CONSEQUENCE
PRIVATE WEALTH

Talking Points
Tax-efficient diversification, asset allocation and saving with a TFSA

Morningstar Investment Management South Africa
16th September 2019

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For Financial Advisors and their Clients

As the old saying goes - only two things in life are certain: death and taxes. While most people avoid the topic like the plague, tax remains a key consideration for all individuals earning an income in South Africa.

In 2015, National Treasury introduced tax-free savings accounts (TFSA's) to improve the overall savings rate of South African citizens. It's not often you get a gift from government, especially in the form of a tax-saving, so it is best to make the most of it.

The basics of a TFSA

A TFSA allows an individual to invest in various asset classes without having to pay income tax, dividends tax or capital gains tax on the returns from these investments. These accounts can be opened with various banks, asset managers, life insurers and stockbrokers. The annual limit for individual investors in the product is currently R33,000 and the lifetime limit per investor is R500,000. It is essential that contributions do not exceed the annual individual limit of R33,000, as any contributions over and above this amount are taxed at a rate of 40%.

A TFSA is a long-term investment

The term "savings account" is rather unfortunate, given the fact that most individuals would associate this with something that is short-term in nature and easily accessible to fund any unexpected expenses. At Morningstar, we view these investments as long-term savings vehicles, with returns maximised through capital and income growth and compounding over extended periods of time. Something to keep in mind is that, although you may not be taxed on the withdrawals from a TSFA, once you withdraw an amount, it is taken off your lifetime limit.

A TFSA allows for tax-efficient diversification and asset allocation

Another benefit of these accounts is that it is not subject to any regulatory limits in terms of where the money can be invested. A TFSA, therefore, allows an individual to diversify away from South African specific risks through a highly tax-efficient product, without restrictions in how the money is invested.

The question that we often get asked is – "if I can invest in any asset class, what's the ideal asset allocation for a TFSA?". We recommend that investors think of a TFSA as a minimum of a 15-year investment (i.e. using your annual allowance every year but not exceeding the R500,000 lifetime limit). While risk tolerance is likely to be different for each investor and based on their individual circumstances, the nature of the product, however, means that investors will gain the most benefit from significant allocations to growth assets, including both equities and listed property. This would be mainly based on the long-term outperformance of these asset classes against more conservative allocations, such as fixed income and cash.

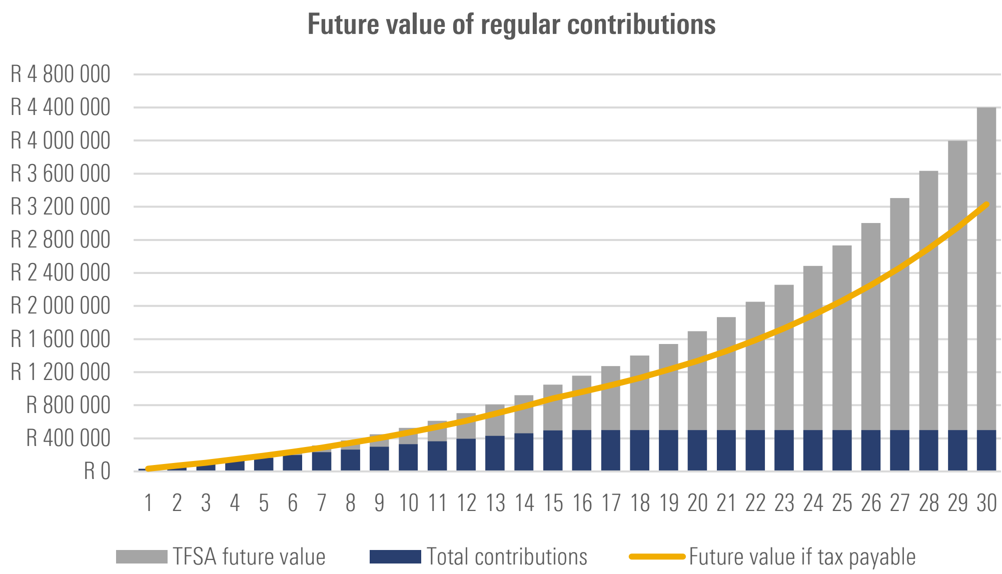
What is more complicated is the decision between how much should be allocated to South Africa versus global exposure. South Africa makes up less than 1% of global stock market capitalisation and, therefore, it makes sense to make use of the large range of opportunities available globally, especially those sectors not represented on the JSE. Investors that have significant allocations in their retirement products to South African equities may want to diversify their exposure by allocating the majority of their TFSA to global equities.

Unit trust versus TFSA

The tax benefit accrued from investing in a TFSA is highly dependent on the individual in question, however, it is worth looking at a real-life example.

Let's compare the returns generated from a TFSA and a normal unit trust based on the following assumptions:

Annual contribution (at the end of each year)	R33,000
Total contributions (achieved after 15 years)	R500,000
Effective tax rate on returns (combination of income and capital gain)	30%
Annual return	10%

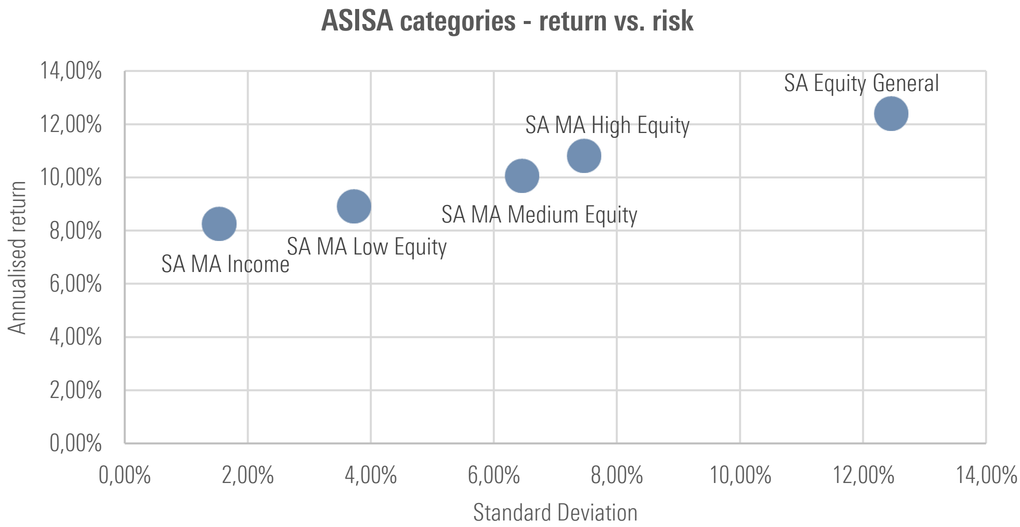


Source: Morningstar Investment Management

What is apparent when comparing the returns of the two different products is that the compounding effect of the tax saving is quite small initially, but over a period of 30 years, the cumulative difference in returns is significant. The taxable series grows to a value of just over R3.2 million after 30 years, while the TFSA series grows to a value of close to R4.4 million – a substantial difference of R1.2 million.

At Morningstar, we view a TFSA as a long-term savings product, especially as the compounding effect of the tax saving is only felt after extended periods of time. This would require meaningful allocations to equity and listed property which deliver higher real (after inflation) returns than cash and bonds.

If we compare the average return and risk of the different ASISA categories over the past 15 years to 31 August 2019, the benefit of higher allocations to equities should be clear. Investors are compensated for taking on more risk (as indicated by the standard deviation), with higher returns. More aggressive asset allocations result in higher returns over longer periods of time, ranging from the SA Multi-Asset Income category (lowest risk and lowest return) to the SA Equity General category (highest risk and highest return). This includes the last five years where investors have not been compensated for taking on risk.



Source: Morningstar Direct

In closing

TFSA's provide South African citizens with a tax-efficient vehicle to save, with the most benefit realised from compounding over long holding periods. We would encourage investors to consider these investments as an important component of their overall savings plans. It is important for individuals to consider their personal circumstances when deciding on different investment options.

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