LOOKING FOR INCOME FROM INVESTMENTS?

JOHANNESBURG: Retired cash investors are suffering because of the low interest rate environment and are searching for better returns. Low interest rates are good for people with debt but investors who have large amounts of cash are getting minimal returns on their asset. As a result they are looking for alternatives such as preference shares, inflation linked bonds and property investments. Whilst there are some good alternatives to cash, investors must never lose sight of the real danger posed by inflation. In this article I will focus on preference shares and normal shares and in the next edition, I will focus on my least favourite income generating investment – property syndications.

INFLATION IS SLOW POISON

You certainly can't control the inflation rate but you can structure your investments to track or beat inflation. If your capital does not grow at the same rate as inflation, your ability to maintain your lifestyle will decline gradually until your whole way of life has changed for the worse. Because it happens slowly, you do not realise the severity of the problem until it is too late. At current inflation rates, if you only invest in cash and live on the interest of R20,000 per month (as an example) it will take 12 years for your R20,000 to buy half of what it could in the first year. The only way to beat inflation over time is to invest in assets that track or beat inflation. All of these inflation beating investments carry some market risk. Low risk investors often equate market movements (volatility) with risk, which is a major mistake. Volatility is certainly not the only risk to a retired investor. By investing all or most of your money in cash, you are guaranteeing that your capital will never keep pace with inflation – for me, this is a far greater risk than market volatility.

PREFERENCE SHARES

Preference shares (Prefs) are an interesting investment to those who want to earn high rates of "interest" and who don't like paying tax. Companies issue Prefs when they want to borrow money from investors for a fixed period of time. The returns from Prefs are not related to the performance of the company, instead they are related to the current interest rate environment. For example, a company could issue a Pref where they promise to pay you 75% of the prime interest rate for as long as you hold the investment. The attraction of Prefs is that the "interest" is in the form of a dividend which means they are very tax efficient.

If you buy the Pref when it is issued and hold it for a period, you will get the dividends every year (or twice a year) until you sell the Pref. There is no inflation growth and the price will not increase if the company does well. During the life of the Pref, the actual price will move in line with interest rates. If interest rates fall, the price is likely to rise whilst the price will fall if interest rates increase. That means Prefs have two different "interest rates" or yields – the initial yield and the effective or clean yield. The effective yield is the yield related to the current price of the Pref.

According to the latest research by Sasfin Securities there are some Prefs that have an effective (clean) yield that is as high as 9.70% (Astrapak). On the surface, this is extremely attractive but there are some issues to consider. Firstly, the yield is not guaranteed, if a company is in financial difficulty, it can elect not to pay the dividend. Secondly, not all these Pref dividends are cumulative, so if the company does not pay dividends for a period, it is not obliged to repay the unpaid dividends i.e. they don't have to catch up. Another problem is that your capital is not guaranteed, if the company goes bankrupt, you can lose all your money. The final concern is that a Pref does not have a maturity date, if you decide that you want to sell your Pref, you will get the current market price. If interest

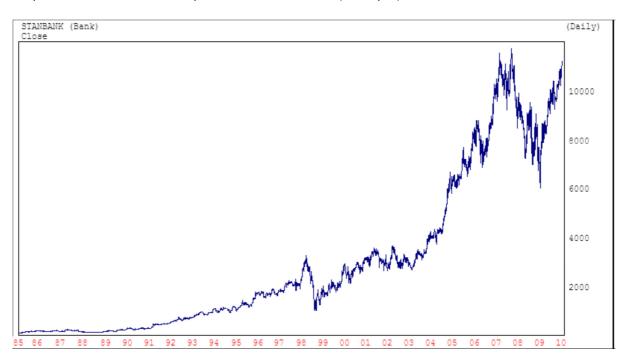
rates have been rising, you could get less capital than you invested however if rates have been falling, you could make a profit.

I think Prefs are good investments for those who want to store their cash for a short to medium timeframe but they will not provide long term, inflation beating growth. The price movements that are caused by interest rate movements also mean that you cannot have a fixed sale date in mind — you will need to be flexible. If interest rates start rising in the next 18 months, you are likely to lose capital and therefore may need to wait until the rates have stopped rising and Pref prices have recovered before you sell. In my book, Prefs are not the solutions for low risk, retired investors however, they can form part of a diversified portfolio.

SHARES BEAT INFLATION

In order to best illustrate the way in which shares can beat inflation, I often use an example provided by Alan McConnochie who is a Director of Robert Cowan Investments. He did some research on the price of a Wimpy meal vs. the share price and dividend increases of Standard bank shares from 1983 to 2010. Over this 27 year period, the price of a fairly typical Wimpy meal rose by 9.98% per year. By contrast, the price of Standard Bank rose by 19.36% per year whilst the dividends went from 4c to R3.86 (18.45% p.a.) As McConnochie puts it, "In those days it would have taken the dividends on 313 shares to buy your meal – now it only takes the dividends on 42 shares to buy your meal." If you wanted to sell shares to buy your meal, in 1983 you would have needed 13 shares whilst today you would need just 1.45 shares.





Whilst I am not suggesting that retirees place all their money in shares, I am saying that shares MUST form a component of your investments. This is especially true if you are retired and need an income from your investments. A cash portfolio will not be sufficient to meet your needs over the long term. You only need one third (33.3%) in shares to get sufficient inflation protection from this asset class. You can keep the remaining 66.7% in cash (still not the best idea) and you should be okay over the long term. As you can see from the Standard Bank dividends and share price performance, the

volatility of shares will not impact you over the long term, provided you are patient and have a diversified portfolio of investments.	