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The low interest rate conundrum

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With interest rates at 50-year lows investors face a conundrum: do they hold on to the safety of fixed-income investments or consider alternatives amid continued concerns about the current political environment and the impact of Covid-19 on the South African and global economy?

Latest statistics from the Association of Savings and Investments highlight the extent of the conundrum after Covid-spooked investors piled into fixed-income investments and invested a net R97bn in funds with a fixed income focus in the second quarter of 2020.

In September 2019, as an investor you could earn a pretax return of 7% in money-market funds and high-yielding bank deposits, translating to 4% after tax for those at the highest marginal tax rate.

This has now reduced to a pretax return of 3.5%-4.5% and an after-tax return of just more than 2%-2.5%.

At these historic low interest rates it is understandable for you to ask what the options are.

Shop around

Compare available rates from the top four or five commercial banks and find something that can beat inflation without locking up your capital.

Money-market unit trusts provide a compelling alternative as the investment managers shop around for the best fixed-income instruments on your behalf.

However, even here you can expect returns to moderate to 3.5%-4.5% before tax - half of what you could have earned a year back.

You can also consider variable fixed-income funds, which target returns that are 1%-2% higher than money-market funds by investing in a variety of fixed-income instruments that are slightly riskier than money-market funds.

At current rates, returns that are just one percentage point higher translate to a 25% higher interest return.

Invest in retail bonds

Even though RSA Retail Bonds have received a lot of criticism from investors, they do remain very attractive at a guaranteed return of 5.25% for a two-year investment.

These investments are relatively safe as governments are seen as the lender of last resort. Interest can be paid out or reinvested and capital is locked up for 12 months, with penalties applying if you want to access it earlier.

Max out your tax exemptions

It only makes sense to invest in fixed-income investments until you have exhausted your tax exemptions of R23,800 if you are under 65 and R34,500 if you are older than 65. After this your money will go backwards if you take inflation into account.

Endowments back in fashion

There are a variety of endowment-linked options available.

Endowments have been designed to be tax-effective and provide you with a guaranteed tax-free return.

Returns vary but are generally above 5% - almost double what you can earn on after-tax cash in the bank.

The disadvantage of endowments is the limited liquidity: you can access a part of their investment in either one, two or three years depending on the insurance company selected, with the balance of capital paid out after five years.

Move up the risk curve

Low interest rates will compel investors to consider more risky alternatives either in SA or offshore.

For more conservative investors this could be multi-asset portfolios with a diversified asset allocation of equities, cash and property.

However, for more astute investors who have been sitting on the sidelines, equities are becoming an increasingly interesting proposition.

The long-term dividend yield for the South African market is 2.8% and for international equities it is above 3%.

This is better than after-tax, fixed-income returns and grows over time as company earnings grow.

Although dividends may be under pressure in the short term, a high-quality dividend portfolio can deliver an attractive and growing after-tax return with a free option on growth.

• *Gouws is a wealth manager at Gradidge Mahura Investments*