GRAYISSUE

The risk that doesn't discriminate: inflation

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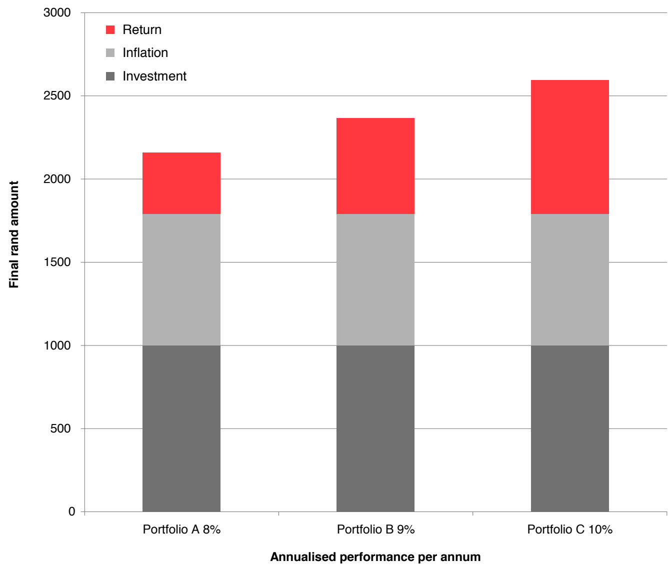
Rising prices are inevitable. Although frequent petrol price hikes and electricity tariff increases make dramatic headline news, the rising cost of most goods and services over time is a fact of life for consumers, eating away at the buying power of the rands they have earned or saved.

The South African Reserve Bank (SARB) defines its mission as protecting the value of the rand (according to its fact sheets). Its efforts to maintain price stability are aimed at achieving low, steady and predictable price increases. Although the inflation rate, or consumer price index (CPI), was reported as 3.7% in July 2010, which is at the lower end of SARB's targeted 3-6%, the inflation rate over the last 10 years has averaged around 6%. Whether at historically higher rates or maintained at the current low rate, inflation remains a reality that consumers need to understand – both in terms of its impact on the cost of living and its relevance in investment decision making.

If you had invested R1 000 for 10 years



Source: Allan Gray research

The aim of investing is to protect and grow wealth over time

The most meaningful way to measure wealth is in terms of buying power, as opposed to number of rands. Where investments are intended to provide an income for an investor, it is particularly important to take inflation into account. Inappropriately high withdrawals combined with the effects of inflation can erode capital quickly. At the same time, inflation clearly impacts the buying power of the income funded by withdrawals, and investors need to ensure that this income can support their lifestyle over time.

Many investors differentiate between investment returns due to capital growth and returns from interest and dividends. A common belief is that drawing the interest and/or dividend portion of an investment protects the capital, and that capital growth alone will protect wealth in the long term. However, the reality is that a significant portion of the total investment return, whatever the source, compensates for inflation first before any real return is earned.

For example, the average money market investment would have returned about 10% per year over the last 10 years. This return would have been purely in the form of interest. However, 6% of this return would balance the effects of inflation, leaving only 4% of real return per year - and this does not take fees and tax into account.

Inflation gets a large piece of the pie

The graph shows three illustrative 10-year investments of R1 000 with assumed performance per year as shown and an assumed inflation rate of 6%. The light grey part of each bar shows the component of the rand amount earned that compensates for inflation. If an investor just considered the original rand investment, then all three portfolios have grown significantly, however by focusing on the real growth represented by the red part of each bar, the differences between the portfolios are highlighted.

Real return shows the difference between portfolios

Although there are small differences in performance per year between the portfolios shown, the differences in return after inflation are significant. For example, with an assumed annualised performance of only 2% more than Portfolio A, the investor in Portfolio C's real wealth would have grown by 45%, more than double the 21% growth in real wealth earned by the investor holding Portfolio A.

When assessing the success of an investment at protecting and growing wealth, investors need to take inflation into account and look at the real return.

Commentary by Richard Carter, Allan Gray