INVESTING

SA bonds have already substantially priced in the risk of a downgrade

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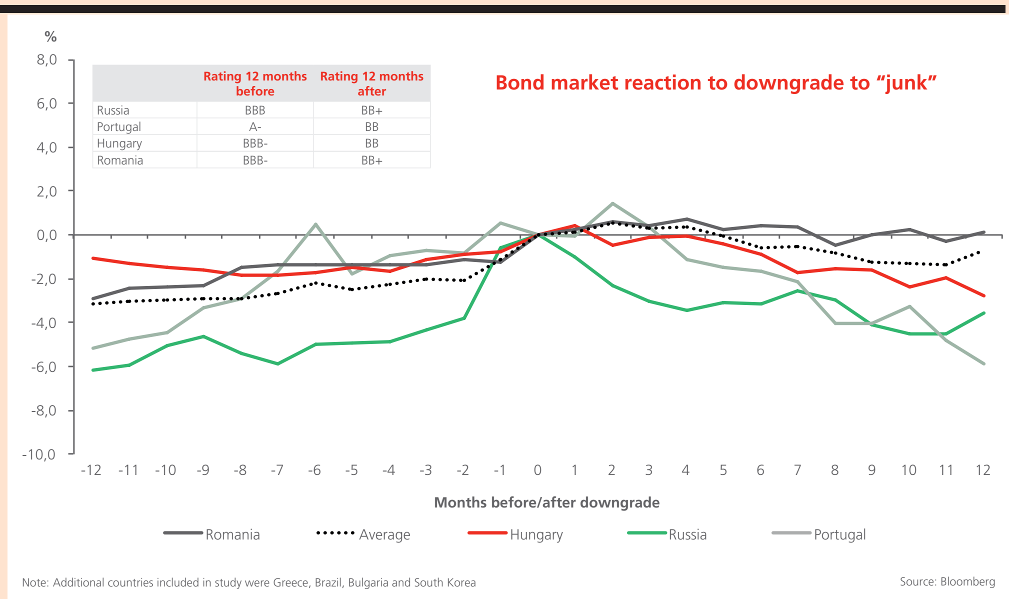
Downgrade impact on bonds not dire



While the possible downgrade of South Africa's sovereign credit rating to below investment-grade (or 'junk') status does present a short-term risk to bond investors, there are several reasons to believe that the medium- to longer-term impact may not be as bad as many investors believe.

SA bonds and other credit instruments have already substantially priced in the risk of a downgrade: Since January 2015, the 10-year government bond yield has already risen from around 7.0% to over 9.0%. This is roughly equivalent to, or higher than, yields in countries like Turkey, India, Indonesia and Russia, which have similar or even worse credit ratings than SA. Investors are already demanding much higher yields for the rising risk presented by holding our bonds.

Given that our bond yields have already risen well over 2.0 percentage points in anticipation of a downgrade, it is less likely that there will be a further huge spike in yields when the event actually occurs. In fact, an examination of the experience of other countries downgraded to junk status confirms this. The graph highlights how, in the eight cases we studied, bond yields rose an average of about 3.0 percentage points in the 12 months prior to the downgrade, but then fell an average of 1.0 percentage point in the 12 months following the downgrade. And, those countries that lost the most in the run-up to the downgrade rallied the most after the fact.

Consequently, if SA follows the pattern of these countries, it is reasonable to expect some further rise in yields from current levels ahead of a downgrade – but a large spike would depart from the norm. Then once the downgrade has occurred, our bond yields would likely rebound over the next 12 months, leaving bondholders (from this point in time) no worse off than prior to the downgrade, or even better off. In fact, countries like Portugal and Hungary fully recouped their bond losses within 12 months or less.

Importantly, any 'forced selling' by offshore investors (such as bond index-tracking funds) will likely be limited, since South Africa's inclusion in the World Government Bond Index depends on maintaining our local currency rating (rather than our foreign currency rating) at investment grade. This rating is not expected to fall to sub-investment grade anytime soon: it was last affirmed at BBB+ by S&P (three notches above junk status), BBB by Fitch and Baa2 by Moody's (both two notches above junk).

In our view, the yields of over 9% on long-dated SA government bonds offer compelling value over the medium term, even factoring in the risks of an impending downgrade and higher inflation over the short term. With long-term inflation anchored at 6%, this translates into real yields of over 3%, significantly above our long-term fair value estimate of 2.25% for this asset class. Consequently, we are overweight in these bonds in our multi-asset class portfolios.

Counting the true cost of upfront fees

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When it comes to the ultimate success of retirement savings, every rand invested over time will have a meaningful impact on the final outcome thanks to the power of compound interest.

Excess, often unnecessary fees, particularly upfront fees and percentage-based admin fees, can have a deleterious effect on the ultimate value of an investment and the returns an investor will enjoy on retirement as it reduces the impact of compounding interest.

Unfortunately, the modern-day retirement investment industry is characterised by complexity – complicated, tiered products that supposedly offer greater returns that are accompanied by complicated fee structures.

Various funds today also apply differing cost structures, with some charging asset-based management and administration fees that increase in relation to the sum invested, which penalise those who save or invest more. These investment fee structures also tend to look cheap at quotation stage when there is no asset, but become excessively high as the fund accumulates over time.

It is also not uncommon for funds to attract other fees such as portfolio-based multi-manager fees and performance-based fees. In many of these instances it is often only the top-line costs that are disclosed, not the underlying asset manager fees. These so-called hidden fees also erode fund value as they add up over time. And don't forget that the financial adviser also needs to take his commission, often in the form of an upfront payment.

The lack of transparency with regard to these upfront fees often leaves investors unsure of what they'll get in return for their lump sum investment or monthly contributions. Therefore, the first step to improving investment returns is to understand the impact that differing upfront fees can have on fund value. This would enable investors to select advisers and investments based on performance and the associated costs to determine real returns.

As an example of how high upfront fees can impact investment returns, take two investors who both invest a lump sum of R100 000 at the same rate of return over a period of 10 years. Based on different upfront fee structures they would realise vastly different returns when the investment matures. Assuming an annual growth rate of 7%, the investor who was charged a lower upfront fee of 1% would realise a return of R194 747.98 after 10 years. Investor B, on the other hand, who was charged a 5% upfront fee, would only receive R186 879.38 over the same period.

In this example, investor B would only recoup his initial lump sum investment after 11 months following the upfront fee deductions. This means he spends almost the entire first year effectively paying his returns to the administrator. Conversely, investor A starts making positive returns in the second month having already recouped the fees. In addition, investor A will earn over 9% extra on his original investment because of the small upfront fee that barely affected his initial lump sum investment.

In the case where both investors choose to make a monthly contribution of R1 000 to a fund that delivers a 7% return per annum on investments that mature in 10 years, when investor A, who was charged an annual fee of just 1%, would receive R163 879.35. Investor B, who was charged a 5% annual fee, would get back only R132 719.66, a substantial difference of R31 159.69.

In this example, the higher upfront fees effectively eroded 31 months' worth of contributions. In the context of retirement savings, this effectively means that investor B would need to work for almost an additional three years to continue making contributions to achieve the same outcome as investor A, just because he didn't query or understand the upfront fees. Add additional monthly admin fee and other hidden charges and it's easy to see how quickly fund value can be eroded further over time.

It pays to take the time to understand any upfront fees that an adviser, portfolio manager or investment provider may charge, to ensure more of your money is invested over the longest possible period to benefit from the power of compound interest.