GRAYISSUE
LONG TERM COMMENTARY

1 June 2004
Issue no. 33

Be realistic about returns

Unit trust investors need to have realistic expectations of returns, based on long-term historic experience rather than current market sentiment and the recent history.

Despite the volatility of recent years, many investors have unrealistic expectations, and continue to hope for the types of returns that were possible in the 10-year bull run of the 1990's.

Over the long-term, an investor who achieves a 3% to 5% real return on a balanced portfolio is actually doing well and it is with this expectation in mind that most investors should base their planning.

Investors tend to incorrectly focus on nominal returns and base their expectations on recent history. Because we have lived in times of high inflation, we expect high investment returns and discount the much lower inflation environment we now enjoy. However, because investment returns equal to inflation are required to merely retain buying power, compounding real returns is the only way to generate wealth and it is on real returns that all investors should focus.

Over the very long-term (the 100 years of the 20th century), real returns on South African equities have been approximately 6.8% p.a., which, interestingly, is slightly higher than that in the US at 6.7% p.a. and much higher than the world average of 5.8% p.a. What is significant is that the bulk of that return has come from dividends and the re-rating of PEs upwards. Only a small proportion has come from real earnings growth, which has been under 2% p.a.

In today's environment, markets are pricing in dividend yields of less than 3% and expected inflation of roughly 5%. This, if historical real earnings growth of less than 2% is factored in, will equate to nominal returns on equities of under 10% and real returns of under 5%. Moreover, real returns on bonds over the long-term have been no higher than 1.6% and on cash no higher than 1%. However, long dated government bonds are currently pricing in real returns of around 4% for investors that hold to maturity.

Unfortunately, fees and costs erode returns. The average initial unit trust fee is 5.7%. This is a combination of Management Company and IFA fees. In addition, asset managers charge an average management fee of 1.5% per year plus an Adviser's charge negotiable up to 1%. Add these together, and the investor could be paying over 8% in fees for the first year and probably 2½% per year thereafter. If his fund achieves a nominal return of 10% pre-fees, this leaves a nominal return of only 2% in year 1. Subtract inflation and his investment is going backwards. These fees obviously reduce in subsequent years, but can easily amount to half the real return.

It is therefore vital to keep a close check on fees and either negotiate more favourable rates or choose an asset manager with a more modest or appropriate fee structure. For example, Allan Gray charges no initial fee and the only upfront fee an investor may pay is that of the IFA which is negotiable up to 3%. A difference of 2% in initial fees can have a substantial impact on returns. A post-inflation return on an investment of R500 000, for example, could mean R25 000 in fees if 5% has been levied and only R15 000 in fees if 3% has been charged.

Despite the potential negative impact of fees, unit trusts have significant advantages as an investment vehicle, with transparency being the most significant advantage. Unlike most investments based on life insurance, unit trust fees and costs are fully disclosed, enabling investors to make more informed decisions. In addition, investors have the ability to switch between managers should it become apparent that their investment is being mismanaged.

It is also vital that investors look for managers whose long-term track record indicates an ability to produce returns well above the average. This is particularly pertinent in today's low-inflation environment.

In conclusion, while the bull run of the 1990's led investors to believe that investing is easy, the reality is somewhat different. Serious investors need to take cognisance of a number of factors and watch the market and their investment closely to ensure they meet their investment goals.

Commentary by Johan de Lange, Managing Director, Allan Gray Unit Trust Management Limited