

Hindsight 2020

2020 was a year unlike any other. For many investors, their greatest fears were realized. In June 2020, amid major market concern and volatility, Harvard House presented “Dividends are Dead, Long live the Dividend”. In this article, we look at some of our assessments in that presentation and how it played out over the remainder of the year.



**Robin
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We specifically looked at three major questions in our presentation and more specifically, those related to the listed property sector, which was the hardest hit in the pandemic.

Question 1: Would I have been better off paying more investment costs and having had a mix of lower risk Balanced Funds?

What we said: We used the model of a client who initially invested in a Local Discretionary Portfolio managed by Harvard House with the first deposit of R300,000 in February 2011 and then added a further R800,000 at retirement in December 2012. At the peak, this client’s portfolio was valued at approximately R2,25 million and an income of just over R13,000pm was being drawn - a draw of almost 7% per annum on the maximum value and 14% on the original investment value. The client held a high portion of the portfolio in listed property to meet the income draw requirements. We acknowledged that on a relative basis, this probably led to a greater fall in market value than a higher cost structure consisting of a selection of Balanced Unit Trusts, which is favoured by many high street advisers.

We illustrated that had the client, at the end of March 2020, invested in the Balanced Funds (an equal investment in the country’s three largest High Equity Balanced Funds) through an adviser on a recognised platform, their market value would have been approximately R175,000 higher. We cautioned that our philosophy recommends that clients stay in asset classes that can grow their income – equity and property - and that we believed that a recovery would not only close this gap significantly but exceed the recovery within the Balanced Fund sector.

We illustrated how statistics demonstrated in previous market crashes that higher risk portfolios recover approximately 15% to 20% more than Balanced Funds in

SPEED READ

- Assets that generate growing income streams (like Shares and Listed Property) have been more volatile from a price perspective during this crisis, but the recovery has been stronger than more conservative assets.
- Sentiment may be the most deceiving investment indicator known to man.
- Covid will reshape the world as we know it. Investing, however, remains a game of buying sustainable profits into the future – whatever they may look like.

the years following a crash, placing the patient investor (who suffered to a greater extent in the meltdown) in a better position overall.

How it has played out so far?

As we know markets enjoyed a partial recovery after the crisis but then drifted off. The lows in the equity market and listed property sector didn’t occur until the end of October when a combination of renewed lockdowns in Europe as the second wave gathered pace and fears over the outcome of the US elections sent shockwaves through all global markets. This meant that the low for the Discretionary Portfolio was at the end of October 2020.

Balanced Funds saw a different profile. While they were also exposed to the same equity market trends, the bond market (which made up at least 35% to 40% of their investments) fared differently. Bond yields rose aggressively in March due to global concern and then South Africa’s subsequent investment downgrade. The remainder of the year saw a strong recovery with yields recovering and the Rand strengthening to levels last seen before the pandemic. This buoyed the Balanced Funds from their March 2020 lows.

As at the end of December, had the client been invested in the Balanced Fund portfolio from the outset, rather than his Harvard House portfolio, his market value would have been R1,323,733 (after all costs and income draws), up from a low of R1,076,685 in March 2020. This reflects a recovery of 22.9%.

The client's actual Harvard House portfolio bottomed in October 2020 at R1,035,650 but recovered to end the 2020 year at R1,219,692, a recovery of 17.9%.

Our story about the rate of recovery may appear invalid. However, consider the market recovery from the end of October to the end of December, where the bond market did very little (and this will probably continue to be the case going forward). The Balanced Portfolio only grew by 7.26% while the Harvard House portfolio grew by 17.8%.

Conclusion: We continue to believe that the evidence suggests that economic recovery and improved sentiment as vaccines are rolled out will benefit our client's Local Discretionary Share Portfolio rather than a higher-cost platform holding Balanced Funds. Markets have demonstrated how quickly they can advance – often by substantial amounts - even when the news flow would appear to be worsening in the short term. The alternatives offer far less certainty than the rewards of being patient.

Question 2: With companies cutting dividends, surely the Harvard House philosophy is dead?

What we said: Using the same illustrative portfolio, we demonstrated our approach to income. While the fear for investors was that no income would be received, we believed this to be nothing more than scaremongering by an eager Press feeding on alarmist headlines. We produced a chart of expected dividends, for the period 1 April 2020 to 31 March 2021. Given our assessment of the client's holdings and our estimates of projected dividends based on our knowledge of the companies, we estimated that their income would slightly exceed R60,000 for the 12 month period.

We emphasised that while we would acknowledge that the reduction in income by around 50% was far from ideal for income investors, it was preferable to the industry's standard approach of focusing on total return after costs and thus creating a dependence on capital growth to generate income returns. During a period of weak markets, the client must sell units to provide income – the less income the units provide, the more units that must be sold to provide the required amount of income. This means that in a period of market recovery there are fewer units to recoup the market value and a quiet erosion of capital occurs. If the number

of units sold can be minimized then the portfolio is in a far stronger position when the recovery comes.

How it has played out so far?

To the end of December 2020, the client has banked R56,224 and we expect additional dividends in the first quarter of 2021 that will bring us extremely close to our projected figure. Interestingly, even though the combined Balanced Portfolio of unit trusts held almost 20% in high-yielding bonds and cash, the dividends received after asset management fees were only R32,892, 42% less. (This covers the 8-month period from April to December 2020). The asset management, administration, and advisory fees charged by Harvard House totaled R9,235 for the period, whereas a client invested in the Balanced Fund would have had to pay additional fees (over and above asset management fees already deducted from the dividends before declaration) of R9,123 to their Adviser and Investment Platform. A comparison of the two scenarios is shown below.

	Balanced Fund Portfolio	Harvard House Portfolio
Income received after asset mgmt fees	R32,892	R46,989
Advisor and administration fees	-R9,123	R0
Client income draw	-R124,506	-R124,506
Capital drawn to supplement income	R100,737	R77,517
Difference	N/a	23% less
SA	3.97%	8.02%

Conclusion: Living on income is better than living on capital. Hands down! Dividends were hurt last year but as economies and company balance sheets recover, so will dividend flows. Harvard House has had to sell less capital to meet the client's income. This implies greater net income as dividends and asset prices recover because the capital growth and future dividend streams will be spread across a broader holding of assets. This compounding effect is what led to the client reaching a peak valuation of R2.25 million versus the Balanced Portfolio's peak valuation of R1.8 million before the crisis. It will be this same effect that will see the client's portfolio recover more strongly over the next 3 to 5 years. The Harvard House income approach, along with investing in asset classes that grow income at

exceptional value, remains robust and as relevant as ever.
Question 3: Surely having suffered such a big decline, I cannot hope to be better off with the Harvard House portfolio compared to moving to a lower risk Balanced Fund, or even cash?

What we said: Using our illustrative client, we did some projections going forward and suggested that, given what we know about Balanced Funds, it made no sense to make that switch. We believed that for it to make sense, Balanced Funds would need to deliver a similar performance to full risk portfolios (which history has never supported.) Furthermore, dividends must drop by 70% and only recover at 15% per year off that low base. We did not deal with cash as we could easily demonstrate that converting to cash was a very destructive move (which is reinforced below).

How it has played out so far?

The best way to show this is by illustrating action. We produced our Insight presentation during June and the client’s Discretionary Portfolio was R1,216,510, the highest valuation since the Crisis unfolded. We have not taken account of trading costs in this illustration. Rather we have assumed zero “slippage” in the transaction. The end values of the various options are as follows:

Investment Option	Illustrative Value at 31 Dec 20
Balanced Fund from Inception	R1,331,639
Convert to cash at end June 2020*	R1,172,776
Convert to Balanced Fund at end June 2020	R1,229,013
Actual Harvard House Portfolio	R1,224,790
* We assumed a cash interest rate of 6.5%, extremely generous	N/a

The table above illustrates that the client would be no better off having taken such drastic action. Just as we suggested in June, the market recovery has benefitted the Harvard House portfolio better than any other. At the worst point in October, the Harvard House portfolio had a valuation more than R200,000 lower than if the client had selected the Balanced Fund at inception. Demonstrating our point, the market movement from the end of October to the end of December (and continuing into January) has shrunk this difference to just R106,668 an improvement of 46%. This is largely because equity and property generally outperform a Balanced Fund in periods where markets show strong appreciation.

Conclusion: The client we chose for this illustration had two characteristics that put him at a distinct disadvantage when it came to comparison purposes. Firstly, he was drawing a very high income (certainly higher than our recommended level.) Secondly, to meet that income requirement, he had high exposure to listed property – the worst-performing asset class in 2020. Despite this, the portfolio has performed admirably relative to the alternatives available to retired investors. (I am excluding being invested solely in a selection of Naspers, Tesla, Amazon, Bitcoin, and other technology shares that hardly pay any income but saw massive moves in 2020.)

We will continue to run this parallel model and report on it. 2020 was difficult for investors and particularly punishing on the nerves of retirees. No investor wants to see their investment value decline, least of all an investor with few options to recreate lost wealth through some form of employment. Nonetheless, retirement is still a long-term game, and with longevity becoming a greater factor with every passing day, having an income stream that can grow into the future is critical. The Harvard House investment philosophy has not been exposed by the events of this pandemic, rather it has been tested and proved sound.

Investors remain convinced that market performance is the “Holy Grail” of investing to the exclusion of all else. We would argue that a much greater predictor of investment success is the level of withdrawal, irrespective of the size of your asset base. Sadly, many investors believe that an asset manager exists that will be able to protect his assets through all events regardless of his income draw. The numbers in this article prove this to be incorrect. Even in the Balanced Fund, this portfolio valuation would have sunk from R1.8 million to R1.3 million – a decline of 30% with almost no exposure to the listed property sector). Investors should also be aware that quoted returns can be very deceiving because they exclude additional adviser and admin fees which must be paid and are effectively an additional income draw.

The pandemic continues all around us, and lives have been impacted in every community across the Globe. We all have a story to tell that leaves us a little aghast at who Covid has taken from us. The markets however are firmly looking to the future. While the future dividends are uncertain and we still must see the recovery in both the economy and profits, there is no doubt that there is a future. Whatever it may resemble, life will carry on, companies will adjust, and profits will return. The last 2 and half months have offered investors some relief, recovery is underway, yet markets may still be volatile. Nonetheless, investors should try to focus on long term truths rather than short term sentiment and anxiety.



Given the uncertainty over a second wave of Covid, we cannot predict with any certainty when we will be allowed to resume our seminars. Until we have clarity, we will continue with our online videos and presentations. Please ensure that you subscribe to our Facebook page and YouTube channel to be kept up to date.



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Please RSVP to Clare Mitchell on 033 3302164 or clarem@hhgroup.co.za.

Topic: N/A

Natal Midlands

Date: N/A

Venue: Fernhill Hotel
Midmar / Tweedie Road
(almost opposite entrance to Midmar)

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

Johannesburg

Date: N/A

Venue: Rosebank Union Church, Cnr
William Nichol and St Andrews
Road, Hurlingham

Time: 7am for 7.30am

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