

5 THE ECONOMIC CYCLE – YOUR INVESTMENT CYCLE

5.1 INDUSTRIES AND THE ECONOMIC CYCLE

The state of the South African economy has a direct influence on the return you get on your investment. We are thinking in particular of the specific investment instrument in which you invest your money (eg property, shares or government stocks). Your investment decision may vary considerably depending on the specific phase (upswing, downswing, recession) of the economic cycle (business cycle). A professional broker should be able to advise you when you have to decide how to invest your package.

Selecting the right time to invest your package is of paramount importance. For example, if you know that the price of unit trusts has just begun to decline and that this decline is expected to continue for a few years, it would be foolish to invest all your money in unit trusts at that stage. The right time is even more important if you want to speculate with your money, in other words when you want to buy shares and sell them at a profit. For people who are investing in shares over the long term the state of the economy is also important. Certain shares are very sensitive to the state of the economy while others are scarcely influenced at all.

You should know how a specific industry is related to the state of the economy (the economic cycle). Certain industries move with the economy while others move in the opposite direction.

Let's look at a few industries, namely growth industries, defensive industries, cyclical industries, interest-rate sensitive industries, and rand-hedging industries.

GROWTH INDUSTRIES

An investment in a growth industry such as computers, the financial sector and electronics will usually perform well, irrespective of the state of the economy. It is important to determine which industries will grow in future.

DEFENSIVE INDUSTRIES

The economic cycle has very little effect (almost none) on defensive industries. People eat, drink and use financial services even in a recession. An investment in the food, beverage and financial services industries will therefore always offer a relatively good return, irrespective of the economic cycle.

CYCLICAL INDUSTRIES

The economic cycle has the biggest influence on cyclical industries, which include durable goods such as cars and furniture. For example, in a recession people will be satisfied with their old cars and old furniture and won't attempt to replace them. You would be well advised to find out more about the state of the economy before you invest in a cyclical industry.

INTEREST RATE-SENSITIVE INDUSTRIES

These industries are largely affected by expectations of rising or declining interest rates. Examples are the building industry, the property industry and the financial sector (banks).

RAND-HEDGING INDUSTRIES

You may also invest in an industry to protect your investment against the depreciation in the value of the rand (rand hedging). Income is usually received in a foreign currency such as dollar or pound. The costs, however, are paid in rand. Shares such as Richemont and Minorco are good examples.

5.2 WHAT DOES THE ECONOMIC CYCLE LOOK LIKE?

In simple terms, the cycle consists of an economic recovery phase, an upswing, a downswing and then a recession.

5.3 HOW DO I INVEST DURING THE ECONOMIC CYCLE?

The returns you are going to earn on your investment will be determined mainly by the decision during a specific cycle to buy (to invest) or sell (to withdraw and reinvest money).

- *Economic recovery*: In a phase of economic recovery short-term interest rates are at a low. You should now invest particularly in commodities (metals and minerals) because of increased demand during the next economic phase, the upswing.
- *Economic upswing*: In this phase investors usually sell government securities, shares and property. Short-term interest rates rise, the inflation rate begins to rise too, and company profits decrease. During an economic upswing new businesses are established and more people are employed.
- *Economic downswing*: In this phase commodities are sold because of an expected drop in demand. Short-term interest rates are very high and government securities are bought because a drop in short-term interest rates and a recession are expected.
- *Recession*: A recession causes negative economic growth. Short-term interest rates drop and investors mostly buy shares and property.

THE PRIMARY PROBLEMS

First you should know the state of the economy – in other words the current stage and which stage in the economic cycle (business cycle) is expected to follow. Then you should know the different types of industry (remember, there are five) and how they react to a specific stage in the economic cycle.

If you invest in fixed property as a speculator the cycle will be of the utmost importance, even more important than the location of the property. The timing of your investment is therefore more important than where you invest. Make sure that you invest in the right place at the right time, especially if you want to speculate. It takes the property cycle about 17 years to move from a low to a high. The return on your investment will be best if you can buy when the cycle is at a low and sell when it is at a high (after about 17 years). The term of a bond is usually 20 years. This is particularly relevant if you have to borrow money (take out a bond) and rent out the property. If you buy when the property cycle is at a low you will have the best protection against rising interest rates.

Of course you should know your individual risk profile and the stage you have reached in your lifecycle, in other words your investment profile. Let's look briefly at investment decisions in the various life stages: youth, family years, career years, years before retirement, and years after retirement.

- *Youth (20–30)*: At this stage you have to learn financial discipline. Any package you receive in these years should be invested for capital growth. Risky investments are recommended because of your age and the number of years before retirement. Invest in property (your own home), unit trusts and shares.
- *The family years (30–40)*: You should still invest for capital growth with a view to your children's future financial needs (yours as well as theirs).
- *The career years (40–50)*: The children leave home and you will probably have more money of your own, in addition to the money from your package, to invest for retirement. Investments for capital growth are still recommended. If you are temporarily or permanently unemployed you should also invest for a monthly income.
- *The years before retirement (50–55)*: Investments for capital growth should now be less risky. Increase your annuities and diversify your investments (spread your investment risk – never put all your eggs in one basket).
- *The years of retirement and afterwards (55 and older)*: Avoid risky investments but concentrate on capital growth if your income needs permit it. Pay off your debts and manage your credit. Protect your investments (your provision for retirement) against inflation.

It is therefore very important to be well informed about

- the economic cycle
- investments in various products in various industries
- how different industries react in different economic cycles
- the stage of your lifecycle
- timing when you are making an investment decision

If you think that the rand will continue to drop for many years to come you should invest in products and industries that will protect the value of your rand. To repeat: first think of your needs, risks and objectives.

6 AVOID THESE PITFALLS!

The investment of your package should be an integral part of your personal financial management. You cannot separate your investment decision or investment planning from your income tax planning, estate duty planning and retirement planning. These four planning areas should be considered carefully before you invest your package, even if you have to consult different advisers.

Example: You receive your package benefits in the form of R200 000, which is taxable, and a further R100 000, which is not taxable. You now have various options:

- *Investment planning:* Invest R100 000 by buying an existing business in order to make a living.
- *Income tax planning:* Invest the R200 000 in a voluntary annuity to partly avoid tax. Only the interest will be taxable.
- *Estate planning:* Take out life cover for future estate planning. This will be necessary as a result of your investment in the business (either take out a life policy or add the money to your annuity). Establish the business as a close corporation to reduce your future estate.
- *Retirement planning:* Say you are 53 years old. As soon as your annuity can be converted into cash in another two years' time (voluntarily), invest one third in unit trusts. Invest two thirds in a living annuity and initially request an income of only 5% so that you will have maximum capital growth.

6.1 INVESTMENT PITFALLS AND HOW TO AVOID THEM

There are many investment pitfalls that most of us will fall into at some stage. Some pitfalls are obvious but to avoid others you will need to know a lot about investments and investment planning.

PITFALL 1: COMPARING THE RETURN OF THE INVESTMENT WITH THE PURPOSE

Comparing the return of a specific investment with the purpose of that investment is definitely the number one pitfall these days. For example, you should never compare the return of an investment in an own home with the return on a risky share. (In South Africa we had to listen to such a debate not so long ago!) Never evaluate the investment in a home only in terms of money.

When it comes to money matters, surely the most basic right is the right to do what you like with your money – this is what personal finance is all about. We have already learned that we should try to be financially independent after retirement, but very few people attain this objective. Each individual is and remains entitled to deal with his hard-earned money/capital during his lifetime as he thinks fit.

In this discussion we look at the financial reasons for buying or renting a home, as well as the non-financial ones. The aim of investing in your own home will hopefully be placed in perspective. Remember that we are not talking about an investment in a second house, but in a home to live in.

What is the argument all about?

Suddenly the media paint a scenario that makes many of us wonder whether we have wasted our lives! We often read (and are told by many brokers) that it is more profitable to rent a house and invest our money in unit trusts or shares. So, sell your house and immediately rent a cheaper house. Invest your 'profits' lucratively. People who are thinking about buying their first house are also advised to rent forever and never buy a house. Invest the difference between the rent and the higher amount that you would have spent on your own home in unit trusts or shares, it is said.

But do we all feel like this about money and the return we'll earn on it? Are all of us motivated by money to the same extent? The answer is a definite no. If this was the case most of us would complete the same studies, do the same work, rent single rooms and measure all our daily activities and our lives against the return on our investments. People are motivated by different things, as has been proven time and again in literally thousands of educational and management books. In the same way some of us are always bowing low before Mammon, others do it only now and then, and God-fearing people never bow

before Mammon. We don't all react in the same way in the presence of money.

What about your other possessions?

If we argue in favour of renting a house we should also weigh up the value of our furniture, jewellery, expensive holidays (are they not all expensive?), social activities, private schools, etc, against the possible return on our money (our investment). This would mean that you should not own anything on which you could have earned a return somewhere else – this is the argument in favour of renting a house.

If this argument is true, you should of course also sell your car and invest the money. People who want to buy cars should rather invest the instalments. Everybody will then have to use 'cheap' public transport – the bus fare is only about R110,50 per month (1999). However, the market mechanism (the way in which the market is operating, ie, supply and demand) will lead to an increase in the demand for bus transport and this demand will push up the monthly bus fares to, say, R1 000 or R2 000 per month. At these rates it would be better to buy your own car and invest the 'bus fare instalments' somewhere else.

Financial considerations when you are renting a home

The same argument holds when you are renting a house instead of buying one. If you rent a house you are using your own money and you don't take out a bond. This means that your money is particularly expensive, because you don't make use of 'leverage financing'. The less money of your own that you put into a house or business the higher the return on your money (usually). If you use only your own money you'll also not be able to rent such a big, expensive house as you will be able to buy.

Nor will you always know when the rent will be increased and by how much. You can never be certain that the house you are renting will not be sold, and if it is sold, you may have to move because you cannot enter into a new contract with the new owner (who wants to move into the house).

Someone who is renting a house will never have peace of mind about his accommodation. Someone who invests his surplus money (which he'll never have, as a result of the market mechanism) on the Stock Exchange when share prices are low will soon sell the shares and buy an own home to acquire peace of mind.

And remember, if everybody rented their homes, rents would become so high that nobody would want to rent. Everybody would then want to buy a house because of the high rents, that is, the high return on an investment in a house (residential property).

After many years of renting a house you will still feel like an immigrant or a student with no more than a place to sit, sleep and eat.

In the past 15 years the return on houses has outperformed the return on shares. When you buy a house you may use the house as security, but financial institutions will not easily lend you money to invest in shares if you don't have security.

After a lifetime of renting a house you will have nothing to show. But if you buy a house your property may be worth a million rand or more (particularly if the house is in an urban area, even an average area).

Retirees and people who are old or sick and who are no longer physically or financially able to look after their own homes may

- rent
- buy property in a full title/sectional title/group housing/retirement scheme that will be maintained on their behalf

Neither technology nor the twenty-first century will change the fact that we all want to own our own homes. We want to have control over this aspect of our lives at least. Even the high interest rates that we experienced in South Africa in the second half of 1998 did not affect the arguments against renting and in favour of buying – particularly over the long term and over a lifetime.

When you rent a home you run the risk of losing your accommodation at any time, but you don't need to pay maintenance, insurance or property tax, and there are no implications for your estate. If the rent becomes too high you simply move again. There are also myriads of household risks attached to owning an own home. These possible expenses are absent or minimal when you rent a home.

Many people rent for years. When you get along with the owner you may even benefit financially (eg you look after the garden and pay less rent; you have a first option to buy, etc).

Financial considerations when you buy a home

People usually buy houses when they are about 25 years old, and most people

own houses by the time they are 45. Because you can buy a house with borrowed money you can buy a bigger house while you are using very little of your own money (usually only the deposit). You thus receive a higher return on your money. Even though your house gets older it increases in value because of inflation. The value of the stand usually increases continuously because less land and fewer stands are available.

When we consider that nowadays children live with their parents for quite a few years after they leave school (without paying rent elsewhere or even to their parents) homeownership holds a lot of financial and other benefits – particularly if the children are unemployed and their parents would have had to pay rent on their behalf.

Buying a house in Clifton, for example, made some people so rich that others can hardly understand how anyone could have bought a house in such an expensive neighbourhood. The subsidy you get from your employer makes it even more beneficial to own a house. If you don't utilise this opportunity you currently (first quarter of 1999) lose about R500 per month. It is an immense financial benefit to receive this amount every month for about 20 years.

A house may be used as security for further loans and a paid-up (or partly paid) mortgage bond may serve as a lifelong emergency fund. If you buy a house today in an 'average' neighbourhood it could be worth a million rand in 20 years' time. Besides, you will enjoy the non-financial benefits and will continue to enjoy them.

The positive aspect is that the house becomes your property at the end of the repayment period. But you pay a lot more for the house because of increases in the interest rate, maintenance, property tax, extensions/up-grading/repairs, etc. Increases in interest rates or sudden unemployment, for example, could mean that you can no longer afford your monthly instalments and that you may lose your house (it may then be sold at auction) as well as all the money you have spent on your house. The result of this, compared with renting, will also be that you'll 'have nothing', and you may be in a worse situation than if you had rented a house. If your employer transfers you and you are forced to sell your house you may also lose a large percentage of your money, particularly if you have to sell the house for less than it is worth. Also, the area in which your house is situated may no longer be regarded as an 'elite' area, which will affect its value. The market may also have a negative effect on your investment. But a paid-up house has many benefits for heirs – it gives them security and creditworthiness.

Why do people buy their own homes?

Nobody will buy a first home at, say, the age of 25 because he or she can/will get a high return on his or her money. No, people leave their parents' homes to stand on their own feet. They hope that owning a home will be part of this independence. Just as you would like to own your own car, you would like to own your own home.

The following reasons for buying an own home have been identified:

Self- and family-oriented needs

Psychological and economic factors are at the basis of self- and family-oriented needs. Psychological motivations for buying a house include

- having a place to stay
- the safety of the family (a safe place to stay)
- independence and freedom (own home and a piece of land for the family)
- creativity (designing and utilising a house)
- adventure (finding the right house)
- gaining knowledge (learning more about contracts and financing)
- peace of mind (no escalation in rent)
- emotional needs (the love you associate with a home and living in a certain neighbourhood)

Economic motivations

- the credit position of buyers (better loan terms, better credit terms)
- amortisation (paying back a loan)
- appreciation (the rising value of a property)
- peace of mind (financial security)

Group-oriented needs

Group-oriented needs when buying an own home revolve around an individual's place in the community. A homeowner

- is a responsible person (creates an element of stability in the area)
- has an interest in the community he lives in
- has a positive attitude towards the area (it's in his interest to improve it)

Political participation by a homeowner

Homeownership may lead to the following:

- political participation (the owner is interested in a stable government)
- public support (the owner contributes to the national wealth by investing in a house)

What are the non-financial benefits of homeownership?

Let's forget for a moment about the financial reasons or motivations for owning your own, fully paid-up house during or after a life of hard work. Let's think about life and the role an own home plays. Those who are living happily in their own homes and neighbourhoods would never swap their houses for more money, particularly if they have lived there for a long time. The pride in their own homes cannot be replaced by money.

All the hard work in the garden, the building of a braai (to suit your own needs), the entertainment area, the swimming pool, rooms for the children and/or grandchildren, the snooker table, sauna, jacuzzi, the fireplace in the main bedroom and/or the family room – all these things are there to satisfy your needs during your lifetime (and you only live once).

A rented home can never give you as much happiness and you can never be as proud of it as of your own home. The things that you do at your own home with your own money can never be compared with the return on another investment, even if others regard your improvements as over-capitalisation. If we always weigh up the value of improvements against the return we could have received, we have lost a lot of what life is really about.

Conclusion

Man has more higher-order needs than receiving the maximum return on capital. If life were only about a higher rate of return on capital we would have to replace most of our possessions (particularly our cars and furniture) with better investments. It would also mean that we would never be able to use our money for travelling, for going overseas, for spending on our children and grandchildren, or for going on holiday, even after retirement, because we would then lose the future return on our investment. We do not buy a place to live in order to get a return on our money: we buy a house to have a place to

stay. But we do choose the best house we can afford (pay our own deposits and finance the transaction ourselves). It is well worth investing in a house. Enjoy owning your own home!

PITFALL 2: A MISCONCEPTION ABOUT INVESTING IN A LIFE POLICY

Nowadays another common pitfall and investment mistake is the misconception that shares will give you a higher return than a life policy. Your investment aims (reasons for investing) and financial needs should never be confused with the return on your investment in, say, a life policy, or on another investment such as shares. Let's take a closer look at this argument.

Many people regard a life policy as something that has been foisted on them by a policy hawk at some stage – possibly the most misguided view a policyholder can have. The truth is that a life policy provides for more needs and objectives than any other human creation or investment.

A life policy is an asset, like a house or a block of flats. It's a non-tangible investment that enables you to transfer your largest financial risks to an insurance company. In return for the monthly premiums you, the policyholder, receives an acceptable yield on an investment with very low risk, not to mention peace of mind.

We have stressed that financial independence after retirement should be the primary objective of every individual. A life policy (even two or three) can help you attain this objective in a way that no other investment can match. Owning a life policy therefore has far-reaching financial implications for the policyholder and, on his death, for the family or next of kin.

Personal financial planning involves different fields of planning. Let's briefly discuss the role of a life policy in a few of these fields.

Career planning

You may take out a life policy to make provision for your child to go to university in 18 years' time. Let the policy mature after 18 years (particularly if you and your spouse have various life policies). After three years all life policies have a maturity value, which is tax-free after five years (previously ten years). You may use an endowment policy to buy a car for a student (child) but you may also use a life policy.

Credit planning

If someone is in debt, his estate could be sequestrated after his death if he hasn't taken out a policy with life cover linked to the debt. Here we are thinking in particular of money owed on a car or a house.

If these debts (car and/or house) have been settled, a life policy could be used to cover estate fees, or could go to the heirs. You may also offer a life policy as security when you borrow money, which means that you don't need to offer your car, plot or house as security. Parents also often use a life policy as security when they borrow money to pay for their children's studies.

In an emergency a life policy may be surrendered (converted into cash). However, the policyholder will lose a large part of his investment.

Investment planning

A life policy is the first investment a school-leaver should make (if he has found a job). It should also be the first investment a couple should make for their children. In the middle years, or even after retirement, a further life policy is an ideal non-risky investment. Potential investors should take the trouble to compare life policies to other investment alternatives. Use the various investment criteria for this (see table 6.1 on the next page).

Retirement planning

You may request that a life policy be matured in order to provide in your needs after retirement. This strategy should only be followed in an emergency, or if you have made other provision for your retirement and for covering the cost of winding up your estate.

The same can be done when your estate is relatively small and/or there are no heirs. The protection against inflation and the capital growth offered by a life policy make it particularly suitable for providing in your retirement needs, while various risks (eg your bond) are covered at the same time.

Protection planning

When it comes to protection against possible risks and future events, an investment in a life policy has no equal.

We all want to protect ourselves and our possessions. There is always a

Table 6.1 A life policy measured against the investment criteria

Investment criteria	Life policy
Risk	Low
Return	Acceptable
Amount invested	Very low (per month) – depending on the state of your health
Term	Three years for surrender value; after three years it may be converted into an endowment policy
Ease of management	This is left to the insurance company
Required level of knowledge	None: an agent can inform you
Safety of your capital	100% safe – guaranteed
Capital growth	Acceptable capital growth
Liquidity	Very liquid after three years
Taxability	The return is tax-free after five years (previously ten years)
Flexibility	Very flexible – the contents can be adapted
Transaction costs	Acceptable. Table 6.2 indicates other domestic and business risks that may be covered by a life policy (irrespective of the return on the investment)
Timing	Doesn't play a role – now is always the best time to take out a policy
Diversification	The risk of a portfolio can be lowered by taking out a policy
Protection against inflation	Premiums may be increased annually with up to 20% to make provision for inflation

possibility (risk) that we may lose these possessions because of circumstances beyond our control.

From earliest times uncertainty and risk have been part of man's environment. To rid ourselves of this burden we transfer the risks to an insurance company that is prepared to carry these risks for a fee.

Estate planning

A life policy can be very useful when an estate has to be administered. A life policy may be taken out on the life of a child over the age of 14. If his parents have not made sufficient provision for the administration of the estate, the child may use the proceeds of the policy to meet these obligations. A life policy is particularly suitable for paying estate duty after a person's death, as well as for paying transfer duty if fixed property is transferred to a natural person or a legal entity.

Conclusion

A life policy may be used in various fields of personal financial planning. As an investment alternative it is surely the most flexible investment instrument because it can be used in so many different ways. A policyholder may use a life policy to cover 90% of his risks, irrespective of whether he's poor, rich, earning a salary, or has an own business.

A life policy could bring you peace of mind in the midst of South Africa's political and economic uncertainties and anxieties. A life policy may be used after the death of the policyholder, but also during his lifetime.

A life policy can be used to cover all the risks indicated in table 6.2.

Table 6.2 Risk cover via a life policy

Type of risk	Insurance
1 Personal risk	
Loss of income as a result of death	Life policy
2 Property risk	
House with a mortgage bond	Life policy
3 Business risks	
(a) Agreement of purchase and sale	Life policy
(b) Partnership insurance	Individual life policy Policy on the life-of-another
(c) Proprietary limited company insurance	Life policy
(d) Close corporation	Life policy
(e) Professional incorporated companies	Life policy
(f) Policies to the benefit of the employer	
(i) Key-person insurance	Life policy
(ii) Bank overdraft	Life policy
(iii) To cover a personal guarantee	Life policy
(iv) To cover a shareholder's loan account	Life policy
(v) To cover a mortgage loan	Life policy
(vi) To make provision for a cash reserve	Life policy
(g) Policies to the benefit of the employee	Life policy
(h) Deferred compensation scheme	Life policy
4 Liability for estate duty	Life policy
5 Estate administration fees	
(a) Executor's fees	Life policy
(b) Transfer duty	Life policy
(c) The cost of selling assets	Life policy
6 Transfer duty	Life policy

PITFALL 3: UNDERESTIMATING THE NEGATIVE EFFECT OF INFLATION

The third major investment pitfall for investors is underestimating the negative effect of inflation on provision for retirement.

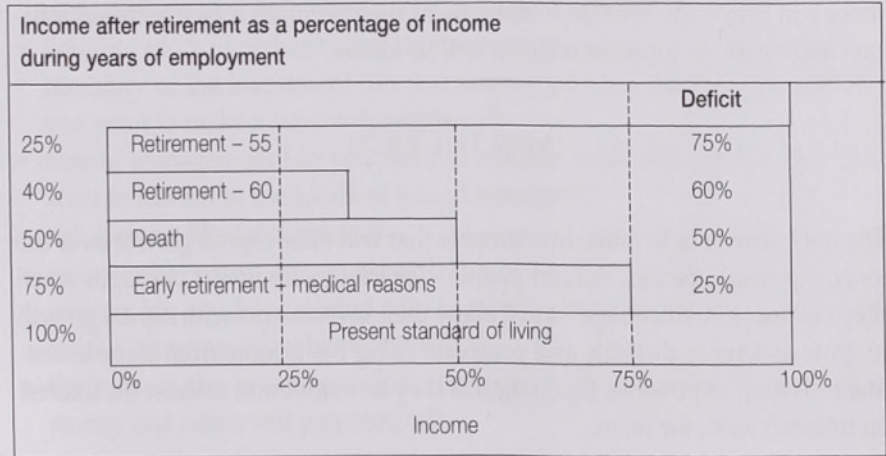
Inflation is the best friend of those who have sufficient fixed property (particularly in the right place) but is a monster to those

- who haven't made sufficient provision for retirement
- who have to rely on income-producing investments (and are dependent on them)
- who don't have any investments that produce capital growth
- who, after retirement, have to rent a place to stay at a market-related fee (ie, they don't own property and don't have sufficient investments with the necessary capital growth)
- whose policies have not been adjusted for inflation each year, particularly if they have to rely on these policies for retirement

For them inflation will be an inescapable monster that will devour the meagre provision they have made for retirement as soon as they retire.

Many South Africans will find themselves in a difficult financial situation after retirement – particularly if they live for many years after retirement and/or are in bad health and don't have a medical aid scheme.

Figure 6.1 Shortfall in income after retirement



The inflation rate

The effect of inflation is calculated by using the factor 72 formula. Suppose the rate of inflation is 12%. The value of an investment will then be halved every six years ($72 \div 12 = 6$). This means that in six years' time an investment of R50 000 (if it does not provide capital growth against inflation) will be worth only R25 000 in today's money.

The effect of inflation can be countered if an investment produces an after-tax return (where the investment produces taxable income) that is higher than the rate of inflation.

Future inflation rate

From 1960 onwards there has been a drastic rise in the rate of inflation. The shortfall in income after retirement is discussed in the section on retirement planning pitfalls (section 6.4).

The histogram in figure 6.1 on page 151 emphasises this deficit in the event of death, early retirement for medical reasons, and retirement at the age of 55 and 60. The current standard of living of each individual is set at 100% (of the standard after retirement). The histogram and the far-reaching financial implications of inflation after retirement will be different for each individual.

For those who don't have sufficient investments for retirement, inflation will increase the income shortfall in each of the four instances. If the person lives for a very long time inflation will eventually reduce the buying power of his or her money to below the breadline. Retirement then becomes a race between inflation and death. In most cases death will be kinder.

WIN THE RACE!

The only answer is to make investments that will offer capital growth over the longest possible period. Retired people – or those who invest packages when they are near retirement age – must allow their investments with capital growth to grow as long as possible and postpone using the income from these investments as long as possible. By doing this they let compound interest (ie, interest on interest) work for them.

PITFALL 4: HAVING INSUFFICIENT KNOWLEDGE OF INVESTMENT PRINCIPLES

Usually investors have little or no knowledge of investment principles. A basic investment principle is that investments with a higher return are more risky than investments with a lower return. Good fund managers have an immense influence on this principle. As a result we find that in the case of unit trusts

- a higher return could accompany a lower risk
- a lower return could accompany a higher risk

PITFALL 5: BEING UNINFORMED ABOUT THE INVESTMENT CRITERIA

Another pitfall is that investors are not informed about the various investment criteria. Compare these criteria with your financial objectives and resources before you choose one – or more – investments. Choosing a specific investment will be determined by a combination of some of the following investment criteria:

- income (do you need it?)
- capital growth (do you need it?)
- whether the investment is safe (do you want a guarantee that your investment amount will be paid out, or do you want to speculate with it and risk losing it or receiving only part of it back?)
- flexibility (are you looking for the possibility of switching to another investment because of certain other needs you may have in future?)
- liquidity (do you perhaps need the investment within a week or a day?)
- taxability of the investment (do you already pay the maximum tax and do you want to make a tax-free investment?)
- ease of management (do you want to manage your investment, or do you want to leave it in the hands of a fund manager?)
- risk (do you like taking risks?)
- return (what return do you expect?)
- amount (do you have a lump sum to invest and what amount do you need for the investment you have in mind?)
- the term of the investment (for what period do you want to invest your money and when will you need it?)

- your marginal tax rate (have you already reached the maximum tax rate?)
- transaction costs (what will it cost you to invest your money? Do you have the necessary funds, or would you rather invest somewhere else because of the high costs?)
- timing (read chapter 5 on the economic cycle and its effect on specific industries)
- diversification (spread your investments to lower your risk)
- control (how much control do you want to have over your investment or its utilisation? Remember the discussion on pension funds versus provident funds)
- knowledge/management requirements (an investment in shares or a holiday resort will require knowledge as well as certain managerial skills)
- inflation (protect yourself against inflation when choosing an investment – invest for capital growth)
- your investment objectives (the most important criterion of all)

MORE PITFALLS

- Many people don't know the difference between investing and gambling. If you invest money for a very short period and there is a possibility that you may lose it, you are actually gambling. You have definitely not invested the money, neither have you speculated with it. The investment term also determines whether you are saving, gambling, speculating or investing. When you gamble with your investment the term is usually very short. When you speculate (if you invest with a view to making money from fluctuations in the market – shares) the term is longer. When you invest the term will be longer still. This doesn't mean that you are gambling if you sell your unit trusts a month after investing in them. The most important factor is your objective when you make an investment.
- It is dangerous to make an investment before you have determined the following:
 - your personal financial situation
 - your household risks and whether you have already made provision for them
 - your risk profile (are you willing to take a risk, or do you prefer to avoid risks?)
 - your short-, medium- and long-term financial objectives

- People don't know how to choose a broker and often use the services of any Tom, Dick or Harry.
- Often income tax planning, estate planning and retirement planning are not kept in mind when the investment decision is made.
- The investment decision is made without taking the stage of your lifecycle into account, in other words your present standard of living as well as your age and marital status (ie, your lifestyle). A younger person (single, with no children) should choose an aggressive investment portfolio; a young family a growth portfolio; a financially established person a balanced portfolio; and a retiree a conservative portfolio (ie, a less aggressive investment strategy).
- Often people don't have proper investment strategies. You should use specific strategies to increase the return on your investment (to maximise the return in relation to your risk or to minimise your risk in relation to your return).
- People often go through life without empowering themselves in the field of personal finance.
- They often invest their packages without consulting a financial specialist.
- They often decide about investments without being aware of the role of these investments in their personal financial planning. You should know why you are making the investment and where it is going to fit into the scheme of your personal financial planning.
- Many people want to make a specific investment because their rich friends or acquaintances have done so. You should never compare yourself with others. Your investment has nothing to do with them. Invest with your own objectives, limitations and financial situation in mind.
- Never allow buzzwords such as 'shares' to confuse you and force you into making a hurried investment. There are lots of investment opportunities that will make you financially independent after retirement and there are many ways of making provision for retirement.
- Remember, you must protect your income, fight inflation, protect your capital, and weigh up the risk and returns against your personal risk profile.
- Many people make investments without any long-term objective in mind. Do strategic planning before you invest your package.
- Never allow fear to determine the type of investment you make. For instance, don't blindly invest in shares with a high yield if you are afraid that you haven't made sufficient provision for retirement. And don't allow fear of

losing your money on the Stock Exchange prevent you from ever investing in shares.

- Don't allow greed to influence your investment strategy. Rather plan purposefully and base your planning on professional advice.
- Don't call up your investments because of mass hysteria in the market (caused by high interest rates, low share prices, etc). An example is when you feel you should sell your shares when the market is weak (share prices are low). Rather keep your shares until the market recovers, or else you convert your paper loss into a real financial loss.

6.2 INCOME TAX PITFALLS AND HOW TO AVOID THEM

Tax liability is one of a long list of investment criteria that investors should keep in mind when they consider different investments. You should, of course, try to pay as little tax as possible. There are various ways of avoiding tax and they are all legal. Tax evasion, however, is not.

Some methods of avoiding tax are as follows:

- If you have received money tax-free, avoid making it taxable again. For example, when you have already been taxed on your package when it was paid out you shouldn't invest in an annuity right away (you will be taxed on your income). If you need the income to live on, it's another matter. If possible, invest your money for as long as possible while enjoying capital growth and avoiding tax.
- If you have to transfer your package to your new employer's retirement fund, or if you want to leave it in a preservation fund, you should have it transferred directly from your current employer's retirement fund. If you first transfer it to your bank account you will definitely be taxed.
- Invest tax-free in your mortgage bond by paying it off.
- The tax-free allowance for interest earned is R2 000 per person (R4 000 for a husband and wife).
- At present dividends are tax-free.
- Your investment is totally tax-free if you invest in capital growth investments.
- When you invest in fixed property (eg a coastal stand) the capital profit you make when you sell the property (after, say, three or ten years) will be tax-free.

- The following cost items are tax-deductible when you invest in income-producing property (property that you buy and then let to somebody else):

- interest on your bond
- maintenance
- municipal rates, water and electricity, or a levy
- short-term insurance premiums
- administration fees

- If you invest in an annuity your bookkeeper should make the necessary tax-deduction.



- If you receive money in terms of a deferred compensation scheme an amount of R30 000 will be tax-free. This has nothing to do with the one-off R120 000 that you are allowed to deduct as a lump sum.
- With a provident fund, a tax deduction of R24 000 applies if the total amount you receive is more than R24 000.
- Should you establish a trust, tax liability may be shared between the person who established the trust, the trustees and the trust itself. In this way tax may be reduced because it is possible to move the income to the person who has the smallest income and thus has to pay the least income tax.
- Any investment in hard assets (diamonds, Krugerrands, Persian carpets) will be tax-free, unless you start trading in them.
- If you transfer your package to a new employer you should make sure that you (or a tax specialist or tax institution) structure your remuneration package in such a way that you have to pay as little tax as possible. Determine beforehand whether your new employer can make certain contributions/payments on your behalf to lower your tax liability.
- You may donate R25 000 a year to a spouse/child/other person/institution/trust without having to pay donations tax. A married couple may therefore donate R50 000 per year.
- Sell fixed assets to heirs/trusts or buy these assets in their names and lend them the purchase price. Bequeath these interest-free loans (if you prefer) to

them in your will. Also donate R25 000 per year to them (either from the loan or over and above the loan).

- Reduce estate duty by
 - buying assets in the name of a child or a trust
 - selling assets to a child or a trust
 - making investments in the name of a trust or a child
 - making provision in your will for establishing a testamentary trust (after your death)
 - appointing the surviving spouse (in your will) and thereafter a child (or two) as the executor(s) of your estate after your death
 - bequeathing everything to your spouse
- Make sure that you receive the maximum tax-free lump sum from your pension, provident and/or retirement annuity fund. Ask an accountant or tax specialist to help you, particularly if you belong to more than one of these funds simultaneously. The Receiver of Revenue will look at the number of years of simultaneous membership, as well as the specific fund you choose, to calculate this amount.
- You could also invest your package with the aim of trading in, say, listed shares or linked unit trusts. You are legally entitled to deduct investment costs such as the following for tax purposes:
 - broker's fees (fees and/or commission)
 - books, magazines and newspapers
 - a computer(s)
 - computer and share programs
 - Internet fees
 - the cost of managing your business and office (even if you are working from home). Again consult a tax specialist.
- Open a bank and/or investment account for your children so that they are taxed on the income from your investments.
- If you need to borrow money, rather borrow from your spouse (or from his or her investment) so that he or she earns the interest that you have to pay as income (particularly where he or she has a much lower income). The interest is now tax-deductible.
- Invest part of your package in an educational trust for your children. They

will have to pay less tax and your estate will be smaller.

- Make better use of investments from which you receive dividends instead of interest, because dividends are tax-free while interest is taxable.
- Involve your children in your business in order to share and lower the tax liability.
- Divide as much of your income as possible between yourself and your spouse.
- Make sure that you use the income from your financial investments at the latest possible stage of your life. By doing this you will postpone the payment of tax, your investments will have time to grow, and you will probably receive this income when you no longer receive income from other sources – so you'll have to pay less tax.

THEREFORE

- Avoid tax (pay as little as possible).
- Make tax-free investments (for capital growth).
- Postpone the payment of tax for as long as possible.

6.3 PITFALLS IN ESTATE PLANNING AND HOW TO AVOID THEM

Estate planning is involved when an individual's assets are transferred to heirs (who may be natural persons or legal entities) during his lifetime or after death. The following financial objectives should be kept in mind when an estate (ie, the sum total of your possessions) is transferred:

- Transfer costs should be minimised (particularly estate duty, the cost of administering the estate, and the cost of transferring fixed property to heirs, institutions or trusts).
- Assets should be protected.
- Provision should be made for sufficient funds (liquid means) to transfer your possessions (assets).

KEEP THESE OBJECTIVES IN MIND WHEN YOU INVEST YOUR
PACKAGE

It is important that the necessary estate planning is done while you are still

alive. After your death you won't be able to do anything about it and the executor will have to administer your estate in terms of the relevant legislation.

Beware of the pitfalls discussed below.

PITFALL 1: NO ESTATE PLANNING (YOUR WILL)



We don't mean that you have not accumulated any possessions/assets during your lifetime but that you have not made provision for the transfer of your estate to other people (dependants or heirs) or institutions after your death. Even if your estate is very small you should do basic estate planning. You should therefore at least have a valid and up-to-date will. What's the use of investing your package if 'undesirable' people will inherit your money? The

law stipulates that your estate will be passed on intestate if you die without a valid will.

We now look at a will in its simplest form. Note that we also refer to trusts. Trusts are used in comprehensive estate planning.

What is a will?

A will is a document in which you stipulate what should happen to your possessions after your death. In your will you name the person(s), legal entities (close corporation or company) and/or institution(s) that are to inherit your possessions, and state which of your possessions should go to whom.

Who may have a will?

Everybody who is 16 years or older is legally entitled to have a will.

Who may draw up a will?

Any person or institution may draw up your will. You may also draw up your own will.

A will must meet certain legal requirements

The testator (man) or testatrix (woman) must sign each page of the will. Two witnesses above the age of 14 must also sign the last page of the will in the presence of the testator or testatrix. The testator or testatrix and the witnesses must acknowledge all the amendments made to the will by signing next to these amendments. No witness may be a beneficiary/heir of the testator or testatrix.

What is a codicil?

A codicil is a separate document that supplements a will. It contains additions to an existing will. The legal requirements pertaining to wills also apply to codicils. Changes to a will may be made in the form of a codicil instead of drawing up a new will.

Different types of will

Ordinary wills can be divided into three categories: a single will, a joint will and a mutual will. A single individual makes his wishes known in a single will, whereas more than one individual would do so in a joint will. A mutual will is a joint will of individuals (usually two) who are each others' beneficiaries.

The preamble

It is important that a will should indicate whose will it is. It must also be clear whether it is a single or a joint will. The first names, surnames and identity numbers of the testator(s) and/or testatrix(es) must be stated in the preamble.

Revoke all previous wills

All previous wills and codicils must be revoked when a new will is drawn up.

Heirs/beneficiaries

Any person or institution that is to receive benefits from the testator/testatrix in the future must be named. You must also state clearly who is to inherit what.

Appoint the executor

The executor is the person (father, mother, wife, friend or attorney) or institu-

tion (bank, building society, insurance company) that you appoint to administer your estate after your death. The term 'estate' indicates all your possessions and the term 'administration' means the way in which your possessions are dealt with after your death.

What is the power of assumption?

Normally an executor is appointed in a will. This executor is not always (in fact seldom) competent to administer an estate in the legal sense, usually because of a lack of legal knowledge. If the testator/testatrix has granted the executor power of assumption, an inexperienced executor may appoint a professional person (such as an attorney) or a financial institution to administer the estate on his or her behalf. The two executors will then share the executor's fees, as mutually agreed upon.

Exempting the executor from providing surety

In theory all executors are obliged to providing surety with the Master of the Supreme Court. This means that the executor must have sufficient capital or assets before the Master will allow him to administer the estate. The Master must therefore first approve these assets or capital. Not all executors are wealthy enough to be accepted by the Master and not everybody will be willing to act as executors if they have to go through this process. It's therefore important that the executor should be exempted in the will from lodging security with the Master.

Trusts and an administrator

A testator/testatrix must appoint an administrator if his or her estate – or part of it – is to be transferred to a trust. Important information include the name of the trust, the names of income and/or capital beneficiaries, the name of the executor, the names of trustees, the contents of the trust deed, and when and how the trust is to be terminated.

List of your assets and liabilities

It is very important that the executor should have a list of all the assets and liabilities in the estate he is to administer.

Simultaneous death

A will must make provision for various scenarios. In the case of a single will alternative beneficiaries, executors, administrators (if applicable), trustees and institutions must be appointed. It could also happen that a husband and wife die at the same time and leave a joint mutual will that will be worthless.

Legal guardian for minors

It is very important to appoint a legal guardian for minors (people below the age of 21) in the event of the spouses dying at the same time. The legal guardian of a minor usually receives the fixed assets and other property on behalf of the minor. I recommend that a trust be established for minors.

Maintenance of dependants

Indicate what provision should be made for the needs of dependants during the winding up of the estate.

Inheritances and future marriages

The testator/testatrix should specify that all inheritances are to be excluded from the matrimonial property regimes of his or her heirs. This is to ensure that his or her estate remains in the hands of future generations of the family. Your child could marry into one of the most unscrupulous families imaginable. Fortune-seeking in-laws could influence the child's spouse to divorce him/her and abscond with half of your estate.

Dying without a valid will

If you die without a valid will your estate will be passed on intestate, with the result that people whom you don't like and whom you don't want to inherit your possessions may inherit from you.

Various copies

Various copies of your will should be kept safely in your house, by your parents, or by an attorney.

PITFALL 2: INSUFFICIENT ESTATE PLANNING

As soon as your assets increase in value – for example when you receive a package – you should consider doing comprehensive estate planning. This involves more than drawing up a simple will. Among other things, you may decide to set up a trust (before or after your death) and establish a close corporation or a company.

As comprehensive estate planning requires knowledge of a number of specialised fields such as law, investments, tax and insurance, professional people should be consulted to assist the owner of the estate (you). Examples are experts in personal finance, lawyers, accountants and insurance advisers (as well as the institutions they work for). Let's now look briefly at trusts.

When should I set up a trust?

People often wonder what a trust really is, how it functions, and what type of trust they should establish.

There are two main types of trust that may be used as estate planning techniques: testamentary trusts and trusts *inter vivos*. It is important to know the objectives of each type of trust, as well as the financial implications for the person who establishes it and the beneficiaries. It is also essential to plan the trust deed very carefully, because it has legal implications when decisions have to be made about how the trust assets (capital) and income from the trust are to be utilised, etc. People who are considering setting up a trust should first find out more about the legal requirements.

What is a trust?

A trust is an independent entity, like a company or a close corporation. A trust is used in estate planning to reach certain objectives and to solve one or more estate planning problems.

A trust may be used in the following cases:

- Suppose someone owns a large number of shares and unit trusts and he manages (invests, sells, converts) this portfolio himself. His only child and heir (besides his wife) is 30 years old and has no knowledge of investments and the Stock Exchange. He doesn't show any interest in such investments and refuses to learn.

The father may establish a trust (preferably in his will) to take care of his investments after his death. He may also appoint a broker in his will to manage the share portfolio on behalf of his child.

The benefits to which the child is entitled – income and/or capital – are stipulated in the will as part of the contents of the trust deed of the trust that is to be established. (The trust deed is a document in which the father describes the functioning of the trust in detail.) The father then includes the contents of the trust deed in his will. In his will the father stipulates that the child will be the beneficiary of the trust. In this way the child's lack of managerial and investment experience is countered.

- A man lives in Sandton and has five young heirs. His luxury home is his only asset and he doesn't know how to bequeath it to his heirs, as it will not be possible to divide the house. He could now establish a testamentary trust (in his will) and place his house in the trust. As his oldest child is 10 years old he could state in his will that all the children may live in the house until the age of 25. After that the house must be sold and the return divided equally among the surviving children. He could do exactly the same if he owns a farm. This is one way of solving the problem of assets that cannot be divided easily.
- A woman owns a large number of properties, including two houses, a holiday home, a block of flats, a farm and various business properties. She realises that she (not to mention her heirs!) has a major estate planning problem, namely estate duty. For generations to come her heirs will lose the largest part of their assets (or a large part, if sufficient provision has been made for estate duty). A trust will offer a solution and she should transfer all her assets to a testamentary trust. This means that estate duty will have to be paid only once – by her. In the meantime she could use various estate planning techniques to reduce the value of her estate. As far as possible the heirs should be named as income beneficiaries in the perpetual testamentary trust. Capital growth will take place in the trust and the heirs will not have to pay estate duty again.
- A trust could be established (in a will) for a minor. The parent could stipulate that the return on his or her life policy or assets should be placed in the trust and that the child is to receive the capital and/or income on his or her twenty-first birthday.
- If someone has an heir who is mentally impaired (such as a child with Down

syndrome) a trust could be established for the heir, because he will never be able to manage his assets himself. The heir must be named in the will as income beneficiary (in which case he will receive a monthly subsistence income) and capital beneficiary. In the case of a testamentary trust the wording of the will should be such that dishonest family members will be prevented from receiving and spending the income on behalf of the heir (eg through fraud or frequent liquidations). Nor should such people ever be allowed to act as administrators, trustees or beneficiaries of this trust (or any other trust).

- A cash amount could be placed in a trust for the education of your children or grandchildren. Use the wording 'until it is needed by the beneficiaries' to protect the income or capital.
- A childless couple could establish a testamentary trust with a religious, charitable or political organisation as beneficiary/beneficiaries (unless they prefer to maintain a higher standard of living and spend all their money during their lifetime). Because of the nature of the beneficiary/beneficiaries no estate duty will be payable.
- Suppose a man and his wife own five properties and have five heirs. They could set up a separate trust for each heir, with his or her property as a trust asset.

Let's now look at the difference between a testamentary trust and a trust *inter vivos*.

Testamentary trust

If an individual establishes a trust in his will it is called a testamentary trust. The contents and stipulations of the trust deed may be deduced from the will. The trust is established after the death of the individual.

The testamentary trust involves a testamentary arrangement between a testator/testatrix (the individual who establishes the trust or owns the estate) and trustees to the benefit of a third party (or parties), the beneficiary/beneficiaries.

Trust *inter vivos*

A trust that is established while an individual is still alive is called a trust *inter vivos*. The purpose of a trust *inter vivos* is to transfer certain assets to a trust but to keep control over the assets.

Which trust?

It is too expensive to transfer an individual's fixed assets to a trust *inter vivos* because of the exorbitant amount that has to be paid in the form of transfer duty (about R20 000 on fixed assets of R500 000). The law has created liquidity problems for individuals and a testamentary trust is the only way to solve the problem. If you want to establish such a trust, however, you must have sufficient life cover (one or more life policies) to pay estate duty. Group insurance or annuities that don't form part of your estate are not sufficient.

If you already own a lot of assets I recommend that you buy any additional fixed assets in the name of a trust *inter vivos* (or in the name of a company or close corporation). This will allow you to avoid the double payment of transfer duty and to save on estate duty.

Plan carefully with the help of an attorney and/or chartered accountant before you set up any kind of trust.

An offshore trust

If you are thinking about emigrating at some stage you should consider setting up an offshore trust. Invest part of your package (the amount that you are allowed) in this trust. This is particularly important if your children or grandchildren might later emigrate, or study or work abroad.

Since 1 July 1997 offshore trusts have held certain benefits for South Africans. An offshore trust counters the devastating effect of tax legislation on an individual's hard-earned assets.

What is an offshore trust?

An offshore trust is registered in one of the 'tax-friendly' countries of the world (tax havens), for example Jersey, the Isle of Man, Guernsey, Luxembourg, Monaco, Liechtenstein and the Bahamas.

Benefits of an offshore trust

- Instead of drawing up an offshore will you could establish an offshore trust. With a will the testator's assets are actually made known to everybody (locally as well as overseas). With offshore trusts no assets are made known to other people (third parties). Confidentiality is of the utmost importance.

- Your assets are protected against legal and political developments in South Africa because they belong to an offshore trust and cannot be affected directly. New legislation will not have any effect on your assets in an offshore trust.
- Assets in such a trust are protected against estate duty as well as an increase in the rate of estate duty (at present 25% on amounts above R1000 000) and/or a reduction in the rebate (at present R1000 000).
- The beneficiaries can easily trace assets that are part of an offshore trust.
- It is easy to divide assets among capital beneficiaries.
- International tax benefits are obtained in these tax-friendly countries.
- International fund managers are in an ideal position to manage (invest and reinvest) these offshore assets. They also enjoy more freedom than their counterparts in South Africa.
- Assets in offshore trusts are protected when the person who established the trust is sequestered. The same is true of future liabilities.
- Income tax benefits are obtained in these 'friendly' countries – this is really what they are, because they protect their investors.

People who want to invest their R500 000 overseas should consider the benefits of an offshore trust.

If amnesty is granted to people who have money and assets overseas 'illegally' they could use the further protection of an offshore trust.

PITFALL 3: NOT REDUCING YOUR ESTATE

Why would you allow your hard-earned package to form part of your estate, only to give it away in estate duty at a later stage?

Protect and preserve your estate

Very few estates have absolutely no outstanding debts. There is almost always some outstanding debt at the time of the death of the owner of the estate, for example a bond on the house, or instalments on a motor car. There are many more examples, such as bank overdrafts, that have to be paid before estate duty and other liabilities can be met.

All outstanding loans and accounts (creditors) must be listed and the amounts added up. This amount is subtracted from the gross value of the estate. Certain rebates are also subtracted in order to determine the net value of

the estate. An individual's estate duty liability is calculated on the basis of this net value.

It is important to note that an individual's matrimonial property dispensation can greatly affect the value of an estate, particularly the net value.

Permissible deductions

After the liabilities of the estate (debts) have been deducted from the assets, certain deductions are allowed. These include

- funeral and deathbed expenses
- money owed to people residing in the RSA
- donations to charitable, educational and religious institutions
- donations to political parties
- the amount equal to the accrual of the spouse of the deceased, where they were married with inclusion of the accrual system
- all costs incurred during the administration and liquidation of the estate
- the maintenance costs of assets (which have to be converted into cash) from the date of death to the date of liquidation
- the cost of food and grazing for animals or livestock that form part of the estate and must be sold
- executor's fees (whether determined in the will or as laid down by law)
- improvements by a next of kin in respect of property owned by the deceased (with the latter's permission) which forms part of the accrual
- improvements by a next of kin (who inherits the interest in the property) in respect of property belonging to the deceased (with the latter's permission) which increases the value of the interest in the property (the increase in the interest can be deducted from the value of the estate of the deceased)