INTUITION

2 SEPTEMBER 2022

Income is still trumps

I like to believe that my career has been a series of what I call "a-ha" moments. Periods where suddenly the light came on and a series of seemingly unrelated pieces of information suddenly gel together to form an undeniably clear picture in my mind that shapes my future thinking and action. One of those "a-ha" moments was when I realized that income in the form of dividends and movements in the capital value can be quite different and distinctive and that one can go down (capital value) while the other (income in the form of dividends) goes up. I suddenly realized there was a panacea to the fear of market movements, and that was a reliance on dividends for income, not capital changes. It is this revelation that forms the basis of not only how Harvard House manages money, but of how we offer financial planning advice. In a world fixated on asset value and the balance sheet, it is still the income that you need to fund day-to-day living.

Robin Gibson

In the 27 years that I have been at Harvard House, I have been privileged to partner with many clients. Some of those clients died without heirs so we have been placed in the wonderful position of managing the portfolios beyond their death through charitable trusts. This is advantageous from the perspective that we understand exactly what the money can do over time, and because we oversee the trust, we can profile the income in line with our recommended best-case scenarios. In short, these are the clients who never overdraw and don't come to us looking to extract capital for a new car or overseas trip! They provide the perfect example of how things can be.

Recently one of our Financial Advisers approached me as the de facto client to review a portfolio. The data he produced for me provides the basis for this illustration.

The Harvard House investment and financial planning philosophy is founded on 3 guiding principles, we write and talk about them *ad nauseum*:

1. Invest in asset classes that can grow their income stream (largely limited to shares in companies and investments in property) faster than inflation over time.
2. Focus on income growth, not capital movements.
3. Minimise the impact of costs (a topic currently being hotly contested in the financial press)

SPEED READ

- **Investors most commonly ask us what interest rate we offer on investments. It is the wrong question. The answer however is that the ideal income draw to maintain an inflation-adjusted income in perpetuity without destroying capital is 4% - 5% per annum.**
- **Investors could be forgiven for believing that the Harvard House investment philosophy - in the face of state capture, Covid 19 and global inflation - has failed, especially if monitored through the market value of the portfolio.**
- **A recent review of a Charitable Trust portfolio highlights that the thesis of separation of income and capital remains intact and has worked incredibly well through the toughest period in 100 years.**

The outplay is fairly simple. When an investor arrives with a sum of capital requiring income our recommendation is not to draw more than 4% per annum (starting yield) escalated at inflation. Against this guiding principle, 50 years of experience tells us that the investor will enjoy the following benefits:

- They can live to a hundred and plenty if necessary, without their income or capital running out.
- There are likely to be periods in the life of the portfolio when exceptional capital gains may be made that could allow a small lump sum to be drawn without

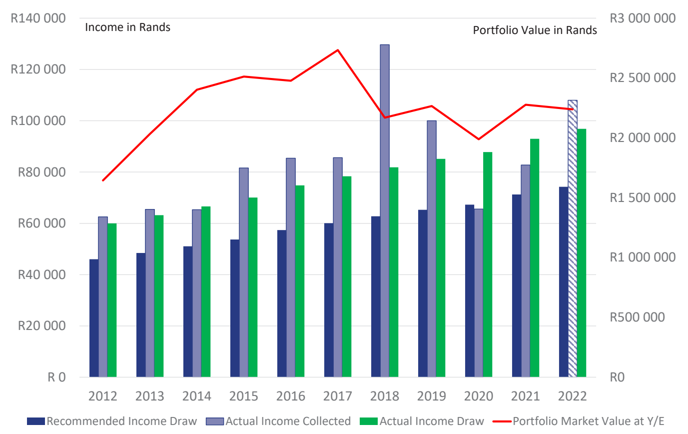
compromising future income (we have not had a period such as this for around 7 years, but it puts us closer to the next one).
- They will not have to adjust their income draw downwards because of a significant decline in the value of their portfolio.
- Their long-term wealth will grow and they will likely provide a substantially bigger inheritance in real terms (after adjusting for inflation) than when they started.

Let's consider our real-life example. We started with an initial capital sum of just under R1.15 million. At our recommended 4% that represented an annual income of R46,000 (although we started at around R 60,000 or 5.2% per annum). Had the investor been capital-focused, they would have been thrilled to see the portfolio balloon to just over R2.7 million over the ensuing 5 years (see the chart below). The income followed too. In 2018 we banked income of R129,652 although this included a special dividend that inflated this number.

From here the capital fell as the pessimism around South Africa accelerated, exacerbated by the Steinhoff Heist and a litany of state capture and Director shenanigans. Simultaneously (and this is not excusing internal events) global winds blew fiercely against emerging markets like South Africa. Then along came Covid followed by the Ukraine Invasion and crazy inflation spikes. The portfolio value fell by more than 30%. You would think that in a portfolio that contained banks (who were instructed not to pay dividends) and listed property (that effectively couldn't claim rentals) the income would have disappeared completely. Not so! Like many portfolios, we collected R65,500 in income in 2020 (65% of the prior year's value). By 2021 this had risen to 80% of 2019 levels and income for the 2022 year is expected to be 100% of the 2019 level. The market value of the portfolio by comparison is only 12% higher than the value at the end of 2020.

It is so easy to lose context in a portfolio that has lost 30% of its perceived value, but how was the client's income statement through the crisis? At the initial recommended R46,000 escalated by inflation, his expected income in the 2020 year (the Covid year) was R67,293. We actually collected R65,567 (but had built up nearly R230,000 in surplus income in the years leading up to this). The 2021 income requirement was R71,263 yet we collected R82,752. The market value? We would argue that is of much less consequence.

DIVIDEND COLLECTIONS / MARKET VALUE



The chart tracks dividend collections and market value against an ideal and actual income target. Demonstrating the immense value of a well-constructed financial plan and prudent investment expectation.

This is just one example of dozens of clients who have benefited from this approach. Market volatility, falling prices, and perceived loss can easily derail us from looking through to the fundamental truth that the portfolio is doing as designed – meeting income needs. It is even easy to become deceived if we don't track the income against a reasonable planned expectation. This merely underpins the exceptional value of a quality financial planner to guide you along the way – and at Harvard House, we have more than 11 such individuals willing and able to help.

Collecting dividends is an essential way to boost income over the long term.

Through a variety of news channels and daily commentators, investors are constantly bombarded with advice on where to invest their money. The most vociferous debates often occur between those who argue that everything should be offshore, and those who argue the opposite. Our next seminar will explore the merits of both markets, through the lens of our identified core themes, and explain why we feel it is wise to hedge your bets.

Harvard House is on Facebook

Harvard House is on YouTube

Topic: **Why still Local AND Global**

Natal Midlands	
Date:	15th September 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	20 September 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

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