GRAYISSUE

6 March 2009
Issue no. 90

What a difference an endowment can make

Many investors choose to invest directly into unit trusts (due to their flexibility, liquidity and transparency). But you can also access unit trusts through other products. This is useful because different products offer different benefits. When deciding which investment product may be most suitable for you, you should consider factors such as when you would like to access your investment, tax implications, and estate planning advantages. If you are not sure which product might best suit your needs, it is best to seek financial planning advice from a licensed Independent Financial Adviser.

Unit trust based endowments are worth another look
At Allan Gray, unit trusts are the underlying investments for all of our products, including our Endowment Policy. Endowments fulfil a valuable role in meeting the needs of high-tax paying investors and offer estate planning advantages (your beneficiaries may be paid out straight away when you die, saving the executor fees on the investment).

As the days of inbuilt upfront fee and commission structures are long gone, investors may find that they are getting a better deal on endowments all round. It may be time to re-look at unit trust-based endowments as a long-term savings vehicle. If you are comfortable with a five-year investment term, an endowment policy may suit your needs. But, you may ask, why choose to lock your underlying investment unit trusts into a five-year investment term when you can access the same unit trusts directly without that constraint?

How does investing in an endowment differ from investing directly in a unit trust?
High tax rate investors who have an investment horizon of five years or more, and do not need to make regular withdrawals, can benefit from enhanced after tax returns by investing via an endowment policy. The level of tax you pay depends on the investment return and the split between interest, dividends and capital gains, as this determines how much of the return is taxable in your hands.

A big difference between an endowment and a unit trust is the way in which they are treated for tax purposes. In terms of income tax legislation, if you have an endowment policy, the life company who issues the policy pays income and capital gains tax (CGT) on the investments in your policy. Income tax is incurred and recovered from the policy when income distributions from underlying unit trusts are received. The life company also pays tax on any capital gains that may arise when you switch between unit trusts. You do not pay any CGT until you redeem your units when the amount you receive may be reduced by a provision for tax. Endowments are taxed at a flat rate depending on the status of the investor. For individuals this is 30%. Twenty-five percent (the inclusion rate) of the capital gains is taxable, which means you will pay CGT of 7.5%.

This differs from the tax process for a straight unit trust investment. In a unit trust investment, you pay tax every time income is distributed or when a CGT event is triggered, not just when you make withdrawal. Tax on unit trust investments depends on your marginal tax rate. If your income is more than R525 000 per year, you will pay tax at the highest marginal rate of 40%.

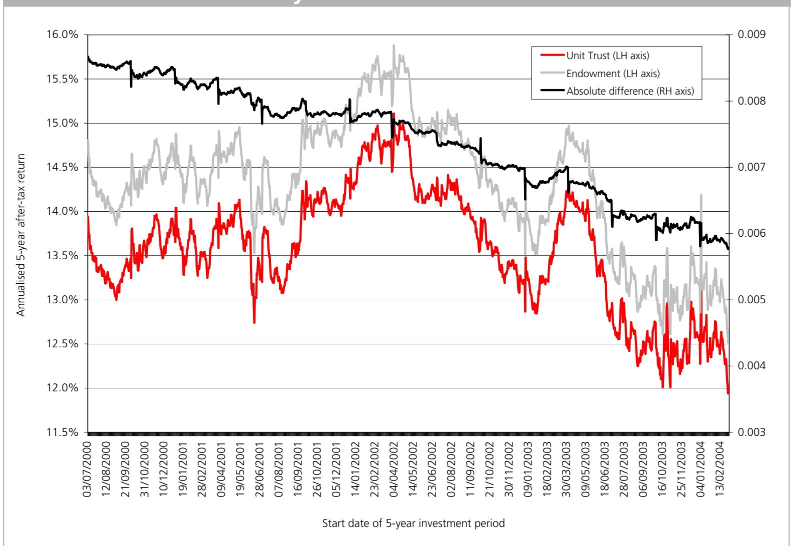
The difference in after tax returns is strongly influenced by the amount of taxable income and capital gains from the underlying investments. The greater the proportion of the return earned from interest income, the greater the difference will be. The example below is based on the Allan Gray Stable Fund. In the Allan Gray Equity Fund the difference would be less, and in the Allan Gray Money Market Fund the difference would be more.

If you invest in the Allan Gray Stable Fund via an endowment policy the after-tax return is higher
We compared a unit trust investment of R100 000 in the Stable Fund with an investment via an endowment policy where the investor selected the Allan Gray Stable Fund as the underlying investment. This example assumes the investor is in the highest marginal tax bracket and redeems all units five years after the investment was made.

As an example, on a direct unit trust investment made on 1 June 2001 the after tax return over the five-year period was 13.77% per year. If the investor made the same investment, but chose to do so using an endowment policy, his after tax return would have been 14.58%. This amounts to a difference of 0.81% per year.

We did the same analysis for every rolling five-year period since the inception of the Stable Fund in July 2000. The outcome is illustrated in the graph alongside. The greatest difference between the two investments was 0.87% for the five-year period starting 03/07/2000. The smallest difference was 0.58% for the five-year period starting 28/02/2004.

After tax return of Allan Gray Stable Fund



The extent of the difference can mainly be explained by the size of the absolute return and the proportion of the returns which are taxable. On average, the proportions of the returns that are taxable have decreased slightly over the period and further contribute to the decrease in the difference in returns between the direct unit trust and endowment returns.

A notable increase in returns
High tax rate investors who have an investment horizon of five years or more, and don't need to make regular withdrawals, can benefit from enhanced after tax returns by investing via an endowment policy. The increased return has averaged about 0.74% per year over the recent past. This difference might not sound like a lot, but would amount to an extra R6 240 at the end of the five-year investment of R100 000.

Commentary by Richard Carter, Allan Gray Unit Trust Management Limited