# Here's an investment for pensioners!

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Those of us who were brought up in an inflationary environment thought that this was how the world normally functions. Not so. The history of the world's major economies shows that through the ages the normal state of affairs has been no or little inflation. Economists seem to have reached consensus that South Africa is now heading back to this normal state of affairs, lagging the rest of the world by about a decade.

This has a serious implication for South African pensioners and others dependent on interest income. This is so because since 1989 they have become used to exceedingly high real interest rates. By *real* interest we mean the nominal interest rate minus the inflation rate.

Once the authorities have wrung inflation expectations out of the system, and once the government has built up a track record for good governance, real interest rates on investments will come tumbling down.

Core inflation is presently 8%, with an *expected* medium-term inflation rate of probably around 5%. In this environment, and assuming core inflation of 7% this year, Table 1 reflects the approximate income yields you can earn in 2000. We note that:

**Table 1: Approximate income yields expected during first year of investment**

| Investment type | Nominal % | Inflation % | Real % |
|---|---|---|---|
| Annuity (a) | 14,0 | 7 | 7,0 |
| Property loan stock | 13,5 | 7 | 6,5 |
| Long-term bond (gilt) | 13,0 | 7 | 6,0 |
| 24-mnth deposit | 10,0 | 7 | 3,0 |
| Financial & ind shares | 2,0 | 7 | -5,0 |

(a) Voluntary joint life & survivorship at age 65

- Property loan stocks and gilts are running neck and neck.
- The annuity quoted is not directly comparable because your estate loses the capital on the death of the annuitants.

- The expected income yield in the first year differs widely between the individual companies, depending on the market's perception of risk and growth potential of the cash flow. This applies to all categories of companies, not just property, and can only be diversified away by buying into a unit trust. However, this is not possible with property loan stocks. No unit trust of listed property companies exists, which is a glaring gap in the market.

Of course, this is not the full picture. To get the *total* return, one should also add the expected capital growth. In addition one should take a longer investment view. So let's assume the economy grows at a real 3% per annum, a stationary inflation rate of 5% and an investment term of 10 years. After adding my expected capital growth, Table 1 now graduates to become Table 2.

Regarding the second table, the following need to be noted:

- The total return for property loan stocks is pretty much "in the bag" because most of this return is based on an already-achieved income yield on purchase (at present prices). In addition the assumed 6,5% capital growth per annum is in my opinion quite realistic.

**Table 2: Approximate real annual total returns expected during next decade**

| Investment type | Nominal income yield % | Plus: Nominal capital growth % | Less: Expected inflation % | Real total return % |
|---|---|---|---|---|
| Annuity (a) | 14,0 | 0,0 | 5% | 9,0 |
| Property loan stock | 11,0 | 5,0 | 5% | 11,0 |
| Long-term bond (gilt) | 11,0 | 1,5 | 5% | 7,5 |
| 24-mnth deposit | 7,0 | 0,0 | 5% | 2,0 |
| Financial & ind shares | 2,0 | 13,0 | 5% | 10,0 |

(a) Voluntary joint life & survivorship at age 65

- Now property loan stocks beat gilts handsomely.

- Nearly half of the capital growth in the case of property loan stocks is generated through a rerating (decline in dividend yield) caused by falling interest rates. All the capital growth in the case of gilts is caused by this phenomenon.

- The total return of financial & industrial shares is pretty much a thumb-suck because the high assumed capital-growth rate is subject to great variability. This is especially so because it is not known how South African firms will compete in the global economy. After all, what is South Africa's competitive edge?

- This means that listed property's risk is generally lower than that of financial & industrial shares. This is in spite of the fact that their expected total returns seem to be in a similar league.

- Income is taxable whereas capital growth is normally not. This may give financial & industrial shares an edge after tax. This especially applies to high-income earners.

Should inflation stabilise at, say, 3%, rather than our assumed 5%, then the nominal returns of financial & industrial shares in Table 2 may turn out to be much lower. For this reason the life assurance industry has just decided to lower the illustrative returns on its products to 6% and 12% compared to the previous 9% and 12%. The average nominal returns on property loan stocks and gilts, on the other hand, should, over the forthcoming decade, not be affected materially by such a very-low-inflation scenario. The reason is that much of the forecast capital growth will be *caused* by the falling inflation.

To sum up, pensioners in need of a substantial income yield should consider putting a part of their capital in a few well-selected listed property companies. But beware of property companies that concentrate their assets in run-down areas of our cities, like some CBDs. Their initial income yield may be sky-high, but there is a reason for this. So, consult a stockbroker that specialises in listed property before you buy. ■