A Value Investor's Guide to Tax-Efficient Investments

Most investors recognise the simple maths. Paying less tax on gains from their investments will increase their net worth. However, as the South African tax regime has evolved over time, so has the array of options to manage tax on investments. Investors are often overwhelmed and confused, and as a result, may either choose options purely to lawfully avoid paying any tax, which may not maximise their returns, or even worse - they do nothing. These are both missed opportunities – and what should be legitimate "money-in-the-bag" is left on the table.

This article outlines a few tax-efficient solutions available to individual investors, while also highlighting the circumstances in which they might make the most sense. We admit – this is a value investor's view of the world – and does not take into account any specific investor's individual circumstances. Comprehensive advice is best obtained from a qualified financial adviser, based on the circumstances of each individual.

Tax in many guises

Tax on investments is paid in various forms, including tax on interest or rentals received, tax on income drawn from an investment, tax on dividends received, and capital gains tax when an investment is sold. Minimising any of the above improves the net return. Even deferring any of the above to a point later in the future is beneficial to investors as it allows investments to compound off a larger base up until that point. Tax savings can also be gained upfront, as is the case with retirement annuities, where individuals are able to make contributions from pre-tax income.

The impact and significance of any of the above tax savings varies widely, depending on individual circumstances. A broad guide based on age and stage serves as a useful starting point in considering what might make the most sense for an investor. The products considered in this article are Tax-Free Investments, retirement annuities and endowments. Please see the appendix for a brief description of each.

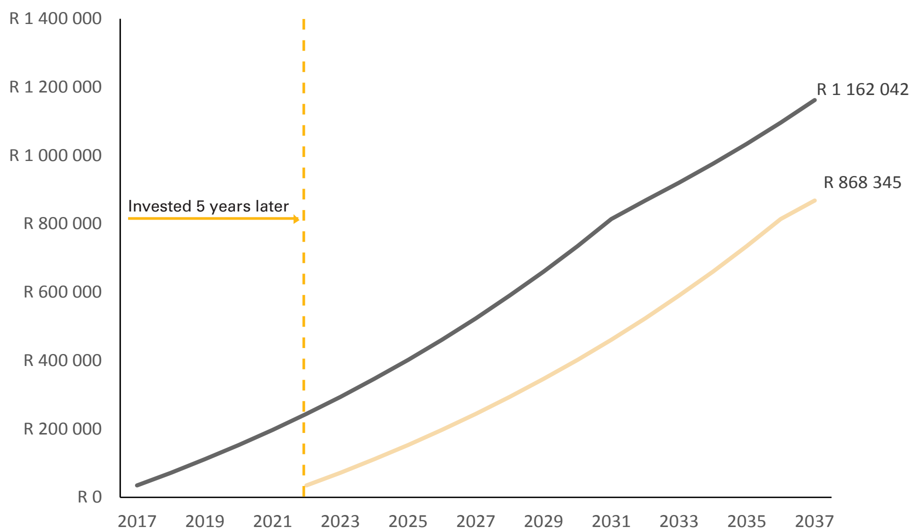
AGE AND STAGE 1: A minor under the age of 18

The main benefit of investing in a Tax-Free Investment on behalf of a minor is time. Capital invested earlier can compound for longer, in a portfolio with the widest possible opportunity set. Add to this a zero-tax regime and the outcome is material.

If the current maximum annual contribution of R33,000 is utilised every year, it would take an investor 16 years to get to the lifetime maximum of R500,000.

To demonstrate the significance of a combination of an early start and zero tax on your returns – consider two investments, spread as above, but starting 5 years apart. (See Chart 1). A Tax-free Investment with the above profile, which starts immediately, and generates 6% real returns, will lead to a difference of more than R300,000 in today's money after 20 years when compared to an investment that starts just 5 years later.

Chart 1: 5 Years Makes a Big Difference



Source: RECM Analyst

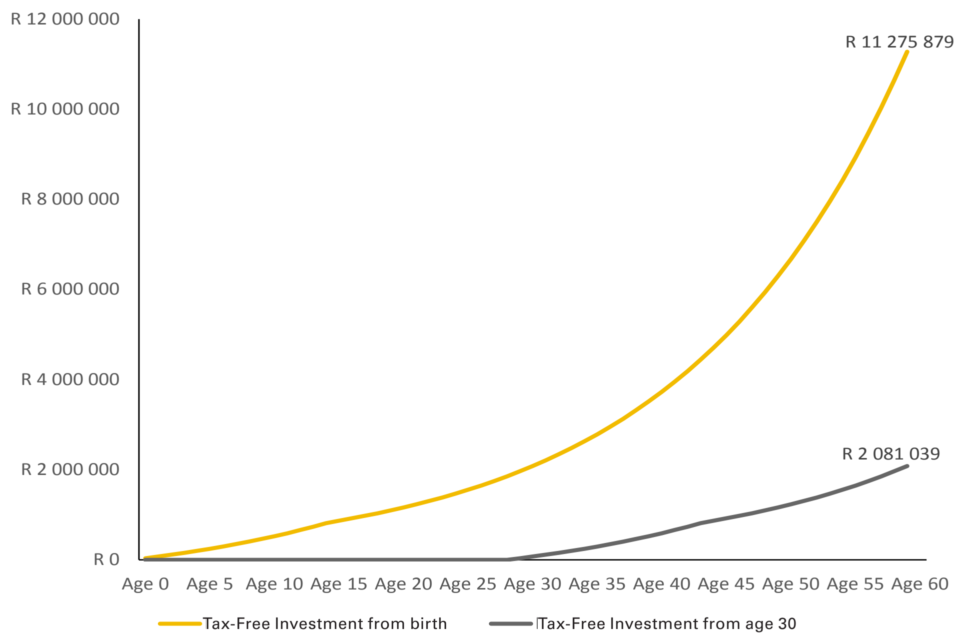
Parents and grandparents need not be overly concerned with "using up" the full R500,000 lifetime limit for a Tax-Free Investment on behalf of their children or grandchildren. Since there is a cap on the annual contributions, contributions need to be spread over a long period anyway. Further, by the time a young adult starts to earn their own income, there are better options available, such as a retirement annuity.

A retirement annuity, which does not make sense for minors who don't earn an income, may well be the best option for individuals during the income-earning parts of their life.

A further benefit however of a Tax-Free Investment is that the investor can determine the profile of ultimate withdrawals. If the redemption is structured as a series of monthly payments, this in essence turns into a tax-free income over time.

Consider this: A Tax-Free Investment from the first year of a child's life, using the full allowance annually, up to R500,000 in total, assuming a real rate of 6% per annum, would be worth R11,2 million in today's terms when the individual is 60 years of age. In contrast, the same investments annually, starting from the age of 30 instead, would be worth only R2 million at age 60.

Chart 2: Real Value of Capital Depending on Age of Start



Source: RECM Analyst

Table 1: Annual income available from Tax-Free Investment portfolio at age 60 for investors starting at various ages

Starting Age	Accumulated Capital (R m) at Age 60	Annual Tax-Free Income Available @ 5%
0	11.275	563 793
5	8.931	446 577
10	6.674	333 708
15	4.987	249 366
20	3.726	186 341
25	2.784	139 245
30	2.081	104 051

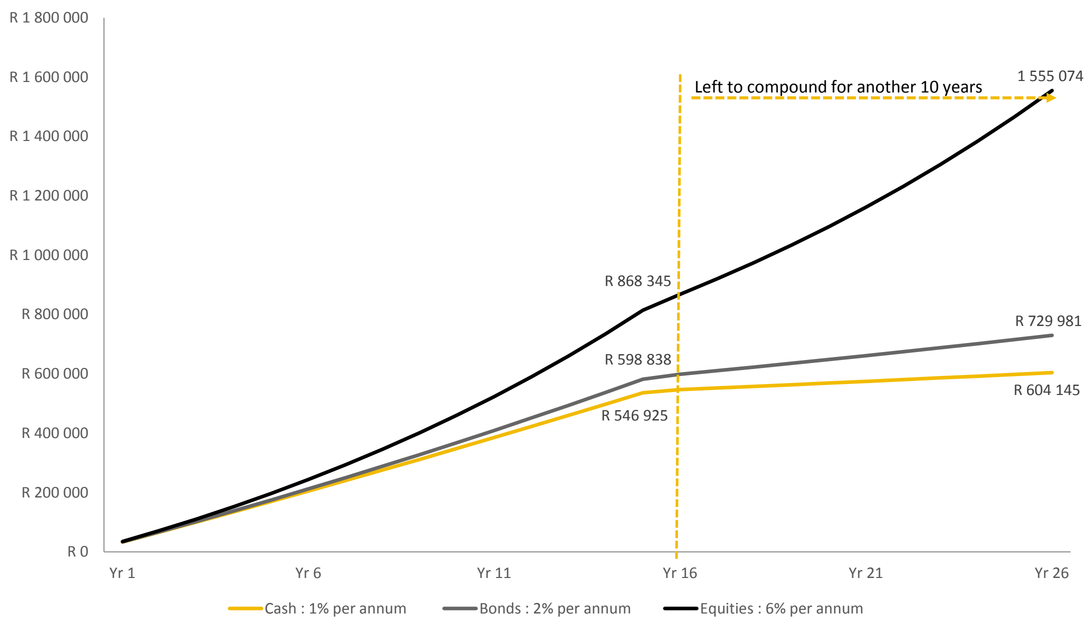
Source: RECM Analyst

A 5% income drawn annually from the capital, which would be entirely tax-free in the case of a Tax-Free Investment (but taxable if from a retirement annuity), at age 60 for the first investor would amount to R563,793 per annum – more than 5 times more than the second investor who started at age 30, earning an income of R104,052 per annum (again – in today's money).

Using a Tax-Free Investment for cash or yield-oriented investments doesn't make much sense for two reasons: Firstly, no tax is incurred until interest earned by an individual exceeds the current exclusion limit of R23,800 per annum. Put another way - an investor earning a 7% yield on a money market fund could invest up to R340,000 outside of a tax-free structure without incurring any tax on the interest earned. So unless the investor wishes to invest substantially more than this, there is no need to use their Tax-Free Investment allowance for this purpose.

Secondly, although it is true that the capital in a Tax-Free Investment is not locked up as it is in the case of a retirement annuity (which could prove useful in an emergency) investing the tax-free allowance in a lower-yielding investment option significantly impacts the potential benefit over time. Ideally, the capital should be left to compound, tax-free, for as long as possible in the highest-yielding asset class. To demonstrate the potential impact of a lower return investment, consider 3 Tax-Free Investments, again utilising the maximum allowance annually, but invested in cash, bonds and equity. Assuming long term real returns of 1%, 2% and 6% per annum respectively for these asset classes, in today's terms, the same R500,000 contribution amounts to R546,925 if invested in cash, R598,838 if invested in bonds, and R868,345 invested in equities. Left to compound for a further 10 years, the gap in returns between the three asset classes widens even further with equities delivering more than double the return earned from cash.

Chart 3: Comparing Investment Options for Tax-Free Investments: Cash, Bonds and Equity



Source: RECM Analyst

AGE AND STAGE 2: An employee earning income

The benefit of the tax saving that comes with contributing to a retirement annuity from pre-tax income makes this the most compelling tax-efficient solution for any income earner paying more than roughly 20% marginal tax. (For lower income earners paying less than 20% tax, factoring in the tax that is potentially paid on the lump sum and income after retirement, the Tax-Free Investment could actually be more compelling.)

A retirement annuity however normally carries Regulation 28 restrictions in terms of the asset that could be held in this form. Equity is restricted to a maximum of 75% and offshore assets to 25%. Retirement annuities also normally have restrictions in terms of access to the underlying assets before retirement age – which is set at minimum age 55.

A Tax-Free Investment makes sense for income earners who have already reached the maximum contributions allowed to their retirement annuity, or for those who would like more flexibility in terms of investment options, and access to capital in an emergency.

AGE AND STAGE 3: Retirement

After retirement, an investor's marginal tax rate is determined by income drawn from the retirement products and other taxable income. If this rate is greater than 30%, an investor may well consider an endowment policy issued by a life insurance company to house their investments. The investor would not benefit from any exemptions on interest income and capital gains for assets in this form, but this may still be worthwhile if tax paid is at a lower rate than would otherwise be the case. Endowment policies have a five-year minimum life however, which imposes liquidity constraints on a portfolio.

The maximum size of a Tax-Free Investment does not allow it to compete head-on with endowments and retirement annuities as a complete solution post-retirement for most investors – unless the full amount is invested early enough for the capital to grow to a worthwhile amount. However, there is very little downside for investors to take advantage of the opportunity to invest this R500,000 without any tax implications in future, into a wide array of products while still having it available if liquidity were ever a problem.

Conclusion

The most powerful force in investing is compounding. If you are able to compound off a larger base through paying less tax or paying tax later, or you are able to compound for a longer period of time by investing as early as possible, this has a formidable impact on the returns generated over time.

Evidence shows that value investing trumps other investment styles over the long term by allowing the greatest inefficiencies in the market to be exploited. The longer the time horizon, the better this is able to work in an investor's favour as markets are erratic and mispricing does not typically correct itself overnight.

This combination of the tax savings, and the value investment style delivering the best returns available to investors when afforded the time horizon to do so, makes a Tax-Free Investment with RECM a worthwhile gift to your future self or indeed, your loved ones.

The following RECM Funds are available as Tax-Free Investments:-

- *The RECM Global Flexible Fund,*
- *The RECM Balanced Fund and*
- *The RECM Money Market Fund*

Disclosure
Collective Investment Schemes are generally medium to long term investments. The value of participatory interests or investments may go down as well as up and fluctuations or movements in exchange rates may also cause the value of underlying international investments to go up or down. Returns are calculated on a lump sum investment, NAV-NAV, net of fees, with net distributions reinvested. Annualised returns are the weighted average compound growth rate earned each year over the given time period. Individual investor performance may differ as result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. Past performance is not necessarily a guide to the future. The manager does not provide any guarantees either with respect to a funds' capital or investment returns. Collective investments are traded at ruling prices and can engage in borrowing and scrip lending. The manager may borrow up to 10% of the market value of the portfolio where insufficient liquidity exists. A schedule of fees and charges and maximum commissions is available on request from the manager. Commission and incentives may be paid and if so, would be included in the overall costs. The quantifiable deduction is the annual management fee (and performance fee where applicable), whilst non-quantifiable fees included in the net asset value price may comprise brokerage, auditor's fees, bank charges, taxes, trustee and custodian fees. Collective investment prices are calculated on a net asset value basis, which is the total value of all assets in the portfolio including any income accrual and less any permissible deductions from the portfolio. Forward pricing is used. Where a fund is exposed to foreign securities, investors should consider the (a) potential constraints on liquidity and repatriations of funds, (b) global macro-economic risks, (c) political risks, (d) foreign exchange risks, (e) tax risks, (f) settlement risks and (g) potential limitations on the availability of market information. Funds may be closed. Prior to investing, please read the Minimum Disclosure Document for your chosen fund/s available at www.recm.co.za.

This document contains objective factual information about our products; does not constitute advice and the reader should approach a financial adviser to determine suitability before investing. Charts, tables and supporting text are hypothetical and provided for illustrative purposes only. No warranty is given as to the accuracy or completeness of the information and no liability is accepted for reliance upon the information.

The RECM Money Market Fund is not a bank deposit account. The price of each unit in the Fund is targeted at a constant value. Investors' total returns are made up of interest received and any gain or loss made on any particular instrument; and that in most cases the return will merely have the effect of increasing or decreasing the daily yield, but in cases of abnormal losses it can have the effect of reducing the capital value of the Fund.

The Fund's yield quoted on an annual effective rate (NACA) basis. The NACA is the effective interest rate an investor can expect to earn over a 12 month period based on the nominal yield of the fund at a point in time. The nominal yield is simply the net interest accrual of all the instruments in the fund divided by the number of units in the fund (the fund NAV). The quoted NACA is always higher than the nominal yield because the calculation is based on an investor re-investing the monthly income distribution back into the fund at the nominal yield. (i.e. The NACA is the compounded annual 12-month rate). Excessive withdrawals from the Fund may place the Fund under liquidity pressures; and in such circumstances a process of ring fencing of withdrawal instructions and managed pay-outs over time may be followed.

The Manager of the RECM Funds is RECM Collective Investments (Pty) Ltd, Company Registration Number: 2004/027540/07, registered under the Collective Investment Schemes Control Act of 2002 and is a member of the Association for Savings and Investment SA (ASISA). The Investment Manager is Regarding Capital Management (Pty) Ltd, FSP No 18834 and the Trustees, the Standard Bank of SA Limited, PO Box 54, Cape Town, 8000.

Summary of Tax-Efficient Priorities Given Age and Stage

	Tax-Free Investment	Retirement Annuity	Endowment
Minor	1	2	3
Very low income/tax rate employee	1	2	3
Higher income/tax rate employee	2	1	3
Retiree with tax rate under 30%	1	2	3
Retiree with tax rate over 30%	1	3	2

THE PRODUCTS CONSIDERED

Tax-Free Investment

The Tax-free Investment option has been available to South African investors since 2015. It currently allows contributions of up to R33,000 a year, with a total lifetime limit of R500,000. Any withdrawals from this investment do not increase your annual or lifetime contribution limit.

Within these parameters, this investment will never pay income tax, dividends tax or capital gains tax and allows a wide array of investment options compared to more restrictive structures such as retirement annuities. Withdrawals from such an investment – whether in a lump sum format or as regular payments, are also completely tax-free.

Retirement Annuity

To incentivise saving for retirement, tax authorities provide a powerful incentive for most income earners: For annual contributions up to R350,000, individuals are refunded the tax they originally paid on the income earned. This is an upfront tax saving, which can be more than 40% of the contribution depending on the individual's tax rate. On retirement the individual can draw a third of the investment as a cash lump sum, which is taxable on a sliding scale with the first R500,000 being exempt. The income drawn from the annuity thereafter is taxed at the individual's marginal rate.

Endowment Policy

An endowment policy is issued by a life insurance company, and effectively swaps an individual's tax position for that of the life insurer. This means they would pay tax at the rate that the life company must apply, which is set at 30%. Endowments are quite restrictive regarding contributions and withdrawals, and only allow one loan and one withdrawal from the policy during the first 5 years, up to a maximum of the original capital plus interest at 5% per year.

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