising interest rates?

Constructing a retirement portfolio in this environment

Retired investors need to consider two aspects: immediate income needs and future income needs, each of which will have different influences on their portfolio decisions.

Looking at immediate requirements: An investment portfolio should provide this income without eroding capital. By eroding capital an investor erodes future income, so it is vital in the early stages of retirement that capital is preserved as far as possible. Investors in living annuities may inadvertently erode their capital by drawing down more than the income earned by the investment. Capital preservation can, however, be achieved by selecting investments that produce the desired income yield.

The portfolio decision regarding current income involves determining the required income level and then acquiring a blend of cash, bonds, real estate and equities that will generate the required income – cash, bonds and real estate providing a reliable high income, and equities enabling the income to grow. Crucially, the choice of equities should include only those which generate a reliable, growing income stream. Examples of these would be Pick 'n Pay, a supplier of essential goods that is able to pass inflation on to consumers, and technology and communications company Altech, with its reliable growing income stream derived from contractual cellphone services.

For future income requirements, an investor's portfolio choice is one that aims to accumulate capital and grow the capital value. This can be achieved by a combination of reinvesting income, which accumulates more capital, and income growth, rendering the capital more valuable. For example, R1 million invested in the RSA government bond R157 in 2001, with all the coupon payments being reinvested in the bond, would currently be worth R2.6 million; the reinvestment of income would have

accumulated the additional R1.6m of capital. If the R1 million was invested in the FTSE/JSE All Share Index in 2001, with dividends reinvested, it would be valued at R4.7 million today. The rise in capital value comes largely from 14% average annual dividend growth. The value of a company grows over time at the rate at which its profit grows. In the same way, the value of an investment grows over time at the rate at which its income grows.

But don't pay more tax than you need to

When planning for future income requirements by maximising capital accumulation and capital value growth, the blend of investments should primarily be influenced by income tax considerations as well as an investor's risk tolerance.

Where income is tax free, the portfolio should be biased towards higher yielding (lower risk) investments like income funds that generate interest and rental income. However, where income is taxable, the portfolio should be biased towards higher income growth (the higher) investments like equity funds that generally produce tax-free dividends.

Investments in financial products like preservation funds, retirement annuities and living annuities, which allow for all income to be reinvested on a tax-free basis, should be biased towards income funds. Investments held by an individual outside of such financial products – unit trusts, for example – should be biased towards equity funds.

Rather than following the traditional balanced fund approach, investors would be well advised to minimise

their tax liabilities by using the income fund portion of a balanced portfolio in their retirement products, and the equity fund portion of a balanced portfolio for their personal savings. This would produce a holistic balance to their portfolio whilst minimising tax.

The future is not as rosy

We do not expect future returns to match those that we have seen in the past. For example, income funds are currently yielding 6% to 8%, whereas the yield was in excess of 11% in 2001. On the equity front, income growth of 14%, on average, over the past decade is likely to be less than 10% for the next decade.

With interest rates likely to rise, we would recommend that investors avoid fixed interest bonds and property at present and wait for higher income yields. Securities such as inflation-linked bonds, NCDs, corporate debt, preference shares and bank deposits provide relative capital stability and will benefit from rising interest rates. On the equity front, high dividend yields in excess of 4% may be had from the multinational companies listed in the US, UK and Europe. In South Africa, the focus should be on the reliable dividend payers in the telecommunications, pharmaceutical, clothing and food industries, as well as a reasonable exposure to good rand-hedge equities. ■