May 2022

Capital Gains Tax is no small change

Many of us are resistant to change and, in many cases, look for ways to avoid it. In investments, this aversion is complicated by the fact that near term costs – such as capital gains tax – are offset with future gains which are uncertain in terms of both timing and magnitude. In addition to this uncertainty, the expected future gain as a result of making a change may not even materialise!

However, for well-considered investment decisions, we believe there are material long term benefits in making changes to an investment portfolio, but where capital gains tax needs to be paid upfront.

In this month's comment we step through the typical thought process to understand the implications of making portfolio changes, and importantly the implications of avoiding changes.

Why make a change to a well-considered portfolio?

In a perfect world, we would invest in a portfolio on day one and leave it alone for a decade or two, with no tinkering. For this to happen we would need to assume a few things to take place:

- All of the underlying instruments, such as funds or shares, retain their investment merit and integrity over the long-term investment horizon which often spans multiple decades. This would mean that funds retain capable and competent management, and that the fund management businesses responsible continue to thrive (and survive!). Individual shares (companies) are also required to stay in business, innovate and ward off competition all the while surviving financial crises and any manner of adversity.
- There are no changes to the underlying assumptions governing asset allocation between equities, bonds and cash, or local relative to offshore prospects. This is outside of any changes to regulations – such as those allowing more investments offshore in your personal capacity.
- There are no issues holding onto the winners which increasingly dominate a portfolio over time. By way of illustration, over the past thirty years, a simple balanced portfolio which started life at 60% invested in shares in 1990, would today be 83% in shares when left untinkered – a significantly higher risk profile than what was originally set out, and likely at a time when the investor is requiring less risk, not more.

Realistically these assumptions may endure for some time, but history tells us that we need to be more flexible in our expectations in order to maximise wealth over time, and this requires the appetite to make portfolio changes.

There are a few mitigations which can reduce the need for making portfolio adjustments. For instance, forward looking fund due diligence can help to identify problems before they occur, and avoid allocating money to funds which will likely need to be sold later. Establishing a broadly diversified strategy also helps to balance the risk and return profile, enabling a smoother investment journey and less urgency to make many smaller adjustments on a daily, weekly or monthly basis.

Also bear in mind that the bulk of trading in a portfolio consisting of individual unit trust funds happens within each separate fund and shields the investor from numerous and frequent tax payments.

Despite these mitigations, there are cases where adjusting a portfolio makes sense. Below we step through the two main categories to assess how we can factor this into our decision making.

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Investment Linked Reasons

Firstly, changes are likely required when there has been a material change to the outlook of an asset class. We identify these opportunities to rebalance through our internal investment and fund research process, fund insights, and internal valuation models. There are several examples; below are two of the most common.

- *"Selling high, buying low"*

Essentially, you are selling the winners and buying the losers. Doing so has two main benefits; firstly, you maximise the portfolio's return by taking your profits and reallocating them to a cheaper/better opportunity. Secondly, by selling an expensive part of your portfolio, you minimise the portfolio's risk. For example, taking profits on high growth style equities which benefitted from COVID-19 lockdown in 2020, and recycling into cheaper value style equities which were severely punished, was a profitable change to a portfolio.

- *"Selling low, buying low"*

Sometimes there are cases where it makes sense to sell a part of the portfolio which is lagging, and replace it with another opportunity which has similarly underperformed but has better prospects. (Selling a loser for a better loser). This sell-low approach also affords the opportunity to make changes when capital gains costs are minimised.

These opportunities to rebalance come and go, and mostly are 'use it or lose it' scenarios. We have experienced numerous investors wanting to hold onto their past winners, and who in extreme cases have remained substantially undiversified and have suffered the consequences when these positions take a turn. The most common example is Naspers, often held as the largest position in domestic share portfolios over the past decade, and which is now 55% off its highs in 2021. This could be an opportune time to buy into a broadly diversified emerging markets fund for example - performance similarly weak, but many opportunities to recover given the range of underlying holdings; whereas Naspers is a single instrument underpinning a recovery of investor capital.

This is an underutilised 'escape route' from problem legacy holdings in our view.

Risk or Governance linked reasons

The second broad reason we would look to rebalance a portfolio is when there has been a material negative change and a reduction in our confidence levels in a particular fund manager. While we aim to mitigate these instances through our fund research, such changes can and do happen. In this instance, we are aiming to preserve the future return potential of the portfolio by retaining only fund managers in which we have a high level of conviction. Examples of issues we would have natural concerns with include a corporate buyout or significant business change; or any team changes that involve key people in the fund or business.

Generally, consequences come quickly or slowly. Firstly, in cases where the problem is evident and happens quickly, such as a critical member of the team leaving, you could see significant short-term performance issues, potentially leading to liquidity challenges and forced selling within the fund which can lead to permanent capital loss for investors.

Secondly, you get cases where the change is not significant enough to affect performance immediately. Instead, the concerns play through more slowly; in this case, you can see a longer-term performance drag on a portfolio which often struggles to course-correct.

In both of these cases, the solution requires a fund replacement.

These scenarios each have varying degrees of comfort for investors. Selling a 'winner' often seems like a bad idea, particularly when there is a tax bill. Making a fund replacement, often on terms which can be opaque, or after a fund has underperformed, may lead investors to take their chances and sit it out.

To make sense of these potential decisions we first need to evaluate whether the trade-off is sensible.

Evaluating the cost-benefit

Once there is a proposed change to assess, it is important to test whether it is sensible by comparing the costs and benefits.

Firstly, *the cost or tax to be paid*. A helpful way to think about this is to convert it into a percentage of the total portfolio. For example, a portfolio with a value of R1,000,000 and, due to a planned rebalance, a CGT liability of R20,000. This is a known upfront cost of 2% of the portfolio's assets, a material amount.

Secondly, you need to *establish the potential payoff.* This is where it becomes tricky, as these payoffs are in the future and will differ depending on why you are restructuring the portfolio. Some payoffs are easier to establish than others. For example, the impact of a significant change to an underlying fund manager or considerable market dislocation is likely to benefit a portfolio in the short to medium term. However, payoffs expected over the longer term, such as the benefit from increased exposure to a particular investment style, are harder to establish.

Ultimately, the expected future gains need to outweigh the near-term costs, and in our example above we would need to achieve a total return benefit greater than the R20,000 outlaid.

In the example below, we compare two scenarios to illustrate the points above over a 5 year horizon. Firstly, where a change is considered but rejected due to the CGT implications. Then secondly, where the change is agreed and implemented.

1. A starting point where we have budgeted on an annual return of 10% after fees over 5 years;
2. An identified issue with the current portfolio which we wish to counteract, and which is expected to cost 1% per year in returns if we don't;
3. We have also identified a return opportunity where we can hope to add value in future, at 1% per year benefit above the original return;

To implement both the mitigation to the current issue identified as well as take advantage of the return opportunity, it will cost 2% of the asset value of the portfolio today paid in taxes:

	Option 1: No change	Option 2: Changes made
Starting Investment Value	R1,000,000	R1,000,000
Original Expected Return per year	10%	10%
Capital Gains tax paid (2% of Starting Investment)	-	-R20,000
Return issue identified (2)	Original Return less 1% p.a	No impact/mitigated
New return opportunity (3)	No change	+1% p.a
Final Investment Amount (Year 5)	R1.54m	R1.65m

Table 1: Cost vs benefit

This simple example illustrates how incurring relatively material upfront tax costs can be overcome relatively easily by making both corrective and opportunistic changes. In Option 2, the investor is over 7% wealthier after five years, despite paying away 2% of their portfolio at the outset to the tax man. Also, the investor manages to achieve a higher return when compared with the original portfolio, assuming no issues took place over the 5 year period.

The second hurdle is that paying CGT today requires cashflow that many investors do not want to solve at the time. How do they fund it? From the investment itself or from other sources, and at what cost?

If the portfolio is global, do you bring more assets back to SA to fund it, or do you use local assets? These are often tricky decisions to make, despite being in the investors best interest. There are alternatives here such as endowment products which assist in shielding against ongoing tax payments.

Investment portfolios are living, breathing things which require constant care and attention. In the majority of cases, changes are required to make sure that the portfolio stays on track with what was originally planned. This does come with a level of ongoing tax cost, however when you factor in the potential to enhance returns, mitigate risks and continuously reposition for the future, it is likely to make the cost worth it.

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REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

May 2022

data provided by Refinitiv

MARKET REPORT

31/05/2022

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-4.0%	-0.3%	11.0%	13.0%	9.8%	11.6%	15.5%	13.1%
FTSE/JSE SA Listed Property	ZAR	3.6%	-2.6%	15.5%	-5.0%	-5.2%	4.5%	26.3%	21.3%
SA All Bond Index (ALBI)	ZAR	-0.2%	1.2%	5.6%	7.7%	8.2%	7.9%	8.1%	7.9%
SA Cash Index (SteFI)	ZAR	1.1%	1.8%	4.1%	5.1%	6.0%	6.1%	0.4%	0.4%
Balanced Benchmark	ZAR	-3.1%	-3.0%	8.7%	10.6%	9.0%	11.1%	10.6%	8.8%
SA Inflation (1 month lag)	ZAR	2.2%	3.0%	5.9%	4.6%	4.4%	5.0%	1.2%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	-5.5%	-12.8%	-4.4%	13.2%	10.3%	11.7%	15.9%	13.3%
Emerging Markets Equity (Datastream EM)	USD	-7.2%	-11.7%	-19.6%	5.4%	4.2%	4.5%	16.8%	15.6%
Global Property	USD	-2.9%	-12.9%	-1.6%	5.3%	6.3%	8.2%	15.6%	14.1%
Global Bonds (Barclays Global Bond Index)	USD	-10.1%	-13.6%	-16.2%	-1.8%	0.1%	0.6%	6.3%	6.1%
Global Cash	USD	0.3%	0.3%	0.4%	0.8%	1.3%	0.9%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-4.0%	-0.3%	11.0%	13.0%	9.8%	11.6%	15.5%	13.1%
Global Equity (Datastream World)	ZAR	-4.7%	-14.8%	8.6%	15.8%	14.0%	18.6%	16.2%	14.8%
Emerging Markets Equity (Datastream EM)	ZAR	-6.4%	-13.8%	-8.6%	7.8%	7.7%	11.0%	14.2%	13.1%
Global Property	ZAR	-2.1%	-15.0%	11.7%	7.7%	10.0%	14.9%	17.3%	15.0%
SA All Bond Index (ALBI)	ZAR	-0.2%	1.2%	5.6%	7.7%	8.2%	7.9%	8.1%	7.9%
Global Bonds (Barclays Global Bond Index)	ZAR	-7.3%	-13.2%	-1.3%	1.6%	4.2%	7.2%	15.5%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	-3.1%	1.2%	-3.2%	12.4%	7.8%	1.7%	12.7%	14.5%
Gold (Rands)	ZAR	-2.3%	-1.1%	10.0%	15.0%	11.5%	7.9%		
CURRENCIES									
Rand / Dollar	ZAR	-0.8%	2.4%	-13.6%	-2.3%	-3.4%	-6.2%	16.0%	14.9%
Rand / GBP Pound	ZAR	5.3%	9.1%	-0.7%	-2.3%	-2.9%	-4.1%	14.8%	14.6%
Rand / Euro	ZAR	3.8%	8.0%	0.5%	-1.0%	-2.4%	-4.7%	14.3%	13.7%

Spot Rates		31-May-22	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	15.58	14.61	13.72	13.19	8.56	9.77
Rand/GBP	Rand	19.64	19.23	19.52	17.02	13.18	14.29
Rand/EUR	Rand	16.69	16.26	16.77	14.83	10.59	9.13
RATES							
Libor 6m $	US$	2.11	1.47	0.17	1.42	0.74	2.08
Repo Rate	Rand	4.75	4.25	3.50	7.00	5.50	11.50
Prime	Rand	8.25	7.75	7.00	10.50	9.00	14.00
All Bond Index Yield	Rand	10.43	10.08	11.64	9.25	8.02	9.74
COMMODITIES							
Gold ($/oz)	US$	1 845.14	1 941.15	1 905.99	1 267.97	1 566.05	325.30
Platinum	US$	963.00	983.00	1 170.00	947.00	1 405.00	548.00
Oil (Brent Crude) $	US$	122.98	107.46	69.71	50.01	103.01	23.81
INFLATION							
SA Inflation	%	5.9	5.9	5.2	5.5	5.6	9.4

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