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invest with the times

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## Trust days numbered

Investors may no longer rely on a trust to protect their wealth. Certainly not if the Davis-tax committee's proposals on taxation of trusts are to be accepted.

The committee has recommended in its preliminary report on wealth tax that all income and capital gains of trusts must be charged at a fixed rate of 41%! At this stage the inclusion rate for trusts is 66,6% and the effective rate is 26,67%.

In the past the tax rate for individuals was considerably higher than the taxation of trusts. It made sense to transfer assets to trusts to save tax and to plan better for estate duty tax.

The committee aims to disable this benefit. They know investors will use trusts less readily if they offer no income tax benefits. This will mean that the state will be able to collect more on estate tax, which currently makes up only 0.1% of total collections.

Many investors who make use of trusts, may soon sit with expensive tax structures that no longer makes sense. This has far-reaching implications and representations are expected to postpone the application date set for the beginning of March 2016.

The proposals of the Davis committee to increase value added tax (VAT) are not considered by tax experts as unreasonable, since many countries' rates - especially in Africa - are much higher.

The trend worldwide is to collect more indirect taxes, such as VAT, instead of increasing company or individual taxes. An increase from 14% to 17% in VAT will mean an additional income of R45 billion for the state.

If VAT – which currently contributes 27% of tax revenues – is not increased, personal income tax will have to be increased by 6.1% and corporate taxes by 5.2% to generate the same R45 billion.

Interesting is that the committee does not propose higher tax on luxury goods because this will cause too much administration and complexity. The zero-rate on products such as maize will remain because it is a staple food.

The increase in taxes is actually a small price to pay, compared to our country being downgraded to junk status (Moody's Investor Services lowered South Africa's credit grading last year to Baa2, the second lowest investment grade), the ever sliding rand, rising inflation and increased interest rates.

We are experiencing truly challenging times – also on the tax front!

## To Diversify or Not?

The distribution of investments between and within the different asset classes is generally considered to be the key to investment success.

The aim is to compile a portfolio of different investments which reduces the risk of the total portfolio.

It simply means not putting all your eggs into one basket. If the basket falls, the whole lot will break! However, when you distribute your eggs in different baskets, you minimize your risks. It is known as "diversification" and it is in fact regarded as the most important concept in investment management.

But this is a double-edged sword, because diversification is often used in bull markets (upswing in the market) when investors do not particularly need it – and it may very well lead to an increase in costs without any benefits.

In a bear market (downswing in the market) but especially in a total market crash, historical correlations are broken down and investors lose on both the growth and protection portions of their portfolios.

We saw this in 2008-2009 when the stock markets collapsed worldwide and diversification offered little benefit to investors.

This loss was attributed to the fact that investors were not sufficiently diversified. Many thought the inclusion of some bonds or money market investments with their shares would protect them. Investors could have been much more aggressive and diversify the risk in and between the different asset classes.

Too much share diversification means individual investment will not have much impact on the portfolio which would then be no different to an index fund. This is a very expensive route as each individual investment has separate costs.

Chances are that the world economy could soon be entering a bear phase – when stock exchanges fall by at least 20% - or could even end up in total collapse as in 2008-2009.

The world economy rests on three pillars, namely the USA, Europe and China. Two of them are at risk: Europe with the Greek developments (possibility that Greece will leave the euro area) and China – the Hang Seng Index of Chinese enterprises has already fallen by 20% and is officially in a bear phase.

Several factors contribute to a bear market. Among them are weak economic growth, negative international developments, falling sentiment and increased interest rates. It is especially higher interest rates, which will have a negative impact on share prices, because the cost of capital for companies will increase.

Spread your investments

In South Africa the repo rate increased last month by 0.25% to 6%, which in turn increased the prime rate to 9.50%. It is expected that the repo rate will gradually be increased by the Reserve Bank and that next year this time it will be a full percentage point higher.

The USA central bank (Fed) is expected to increase interest rates in September and December this year – the first time in nearly a decade. Capital will flow from emerging countries like SA to the USA, because they offer better security. To preserve capital in South Africa, the Reserve Bank will have to increase local rates. The consumer price index (inflation) increased in June to 4.7% and is expected to peak at 7.2% in the first quarter of next year – higher than the 3-6% target range of the Reserve Bank. It is also possible that the Value Added Tax could increase from 14% to 17% which would increase inflation. At the same time inflation can, however, be controlled by increasing the interest rates.

The weakening of the rand disrupts the economy and increases inflation. Add to this the fact that business confidence is at its lowest in sixteen years and growth expectations in the economy is no more than 2% this year, and it is clear the rand can only continue to weaken. The easiest way to control the sliding rand, is to raise interest rates.

The question is how investors are to deal with the expected bear market?

In uncertain economic times, with a looming bear market, preference shares offer a "margin of safety" with a fixed rate of return which is not affected by the trends in the markets.

Diversification offers the following options:

1. Diversify into equities as an asset class

Shares performed better than all other asset classes during the last few decades and the longer the investment is held, the greater the yield.

2. Diversify within shares

- A share portfolio can be hedged by including preference shares in the portfolio, which reduces the volatility or risk of the total portfolio.
- The shift to preference shares can also be part of a protection (defence) strategy, especially if it is clear that direct shareholding is getting risky.

Moreover preference shares do not require as much management or attention as, for example, direct equity investments which need to be managed consistently. Preference shares certainly bring less stress and more peace of mind.

In uncertain economic times, and with an impending bear market, the best solution is to look at alternative investments, particularly in preference shares.

- Ecsponent offers fixed rates on Class A (monthly income) and Class B (capital growth) regardless of changing rates or what is happening on the stock market. Class B provides a fixed rate of 11.2% per annum and 14% per annum if invested for a period of five years. After five years the investor earns a net return (no costs are deducted) of 70% on Class B.