INVESTMENT REPORT

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DON'T MISS THIS CHANCE TO BOOST YOUR RETIREMENT SAVINGS

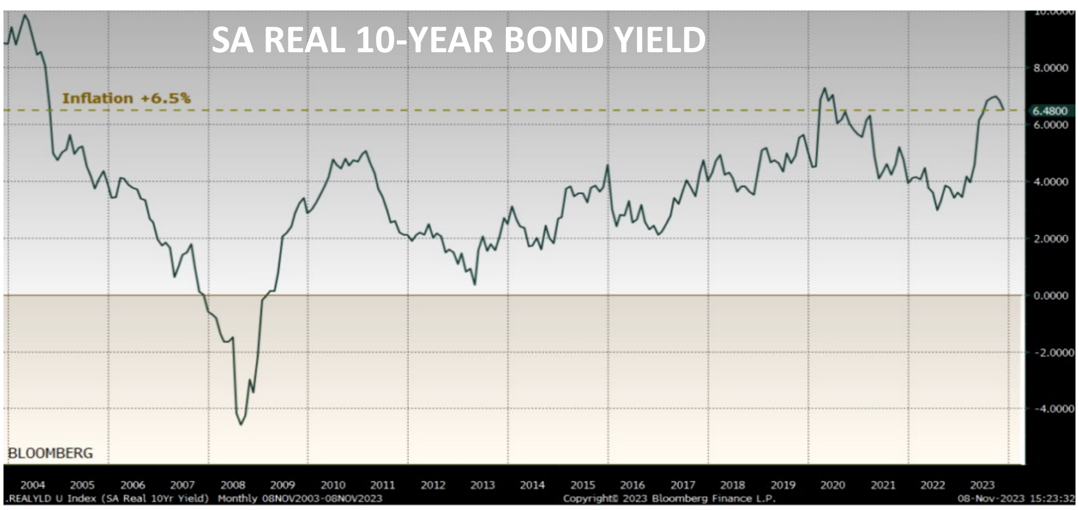
By Suzean Haumann | Certified Financial Planner®, Brenthurst Bellville

At dinner party conversations, bonds aren't often alluded to as exciting investment strategies or as investment opportunities ripe for the picking. But maybe they should be, especially as we move out of the high-interest-rate world we've been living in for the past few years.

Here's why: From March 2022 to October this year, SA government bonds outperformed domestic equities by around 11%, at roughly half the volatility. This is a return of inflation plus 6.5%, which is what you'd normally expect from equities.

More importantly, we're at the top of the interest-hike cycle, which means that as rates start to drop, so the returns from bonds also start to taper off.

Confusing? Not to worry. I'll explain what bonds are, how they work and react in different market conditions and, ultimately, why you shouldn't ignore them.



Bonds tend to increase in value whilst listed equities are losing value. This is why bonds are commonly used to hedge against falling stock markets.

The diversification argument is further strengthened by the fact that bonds are typically less volatile than equities.

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WHAT ARE BONDS?

When you buy a bond, you're essentially lending money to an entity, such as the SA government. National Treasury issues bonds to raise funds to run the country. Private and listed companies also issue bonds as an alternative way to raise funding. But for the sake of this article, I will be focussing on government bonds.

The bond issuer essentially commits to paying you a fixed amount for the term of the 'loan' – 10 years is a common contract period – and then returning your initial deposit at the end of the term. So, you receive regular income payments (usually paid monthly) which are guaranteed. Simple enough, right?

BOND TERMINOLOGY

Some of the confusion around bonds is due to the different terms used to explain commonly-understood concepts found in other investment types.

BOND COUPON: The amount of money you receive as 'interest' payments from your loan to the government.

BOND PRICE: This is the unit cost per bond. It can be confusing because this price varies according to a number of factors, which I'll explained shortly.

BOND YIELD: This is essentially the percentage 'interest' that you receive. This can also vary according to various factors.

HOW BONDS WORK

Let's say you buy a 10-year bond with a R1,000 face value that pays a R100 annual coupon (interest payment). This will give you a yield (interest rate) of 10% for the duration of the bond, as you hold onto the bond until maturity.

If you don't, then you expose yourself to the more complicated characteristics of a bond – the bond yield and price change over the term of that bond. But this is only applicable if you sell your bond before the 10-year term ends, or if you buy in after the commencement of the 10-year period.

The price change only affects those who are selling out at that point – before the 10-year term has ended – and for those buying the bonds at that point. However, if you buy and hold a 10-year bond at a 10% yield, your income will remain unchanged, even as the bond yield changes over its 10-year term.

This predictability is one of the reasons that bonds are a popular diversification tool.

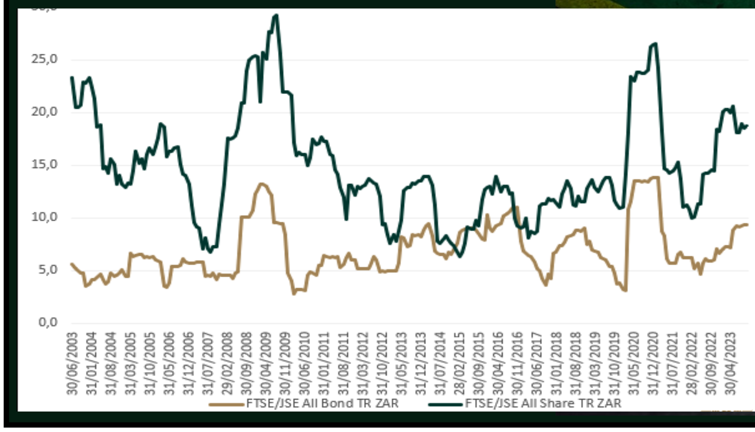
BONDS VS EQUITIES

A more important diversification consideration is that bonds tend to increase in value whilst listed equities are losing value. This is why bonds are commonly used to hedge against falling stock markets.

The diversification argument is further strengthened by the fact that bonds are typically less volatile than equities.

However, recently the stability in bond prices have been less consistent, with the trailing 12-month annualised bond market volatility coming in at over 9% by October this year. This is higher than the long-run average of 7.6%, but still at least half of the volatility of equity markets.

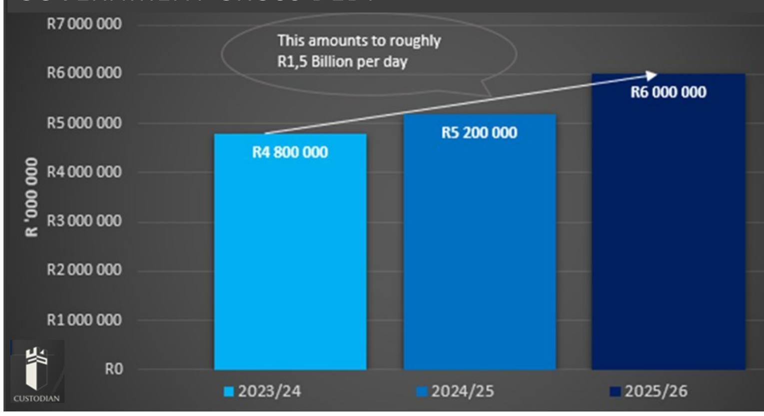
12M TRAILING VOLATILITY



LOCAL IS LEKKER

South African bonds have outperformed developed market bonds in recent years. Despite our high debt-to-GDP ratio (currently above 70%), SARB's Monetary Policy Committee managed to steer inflation back towards 4.5%. The expectation is that interest rates will steadily decrease as long as we remain in the Reserve Bank's 3 – 6% inflation target band. This means that the time of long RSA bonds yielding around 13% could end.

GOVERNMENT GROSS DEBT



Investing in SA bonds now offers the potential for inflation-plus returns.

The combination of government guarantees and the possibility of capital appreciation from interest rate cuts presents a compelling opportunity.

**Source: MTBPS, 01 Nov 2023

***Sources: DFM Global and Rowan Williams-Short (Vunani Capital)*

ADVISOR PROFILE: SUZEAN HAUMANN |CERTIFIED FINANCIAL PLANNER®

SUZEAN is head of the Tyger Valley office as well as one of the company's key individuals.
She is a CERTIFIED FINANCIAL PLANNER® and a registered member of the Financial Planning Institute of South Africa.

Tel: +27 (0) 21 914 9646 **|** **Email:** suzean@brenthurstwealth.co.za

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