Hindsight is Foresight

If you have been involved in investment markets for any length of time you would have heard the term "historic performance is no indicator of future return". It is even in our disclaimers if you want to go and dig for it. Of course, the other well-known saying attributed to Mark Twain is "History doesn't repeat itself, but it certainly does rhyme." To proffer an example, I am amused as I watch the governing party declaring success, future success, and, well, nothing short of whistling while the Titanic goes down! To me, I constantly see the rhyme in our politics. I was only in my late teens/early twenties between '85 and '94, but I am sure I have seen blustery denial, and "all is well" speeches from the previous ruling party to our current one. It is easy to be certain now having watched history unfold (and lived it), but I am sure there was the same exasperation among anti-apartheid activists as there is among citizens now – will it ever change, they ask?

It makes me think of my 34-year career in investment markets. It started as a young 20-year-old in 1990. Two weeks later the US went to war in the Gulf against Iraq. I am now 54. Last month, the US shelled targets in Iran – not much has changed.

Robin Gibson

1. Time is the only free lunch in investment markets

We live in an instant world. Marketing machines are bombarding us with the idea that we should do it now, get it now – why wait? I have seen investors of every age give up on investing after just 6 months because 'nothing is happening'. Undoubtedly, time is the most significant contributor to successful investor outcomes – it is also the only thing that every single human being gets issued with equally. (I am not talking about longevity specifically here – rather 60 seconds to a minute, 60 minutes to an hour, 24 hours to a day, 7 days to a week and 52 weeks a year. The length of time your money can work for you will influence how much it can attract in money you did not physically earn. This concept should be taught every year for a child's twelve years in school!

2. Compound Interest IS the 8th wonder of the world

I have seldom met an educated individual who didn't know that compound interest was an incredible wonder or force for good. However, I have met only a handful who truly understood how it is successfully applied.

SPEED READ

- History never repeats exactly, but the ancient wisdom attributed to King Solomon suggests "there is nothing new under the sun."
- Markets by comparison work on well-established cycles of rising and declining inflation and interest rates. The only problem is we don't know when the next cycle starts or ends.
- Over 34 years I have heard the same objections from successive generations (the 40-year-olds objecting now were barely in primary school when I first heard the same objections they are delivering now).
- While no one can predict the future, there are a few time-worn maxims or knowledge that existed long before I was born and still hold today. Here we consider just five.

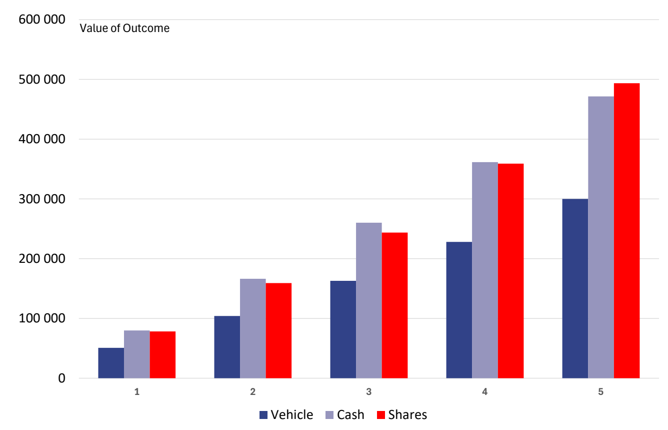
Let's first consider compounding for you and against you. Compounding against you is best illustrated by a loan from a financial institution for a vehicle. Let us consider a R300,000 car loan over 5 years with an interest rate of 10% per annum (probably reflective of many shiny cars on the roads today). In this instance, the lender is going to pay R6,374.11 per month. They will repay R382,446.60 in total - R300,000 in capital and R82,446.60 in interest. At best their asset may be worth R300,000 at the end, but it is unlikely.

To demonstrate how compounding has worked against you, let's take a second individual who invests R6,374.11 every month into a bank account paying 8% per annum interest. He too will pay R382,446.60 into the account, but he will earn interest on interest and consequently have a whopping R471,471.89 at the end. This means he has created additional capital of R89,025.29, but this belongs to him, not the bank! This is an effective R171,471 swing in value.

Let's take compounding into the investing world. We have already illustrated the benefit of an interest-earning bank account. What about a growth asset like a share? Shares don't pay interest like a bank account. Rather, they distribute your 'share' of profits (kind of where the name comes from) through dividends. Logically, different shares have different yields (the dividends paid in a year expressed as a percentage of the share price), but for this exercise let's assume a 3% after-tax yield. Let's also assume that the company increases its dividend by 4% better than inflation over 5 years (assuming 6% inflation). Let's also assume the share price stays unchanged for 3 years and then rises by 10% p.a. in each of the last two years. Now let's take our R6,374.11 and plug it into those assumptions.

What is obvious from our outcomes is that patience is required. For the first 3 years, cash looks like the better option, but the power of compounding income comes into its own as the share price begins to appreciate. (Bear in mind we have used the lower end of long-term returns for the last 2 years. Had we used the average return, the value would be R508,774). Over a longer investment period of 15 to 20 years this becomes a wealth juggernaut.

COMPARISON OF INVESTMENT OUTCOMES



This reflects the cumulative growth in wealth of either buying a vehicle (assuming no depreciation), saving in a bank account earning interest, or saving through a share investment as per our assumptions in point 2. of our article.

3. Cost is a wealth killer

Regular readers will know my obsession with popular psychology, and the concept that human beings cannot make choices outside of comparison. The key is understanding what your comparison is anchored against. For example, investors often anchor their investment expectations in their portfolios against the most highlighted or exciting alternative out there. A good example would be investors' comparisons with Bitcoin returns or one of the recent hyperstocks like Nvidia or Tesla. The comparison makes the investor feel somewhat panicked that they are being left behind. It is a very natural response.

"A good example would be investors' comparisons with Bitcoin returns or one of the recent hyperstocks like Nvidia or Tesla. The comparison makes the investor feel somewhat panicked that they are being left behind. It is a very natural response.

Costs are similar. Costs are quoted to us in percentages. Our framing point for percentages was established over a minimum of 12 years at whatever educational institutions we attended. Thus, a quoted all-in cost of 2% or 3% feels reasonable and quite low. This is where context and framing become important.

It is easy to demonstrate that equities or shares have offered investors the best long-term returns to beat inflation. What many people don't realise is that it is not the absolute number that counts but rather the amount above inflation. This is because returns above inflation are actual wealth growth whereas returns equal to inflation are merely maintaining the purchasing power of your money. Over long periods (20+ years) equities do not exceed inflation by more than 4% to 6% per year. There are periods where it is better than that, but this is offset by equivalent, or even longer, periods where it is less than that. This is the context within which costs must be evaluated.

If an investment returns 4% per annum better than inflation and pays 1% per annum in costs, then costs cause a 25%

reduction in wealth growth. At 6% better than inflation it is a 17% reduction. If you raise that cost to 3% per annum it now ranges from 75% to 50% reduction. That is a meaningful barrier to investment outcomes.

4. The only time to invest is now and as regularly as possible

Over 34 years, and despite increased education and the proliferation of resources, people still remain adamant that they can time the markets. For every success story trumpeted, there are probably a thousand relegated to embarrassing silence. Professional asset managers agree that timing the market is almost impossible. The perceived idea that these managers can predict a pandemic such as Covid, a war, or a crazy politician coming to power is nothing short of absurd. They certainly pay attention to indicators and flags, but they cannot accurately plot the course of events that will impact the market.

This means that trying to time movements between cash and shares or even the best time to buy becomes challenging. What normally happens is the paralysis of a delayed decision. This can often last for years and ultimately costs investors some of the best returns over a longer period. Market turmoil and collapse should be an accepted part of the investor's journey. I have certainly met many more successful investors who have endured 1969, 1987, 1991, 2001, 2008, and 2020 and the market chaos that ensued in those years with a positive outcome than those who have successfully timed the market.

While this is probably more apt for younger audiences, the benefit of sustained and systematic saving in an equity portfolio cannot be underestimated. Start and start soon, it is a great habit to build.

5. Schemes to avoid Tax cost you more in the long run

Governments around the world are hungry for revenue. As South Africans, we find this particularly unpalatable given that our politicians swan around in excessive luxury while service delivery continues to collapse around us. We are forced to pay tax and then extra to replace some expected service that tax delivered historically. We ALL feel the same in that regard. Sadly, this also frames our attitude towards tax within investment planning. Investors do everything they can to avoid it.

Don't get me wrong, mitigating tax is an important wealth-building strategy, but letting it be the only reason not to take action, or even worse, investing through a high-cost, trumped-up scheme is highly likely to lead to disappointment in the long run. We often come across investors who are paying upwards of 3% per annum (and higher) in costs yet refusing to act because of a Capital Gains Tax implication (which is inevitable anyway.) Hence, they continue to erode their wealth growth potential (see point 3 above for reference). Even worse, we have experienced people paying substantial fees to 'expert' advisors for structures guaranteed to skirt the fiscus, only to end up paying substantial sums later to unwind the scheme with a painful implication to the tax man. If you don't believe me, go and find a grey-haired accountant and ask him about timber, airplanes, and horse schemes of yesteryear – all gone and unsuccessful. In recent times a high-profile advisory firm had their scheme unravelled by the Panama papers and to save their reputation they had to appeal to SARS on behalf of their clients for a better settlement. No offer of a refund for those expensive structuring charges.

TAX AVOIDANCE MAY COST YOU

Tax mitigation schemes may in fact be detrimental to your wealth. Too many schemes are expensive, based on faulty interpretations of law and have high fees attached.

It is probably opportune to point out that almost all your reported values would be shaved by some form of taxation if you choose to access or cash out the investment. I often muse that we should report a gross value and an estimated tax-adjusted value to mitigate the feeling of loss, but sadly it's too personalized to individual circumstances to be feasible.

There are many more principles I could unpack - my journey and career has been a privileged one. I have been fortunate to observe other's financial successes and failures like very few get to do. It is this experience that guides the advice we dispense at Harvard House. Our role is really as a trusted partner, and we take it very seriously – all of us.

Our next Insight seminar will be held in March, and will focus on why our investment philosophy places so much importance on income.

[Harvard House is on Facebook]

[Harvard House is on YouTube]

Topic:	**Why the Obsession with Income**
Natal Midlands	
Date:	14 March 2024
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	12 March 2024
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	N/a
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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:

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za