APRIL 2023

INN8
INVEST

WELCOME TO FUTURE FOCUS

AUTUM EDITION

Insights on building wealth for your clients.

In this edition of Future Focus we talk about performance recognition and better transparency in the DFM space. We also share insight on the right number of underlying managers/funds in a solution and how investment managers make decisions. Lastly, we discuss the impact of CGT on the annual retirement savings deductions of your clients.

Navigation

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We hope you find relevant insights in this edition.

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TALKING POINT

*HOVER TO SEE MORE INFORMATION

DFM recognition requires participation and greater transparency

Leigh Kohler

DFM Head: INN8 Invest

Key Points:

- Performance awards have been around for many years. It is imperative that we continue to acknowledge excellent performance by asset managers.
- The massive growth in the DFM space resulted in the first DFM awards to be launched – a great step in providing better transparency.
- However, we need to do more. DFMs need to better support initiatives such as the Citywire awards, and collectively work towards better transparency.

Awards recognise past performance...nothing else

Performance awards across the asset management industry in South Africa have a long and prestigious history. For many years the best performing funds and asset managers have been recognised through awards such as Raging Bull– arguably the most well-known in the industry – and global investment data provider, Morningstar.

These awards typically recognise performance over various periods and are measured in different ways – generally either straight-line or risk-adjusted performance, or some iteration thereof. The point is that each of these bodies define the categories, measurement criteria and calculation methodology – either open and available to the public, or proprietary. They set the rules on how different funds from asset managers are assessed and rated.

As these awards gathered greater awareness, recognition and prominence, there have been critics of the methodologies, calculations or even the bodies themselves. Despite this, the 'rules of the game' of each body have broadly remained intact. The very nature of performance awards is to recognise past performance, which we all know is impacted by many things including market cycles, investment philosophies, styles etc.

Important to reward and recognise good performance

As sophisticated investors, we understand and realise that we cannot use these awards as a proxy for future performance – because we simply do not know what investment markets will look like tomorrow. In our role as Discretionary Fund Manager (DFM) or multi-manager, we need to understand these asset managers and blend them to achieve a more palatable performance profile for clients. Despite this, we have seen that many – but not all – end investors and their advisers place a high value on past performance and awards as the main ingredient for constructing portfolios. We often see advisers using the previous year's winners as the recipe for tomorrow's client portfolios. This is a strategy that is almost always bound to fail. But it should not be a reason to not recognise great performance. In fact, as an industry we need to up the ante on education to clients and advisers around the role of past performance in portfolio construction, but also continue to acknowledge good performance.

First DFM awards launched...despite the challenges

The reason bodies such as Raging Bull, Morningstar and Citywire can award asset managers is because the performance data that they get measured on is transparent, publicly available and frequently published. This is due to the fact that the performance standards and reporting of collective investment schemes (CIS) – unit trusts – is regulated. This makes performance measurement and comparison between various funds rather simple.

Matters are slightly more complicated in the DFM world. Performance measurement is not as straight forward because most DFMs do not manage their own CISs and instead, use model portfolios to execute on their investment views. In fact, according to the latest NMG research, more than 80% of DFMs use models as their main investment vehicle. This is great because model portfolios allow for the very things that have allowed the DFM industry to explode over the last decade – estimations of total assets under management of around R450 billion (Collaborative Exchange DFM Survey 2021).

TALKING POINT

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DFM recognition requires participation and greater transparency (cont.)

This includes portfolio customisation, co-branding of collateral including fact sheets, adviser involvement in investment committee meetings etc. While not all DFMs have the same proposition for advisers and clients, most of them have some view of aligning to the advice process of the adviser and the needs of the client.

The problem, however, is that measuring performance of these model portfolios is very difficult. At present there are no industry performance measurement standards, disclosure standards etc, despite the need for this being well recognised and supported by most DFMs and industry stakeholders i.e. advisers and asset managers.

It therefore came as no surprise when London-based Citywire, a financial publishing and information group, launched its inaugural annual awards for the local DFM industry in 2022. A truly historic moment in our relatively young DFM industry.

Sour grapes or not?

The aim of the Citywire awards is to QUALITATIVELY recognise DFM service by asking advisers, that make use of a DFM, to rate abilities such as investment proposition, technology etc and then to QUANTITATIVELY recognise investment performance by using performance numbers provided by the DFM either from:

1. Model portfolios managed on LISP platforms – verified by the LISP platform, or
2. CISs (unit trusts) managed by the DFM.

Participation is always voluntary – all DFMs know and understand the rules of the game. It could be argued that the service award is subjective, but that the performance awards are objective. The big 'improvement', if you want to use the word, is that advisers and clients are now for the first time, in a position to make some sort of comparison between the various DFMs in our local market.

We are moving to a place of better transparency in performance reporting of DFMs. But the backlash following the first year of DFM awards has been disappointing. There has been both public and 'behind closed doors' criticism of the awards and the methodology and calculations. In other words, the 'rules of the game' have been criticised after entering but not winning.

This is akin to playing a rugby match, knowing the rules, losing the game – and then complaining afterwards that the rules are rubbish because they did not favour their desired outcome

We have heard competitors say that a DFM's main responsibility is not performance – which is just outrageous. If our role as DFMs is not to deliver exceptional performance after fees, then what is it? I would argue that investment performance is a hygiene factor and that everything else in a good DFM proposition are value adds – enhancing the adviser value proposition, investment tools, collateral, fact sheets, co-branding etc. But delivering performance is, and always should be priority. Achieve performance hurdles and benchmarks over relevant time horizons and then, rightfully award those that consistently outperform relative to peers.

DFMs to play ball...submit your returns

Despite the complaints – and a few strange views on performance – most of the DFMs participated. There are a few well-known DFMs that for some or other reason did not participate. Why would a firm managing money not be prepared to disclose performance? Especially in light of the fact that we live in a world where transparency has become non-negotiable. Whilst INN8 Invest won the first ever DFM overall performance awards – which we are super proud of – we continue to be part of a movement pushing towards greater transparency in DFM performance standards and reporting.

Conclusion

It is important that we continue to recognise excellent performance in the DFM industry. Hence the reason we will continue to participate in awards even if we do not win this year or the next. We plan to be a strong voice on important industry topics, even the uncomfortable ones such as performance transparency. Why? Because it is the right thing to do. Clients deserve it. Advisers deserve it. Those working tireless to produce outperformance for clients and advisers deserve it.

Is there a right number of funds/managers to use in a multi-asset solution?

Richo Venter
Joint Head of Portfolio Management (SA)

Key Points:

- The right number of funds/managers to include is not an exact science...you need the art.
- Building a solution is not all about simplistic simulations – it requires other practical considerations.
- Our ongoing research suggests that for a typical balanced solution, the bulk of volatility and tracking risk diversification is achieved through the inclusion of around six to nine funds or strategies.

Introduction

We are often asked by clients what we think the right number of funds is to use in a multi-managed solution. When using an insufficient amount, adequate diversification might not be achieved as individual fund managers can go through prolonged periods of underperformance. Even the most skillful managers with good track records can underperform for years due to bad luck or their specific investment approach being out of favour. Many clients cannot bear such lengthy underperformance and this often results in disinvestments.

By contrast, when using too many funds the performance may be very close to that of the average performance of the peer group from which funds are picked. Although a safer strategy than putting all your eggs in one basket, most clients probably aim for above average performance.

More than one manager... but how many?

In this article we present analysis to explain how we go about establishing a suitable number of funds when constructing a typical multi-asset (balanced) solution. The results from the analysis are by no means a "one size fits all" but should help investors understand the interaction in our solutions between the number of funds, diversification, expected returns and practical matters when constructing solutions.

Methodology

We focused on the ASISA SA Multi-Asset High Equity category, the most utilised Collective Investment Schemes (CIS) category of funds in South Africa. In compiling the research, we used a Monte Carlo simulation – a mathematical technique, that is used to estimate the possible outcomes of an uncertain event.

Thousands of randomly selected combinations

We created 100 000 equally weighted, randomly selected combinations of funds that ranged from combinations of two up to 15 funds in a solution. We then calculated the average volatility and return, as well as the average tracking risk (TR) – previously known as Tracking Error and alpha compared to the benchmark – the ASISA SA Multi-Asset High Equity category.

Diversification results

The diversification results from the simulations are examined from two perspectives – absolute and relative risk – to gather any insights on the right number of funds to use. Let us first look at absolute risk, which we defined as volatility. Volatility is the annualised standard deviation of monthly returns and the higher the volatility, typically the riskier a solution. We view volatility as a suitable proxy for risk given the nature of the underlying assets in the simulations.

Volatility used as proxy for absolute risk

The intention of the exercise is to determine if volatility reduces as funds are added to a solution – as presented in **Graph 1** over the page. The yellow line is the highest volatility result of each combination of funds, green is the lowest, and blue the average volatility.

INVESTMENT CENTRE

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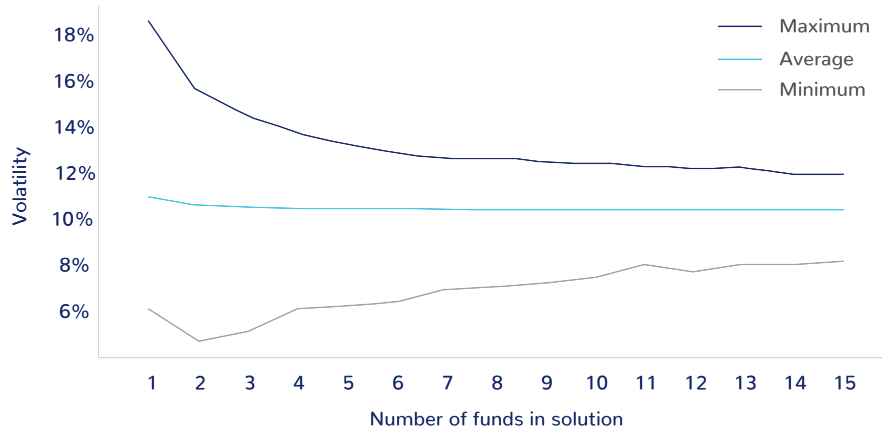
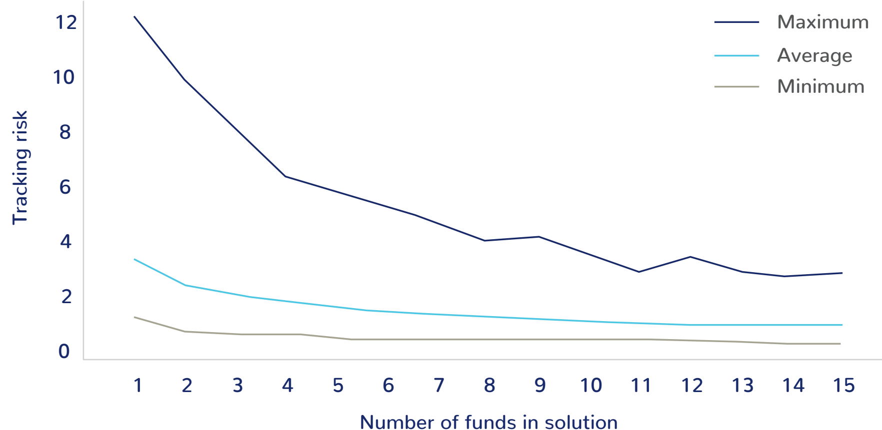
Is there a right number of funds/managers to use in a multi-asset solution? (cont.)

Graph 1: volatility by number of funds in solution



Graph 2: tracking risk (TR) by number of funds in solution



The key take-away from the simulated results detailed in Graph 1 is:

The average volatility marginally decreases as you add funds to a solution, while the maximum volatility (worst case scenarios) improves materially. In other words you can reduce your portfolio's volatility by adding more than one fund. Our ongoing research suggests the inclusion of around six to nine funds or strategies for a typical balanced solution.

As suggested in the introduction, it is difficult to manage investor expectations if peer relative performance is uncompetitive. This is where the next risk measure, TR, is useful, but not perfect. The TR indicates how closely a portfolio follows the performance benchmark used. A TR of 0% suggests the solution and the benchmark performance are identical, which is not appropriate for actively managed solutions as alpha will be zero. A TR above 4% can be considered moderate, with a 32% probability that a solution can out- or underperform the benchmark by more than 4%. For balanced solutions, we consider a TR of between 1% to 2% as appropriate to allow us to achieve above average performance while still managing benchmark risk. We will explain this further below.

TR = Standard deviation of difference between the fund and index returns

Graph 2 shows the simulated average TRs per number of funds used in a solution, and the maximum and minimum values. The key take-aways are:

- On average, a TR of 2% is achieved after including four funds, while a TR of 1% is achieved at around 15 funds – suggesting quite a large range depending on the targeted TR.
- Even with 15 funds, at a TR of 1%, the solution is by no means identical to the peer group average. In other words, a solution does not automatically replicate peers once it holds double digit underlying funds.
- For the maximum TR simulations, note how quickly TR gets diversified when adding funds.

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Is there a right number of funds/managers to use in a multi-asset solution? (cont.)

Return expectations – IR is a helpful measure

In this section we tied up the diversification considerations detailed above with the return expectations to establish if there are any insights on the right number of funds to use in a solution. In our opinion, consistent above average performance compared to industry peers is a good outcome for clients that are peer cognisant, while consistent top quartile performance is exceptional.

Our research suggests longer-term alpha of 0.5% would typically place a balanced solution well into the second quartile – our lowest hurdle for our solutions – while alpha of 1% typically places a solution into top quartile. In aiming for this 1% alpha, the information ratio (IR) is a helpful measure. This ratio essentially shows how much alpha was generated, or lost, from the amount of benchmark relative risk taken.

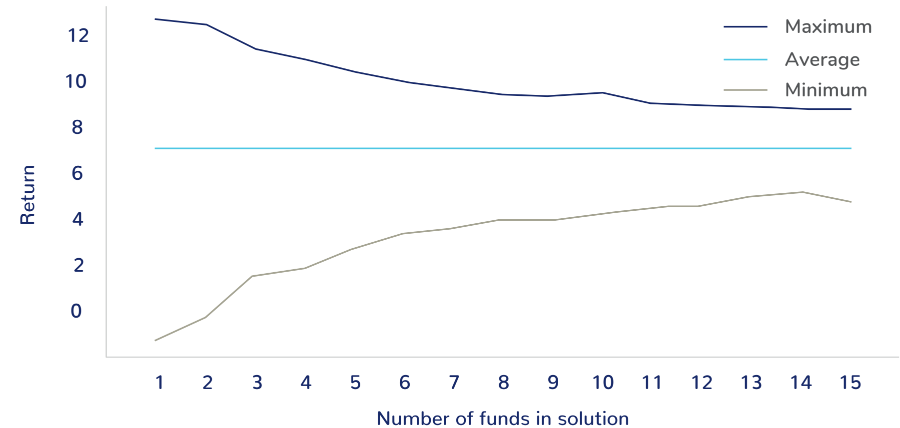
$$IR = \frac{\text{Portfolio Return - Benchmark Return}}{\text{Tracking Risk (TR)}}$$

It is a good measure of performance compared to a benchmark and typically a ratio of 0.5 or above is considered as a good result. Therefore, to achieve the desired outperformance compared to the peer group average, a TR of around 1% to 2% is typically required.

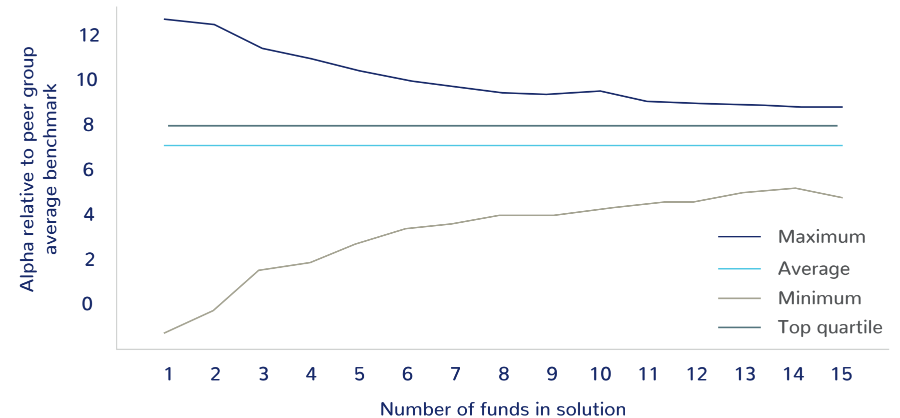
Graph 3 illustrates the simulated average return per combination of funds (in absolute terms) over the past five years.

More interestingly **Graph 4** illustrates the average alpha relative to the peer group average.

Graph 3: return by number of funds in solution



Graph 4: alpha by number of funds in solution



Is there a right number of funds/managers to use in a multi-asset solution? (cont.)

Key take-aways from Graph 4:

- As expected, the average alpha for the simulations is close to zero, which is what investors can expect to achieve on average when selecting funds randomly.
- When looking at the maximum and minimum alpha per combination, note the funnel effect. In our opinion, the typical investor should aim to avoid large underperformance, which gets mitigated as the number of funds increases (light blue line).
- The teal line presents the alpha required to achieve top quartile performance over the past five years of circa 1%. With good fund choice, it is possible to achieve top quartile performance up to almost 15 funds.
- TR is a double-edged sword. The higher the TR, the bigger the chance of underperformance when underperforming funds are selected. Therefore, adding to the number of funds in a solution will likely mitigate severe underperformance.

The **ART OF BUILDING SOLUTIONS** ...more than a simplistic simulation process

Although the historical insights discussed provide good quantitative insights, we also consider practical aspects when constructing solutions.

- Multi-manager role. We spend thousands of hours each year identifying skillful managers, allowing us to generate alpha. We can select from multiple risk type funds/managers or strategies to find our desired outcomes. Our fund line-up is not static but rotates occasionally depending on opportunities. As an example, in our CIS funds, we use segregated account strategies – and not only off-the-shelf funds – to give us further flexibility.

It is not only the number of funds...but the right funds

- Day-to-day management. The larger the number of funds in a solution, the higher the costs and risks. Each of the underlying funds or strategies needs to be maintained on various accounting and reporting systems, adding to expenses.
- Governance. Regular investment and operation due diligence needs to be performed. Too many funds make this task more onerous.
- Fees. Usually, the more assets you place with any one asset manager, the more favourable the fee negotiations. A balance between negotiating favourable but fair fees and using sufficient underlying funds or strategies to meet objectives, is critical.

Conclusion

Theoretically, investors should include all the relevant funds/managers in a solution that are expected to meet the required return objectives, as risk-adjusted returns should continue to improve as you add more funds – but how many is optimal? The optimal number of funds should be determined by the practical considerations 'overlay' to ensure you go beyond the number of funds to also focus on having the right funds/managers in your solution. Hence, there is not a magical right number of funds or strategies, it is a balancing act between diversification, return potential and an investor's unique considerations. We currently use between six and nine funds across our multi-asset solutions, which we view as the "sweet spot".

While many investors might be comfortable being invested in a single fund and the associated risks, we prefer a well-constructed multi-managed solution with sufficient diversification, while still allowing good alpha potential.

MANAGER INSIGHTS

Decoding the decision-making of investment managers

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Jennifer Henry

Deputy Chief Investment Officer

Key Points:

- Investment decision-making is a very important component of the manager selection process.
- Investment managers use various approaches to make decisions – from the use of an individual portfolio manager to co-portfolio or a multi-councillor approach.
- Although we have no ideologies when it comes to decision-making approaches, it is key that the approach adopted enables the manager's philosophy and process for the best potential investment outcomes.

Selecting a fund...do not forget how decisions are made

Selecting investment funds can be a daunting task given the numerous options available. There are more than 1 700 Collective Investment Schemes (CISs) to choose from in South Africa and more than 135 000 mutual funds globally. Even if investors are aided by their financial advisers in narrowing down the opportunity set through risk and needs analysis, there can still be numerous options to choose from.

The investment managers that run these portfolios have different philosophies and processes, which translate into specific approaches towards decision-making. One important aspect of managing money relates to how investment decisions are made. Although this may not always be known to the man in the street, it will have implications and may influence the future performance outcome of an investment manager.

As a DFM, we seek to identify high quality funds and blend them to give investors the best opportunity to achieve their investment goals. This includes unpacking the decision-making approaches of managers and assessing whether it adds or detracts from the final rating allocated to the manager.

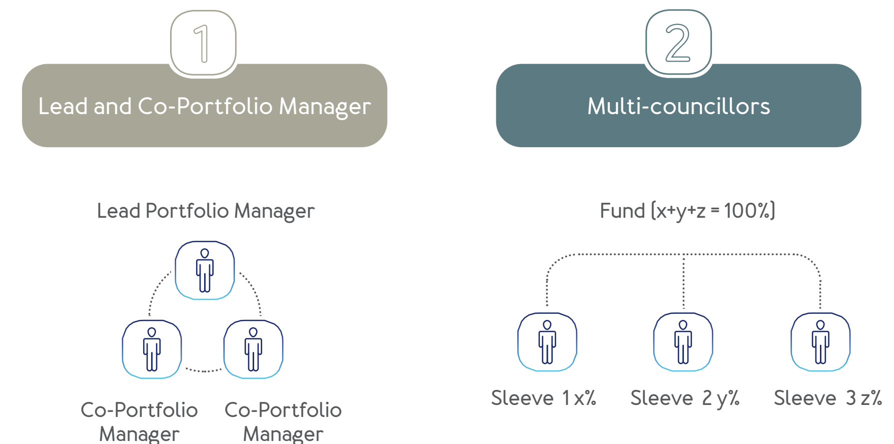
In this article we provide insights into the benefits and pitfalls of the various decision-making approaches. The graphics that follow practically illustrate the differences between the various investment decision-making approaches.

The trend towards collective decision-making

A crucial part of our qualitative assessment of an investment manager is to delve deeply into the investment team, going beyond the assessment of investment experience. We get to the heart of how the investment team is set up for idea generation, analysis discussion and how this leads to the ultimate security selection – stocks and bonds – that ends up in the manager's portfolio. Over time, we have observed that investment managers have trended away from a 'star' portfolio manager mentality to a collective decision-making approach in varying degrees.

Single manager...decision-making approaches

Within a single fund manager, the two distinct approaches to collective investment decisions are:



MANAGER INSIGHTS

Decoding the decision-making of investment managers (cont.)

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Within a co-portfolio manager structure, the lead portfolio manager, who has ultimate accountability, is supported by other portfolio managers who bring forth ideas and analysis, which are then considered by the entire team. The benefits to this are that it reduces key man risk and there is likely better diversity in the ideas and the analysis can be more robust since each co-portfolio manager can watch out for one another's blind spots.

Having a good team culture with robust debate encourages equal participation and contribution from all members of the investment team and is a crucial success factor for collaborative decision making. In addition to having shared responsibility for the assets under management, co-portfolio managers may have the ability to cover more market opportunities and to assess investment ideas.

In interrogating co-portfolio manager structures, we watch out for dogmatic behaviour from the lead portfolio manager. We also look out for the risk of groupthink that can emerge from this approach. Groupthink occurs when individuals within the group prioritise consensus over critical thinking and independent judgment, resulting in flawed decision-making. Furthermore, we assess the investment manager's governance structures that measure and hold each person accountable for their contributions. A potential drawback of this structure is that it can be time-consuming and inefficient, especially in the context of having to make investment decisions during volatile market conditions. We evaluate how co-portfolio managers mitigate these risks and effectively manage conflict and communication.

Single manager: multi-councillor

Like co-portfolio managers, the multi-councillor approach also has the benefits of diverse views and ideas being considered within a portfolio, but the mechanism works differently. A multi-councillor approach involves a portfolio with allocations to individual portfolio managers from the same team, who manage a sleeve or percentage of the overall portfolio. While the team shares insights and collaborate, each councillor implements their highest conviction views and clients receive a blended portfolio with all the individual portfolio manager views being incorporated. Benefits to this type of approach include each councillor's views being assessed by the other councillors for ideas or as feedback to the investment process.

Another benefit is the potential mechanism it creates for transitioning analysts to portfolio managers in a deliberate way, supporting incentivisation and retaining investment talent.

A drawback of the multi-councillor approach is that it can result in over-diversification and the amalgamated portfolio looking like the benchmark. This limits the potential for outperformance. Another pitfall of the multi-councillor approach is that the disclosure of individual councillor's portfolio performances is generally not shared and when there is a change of councillors, it is difficult to pin-point the reasons for the change.

In SA decision-making leans towards the co-portfolio manager approach

In South Africa we see more of a co-portfolio manager approach being used with multi-councillor being adopted by just a handful of asset managers. For example, Allan Gray has been using the multi-councillor approach since the late 1990's, and Foord has used it since 2009. Since around 2015, Coronation has gradually implemented a multi-councillor approach for some of its capabilities, namely Fixed Income, Aggressive and House View Equity. In South Africa the number of multi-councillors responsible for a particular portfolio/fund usually range from 3-5 investment professionals. The investment management houses generally believe that if the number of councillors is too large then the conviction within the portfolio maybe diluted.

DFM and/or multi-manager decision-making approach

A DFM investment approach is where a single investment vehicle – such as a fund – invests in multiple underlying investment managers or strategies. There are several advantages to a multi-managed strategy such as diversification, access to specialised managers, and simplification. Diversification benefits arise when the DFM invests in a range of other investment funds so that the investor gains exposure to different investment styles and the overall fund performance is not impacted by a single manager. This helps to reduce the overall risk of the portfolio and should deliver a more stable return over time. DFMs also have access to a wide variety of specialised managers and can customise mandates with underlying managers to suit the overall fund objectives. Managers within the underlying multi-managed fund are closely monitored by the DFM, who has regular engagement with underlying fund managers to ensure that they are on track to meet their individual objectives. Direct retail clients in an underlying fund are limited in terms of this access and report backs.

MANAGER INSIGHTS

Decoding the decision-making of investment managers (cont.)

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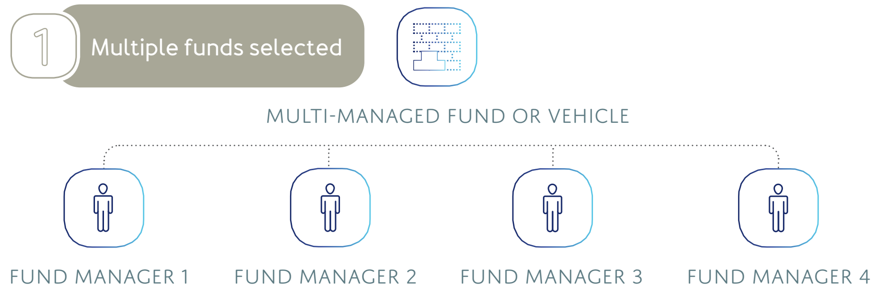
Another approach called best of breed, is where a multi-manager who has a variety of funds defined by various asset classes/mandates and only one manager is allocated within each fund. Therefore, in a best of breed approach the investor only has exposure to a single fund and the decision making set up of that fund i.e., one star portfolio manager, co-portfolio manager or multi-councillor. However, best of breed still has the benefit of a multi-manager who closely monitors the underlying fund manager and has the discretion to replace that underlying fund.

Do not confuse DFM/multi-manager with multi-councillor

Multi-manager and multi-councillor may sound similar, but the key difference is that in a DFM/multi-managed fund, the client is getting exposure to variety of manager styles and different decision-making approaches.



Various investment approaches can be used i.e individual portfolio, co-portfolio manager or multi-councillor

The multi-councillor approach is where the councillors are from the same investment manager and typically use a common buy-list and align their stock or security selection to the overall investment manager's investment philosophy, approach, and process. Therefore, the degree of diversification from adopting a multi-councillor approach is limited to only one investment house and the degree to which councillors differ in terms of the final stock selection and level of conviction. Furthermore, there are many other house and investment considerations that contribute to 'single fund risk', which is not diversified by a multi-councillor approach.

2 Best of Breed

MULTI-MANAGED FUND OR VEHICLE FOR ONE ASSET CLASS OR OBJECTIVE (1)

BEST OF BREED MANAGER SPECIFIC TO THAT ASSET CLASS OR OBJECTIVE (1)

No ideologies when it comes to decision-making approaches

The primary role of a DFM is to assist investors to diversify 'single fund risk'. We also understand that even good fund managers go through periods of underperformance and a multi-managed approach is likely to deliver a more consistent outcome over time, given its diverse exposure to good managers. When blending these managers, one of our objectives is to reduce the impact of individual bias.

Whether investment managers use an individual portfolio manager, co-portfolio, or multi-councillor approach to make decisions, we seek to identify bias that exists within investment managers. This bias could arise from the manager's investment approach, or the experiences and backgrounds of the individual portfolio managers and analysts.

We strongly believe that investment ideologies should not dictate investment manager selection. As such, we do not prioritise any method – whether co-portfolio or multi-councillor. Instead, we consider various factors when assessing a house, such as the expertise and competence of the individuals involved in analysis and the role individuals play.

Ultimately, our focus is to identify investment managers with the skill and ability to generate alpha in the future, based on a comprehensive evaluation of numerous factors, characteristics, interactions, and attributes. The investment decision-making approach is therefore key, only from the point of view that its works well for the particular investment manager and enables the manager's philosophy and process to deliver the best potential investment outcomes.

PRACTICE NOTES

The impact of CGT on your retirement savings deduction

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Albert Louw CFP®

Head: Content & Practice Management

Key Points:

- The inclusion of the taxable capital gain in Section 11F of the Income Tax Act, presents the opportunity to allocate a larger contribution to retirement funds (i.e. tax saving) for that year of assessment.
- However, your retirement savings deduction is reduced to taxable income before the taxable capital gain is added. In other words, your taxable capital gain is still fully taxable. This dispels the myth that retirement contributions can reduce your tax on capital gains.

This article focuses on Section 11F of the Income Tax Act, which relates to the deduction of contributions to retirement funds. We discuss the impact of Capital Gains Tax (CGT) when calculating the amount you are able to deduct for tax purposes.

Review – three limitations to be considered

The amount of the deduction in a particular year of assessment is limited by Section 11F to the lesser (smaller) of A, B and C below.

A: R350 000

B: 27.5% of the greater of:

Remuneration, excluding retirement lump sum benefits and severance benefits; or Taxable income including a taxable capital gain but before allowing this deduction and the Section 18A donations deduction. It also excludes any retirement lump sum benefits and severance benefits

C: Taxable income before the Section 11F deduction and before the inclusion of the taxable capital gains.

PRACTICE NOTES

The impact of CGT on your retirement savings deduction

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'Taxable income' vs. taxable income

– be mindful of the context in which the words are used

Taxable income is used to determine the maximum amount you can deduct for tax purposes for retirement contributions. However, you need to be cautious when applying Section 11F as SARS uses the words taxable income in two instances, which can create confusion. (1) For determining the maximum amount you can deduct for tax purposes for retirement contributions, and (2) to determine your final tax liability.

The following examples illustrate the above application

The calculation is a three-step process:

1. Calculate your retirement fund deduction by applying Section 11F
2. Add your taxable capital gain to calculate your taxable income
3. Apply the tax tables to determine your tax liability

EXAMPLE 1: **R50 000 contribution**

Mrs Selinda earns an annual salary of **R250 000**

Her **employer contributed 20%** (i.e. R50 000) to a **pension fund** on her behalf

She also earned **rental income of R20 000** (no expenses incurred)

She incurred a **taxable capital gain of R2 500 000** after selling shares from the portfolio she inherited from her late father.

PRACTICE NOTES

The impact of CGT on your retirement savings deduction

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STEP 1:

The maximum deduction that she can make is limited to the lesser of:

A: R350 000

B: The greater of:

27.5% x R300 000 (remuneration) = R82 500 or 27.5% x *R2 820 000 = R775 500

*[R2 820 000 = R320 000 + R2 500 000]

C: R2 820 000 (taxable income) – R2 500 000 (taxable capital gain) = R320 000

The deduction will be limited to the lesser of the three amounts in bold, which is R320 000. Mrs Selinda only contributed R50 000 and therefore can deduct the full amount of R50 000 for tax purposes.

To the extent that a taxable capital gain is included in taxable income, it will increase the potential deduction, thus 'saving more tax' for that year of tax assessment.

STEP 2:

The following applies under the tax table:

GROSS INCOME	**R320 000**
- SALARY	R250 000
- EMPLOYER CONTRIBUTION	R50 000
- RENTAL INCOME	R20 000
PLUS: TAXABLE CAPITAL GAIN	R2 500 000
MINUS: RETIREMENT FUND CONTRIBUTIONS	**R50 000**
TAXABLE INCOME	R2 770 000

STEP 3:

The following applies under the tax table:

TAX PAYABLE	R1 081 472
INCOME/'TAKE HOME PAY' AFTER TAX (ASSUME NO REBATES)	R 1 688 528

PRACTICE NOTES

The impact of CGT on your retirement savings deduction

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EXAMPLE 2: Retirement fund contribution of R350 000

Mrs Selinda decided to increase her pension contribution to R350 000 for this year of tax assessment to 'get the full tax benefit' now that she has incurred a taxable capital gain of R2 500 000. She used R300 000 from the sale of shares from her equity portfolio to make a voluntary contribution towards a retirement annuity (RA). The total contribution is therefore R350 000 (R50 000 contribution from her employer and R300 000 voluntary contribution).

STEP 1:

The maximum deduction that she can make is limited to the lesser of:

A: R350 000

B: The greater of:

27.5% x R300 000 (remuneration) = R82 500 or

27.5% x R2 820 000 = R775 500

[R2 820 000 = R320 000 + R2 500 000]

C: R2 820 000 (taxable income) – R2 500 000 (taxable capital gain) = R320 000

The deduction will be limited to the lesser of the three amounts in bold, which is R320 000. Mrs. Selinda contributed R350 000 BUT is now limited to deducting only R320 000 for tax purposes.

Taxable capital gain included BUT your deduction is limited to 'taxable income' only.

STEP 2:

The following applies under the tax table:

GROSS INCOME	R320 000
- SALARY	R250 000
- EMPLOYER CONTRIBUTION	R50 000
- RENTAL INCOME	R20 000
PLUS: TAXABLE CAPITAL GAIN	R2 500 000
MINUS: RETIREMENT FUND CONTRIBUTIONS	R320 000
TAXABLE INCOME	R2 500 000

STEP 3:

The following applies under the tax table:

TAX PAYABLE	R959 972
INCOME/'TAKE HOME PAY' AFTER TAX (ASSUME NO REBATES)	R1 540 028

The result is almost a 50%* (R148 500) tax saving with the additional R300 000 voluntary contribution.

*(*R1 688 528 - R 1 540 028)*

PRACTICE NOTES

*HOVER TO SEE MORE INFORMATION

Investing offshore – CGT depends heavily on the way in which you choose to invest

Dispelling the myth that your retirement contributions can reduce your tax on capital gains

Confusion exists among investors because taxable income, as defined in Section 11F, includes taxable capital gains. However, if you look at the limitations i.e. part C, the retirement savings deduction is reduced to taxable income before the taxable capital gain is added. In other words, your taxable capital gain is therefore still fully taxable – as illustrated per the above examples – and does not reduce the tax on capital gains.

Your taxable capital gain (and the eventual tax arising from it) cannot be eliminated or reduced by the deduction under Section 11F for retirement contributions.

Summary

SARS uses the words 'taxable income' in two instances. This can create misunderstanding and ultimately, the miscalculation of deductible contributions – 'taxable income' for retirement contribution deductions and taxable income to calculate your final tax payable.

The taxable capital gain is included in Section 11F, BUT your deduction limited to 'taxable income' only. Therefore, if you wish to make a larger retirement contribution in a year where you also have a large taxable capital gain, first apply Section 11F to assess the maximum amount you can deduct, before deciding on what your voluntary contribution should be to achieve the maximum tax saving.

INN8 Invest is not a tax professional. Please seek the appropriate assistance/advice from a qualified financial or tax adviser.

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