RSA RETAILS SAVINGS BONDS

JOHANNESBURG: In recent times the RSA Retail Savings Bonds (RSA's) have been tweaked by Treasury to offer more flexibility for investors. I have subsequently received emails from investors asking me which option is best: fixed interest rate or inflation linked interest rate. I asked Daniel Wessels of DRW Investment Research to review these investments because the answer required some financial modelling. As usual, he provided some fantastic research and insights into these excellent investments. Ironically, the RSA's were designed for direct investors but as the product range has increased, so investors are finding the need for advice on their best options.

RSA RETAIL BONDS REVISITED

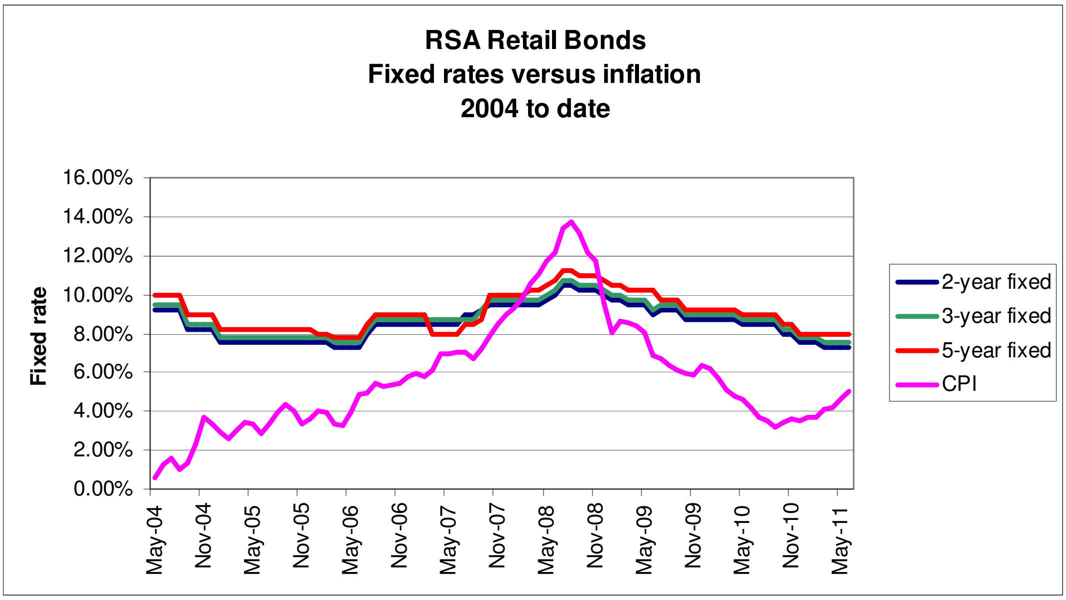
These investments are designed to offer direct investors access to high interest rates paid to them by Government. These products generally offer much better interest rates than those offered by commercial banks and are a serious alternative to fixed deposits for direct investors. Despite the initial scepticism of many, these investments are well managed by Treasury and I have received no complaints from anyone who has invested in them.

There are two basic categories of RSA's; fixed term and inflation linked. The fixed term investments are easy to understand, they pay a guaranteed rate of interest for a specific period e.g. 2, 3 or 5 years. They are most similar to fixed deposits at a bank but the interest rates are generally much better than the banks. The second category of RSA's is the inflation linked products; these products pay a specific rate of interest above inflation over 3, 5 or 10 years. These products are more complex because your interest payments will fluctuate with the inflation rate. In addition, your initial interest payments will be quite low but they will increase with inflation as will your capital.

What is important to understand about the RSA's is that they are offered to direct investors by Government, this means that trusts, companies and other legal entities cannot invest money in them. Because they carry no costs, any investor who wants a long term allocation to cash should seriously consider the RSA's. Whilst I am a massive fan of these investments, I wish Treasury would take the final step of making them tax free as they are in other countries. Savings rates are so low in SA that investors should be given every incentive to save and tax free, guaranteed returns are a great incentive. On a cautionary note, cash investments with high levels of interest are not good long term investments for inflation protection. Shares and listed property will generally provide much better growth over the long term.

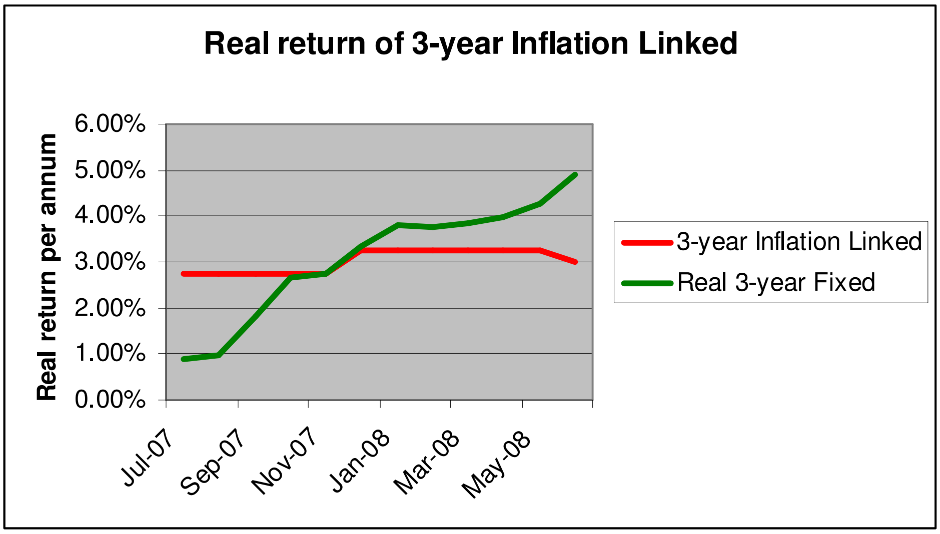
FIXED OR INFLATION LINKED?

Wessels' excellent research shows that there is no easy choice. Ironically, investments which have been designed to bypass the need for advice still require the input of experts. The graph below shows that there have been times when the fixed term RSA's have underperformed inflation significantly. This might lead investors to select the inflation linked alternatives however at other times, the fixed rates have handsomely beaten inflation. It is likely that fixed rate RSA's will perform well when inflation is declining but will not do well when inflation is rising. If inflation spikes above expectations, fixed rate RSA's could actually underperform inflation which is problematic for investors.



Source: The National Treasury, Republic of South Africa, DRW Investment Research

To date, only one inflation-linked RSA has matured and the graph below shows how it compared to the fixed rate option over the same time. When inflation was rising, the inflation linked option was better but when inflation declined the fixed rate option was better. This means that you will need to develop a view on inflation if you want to make a long term investment in either option.



Source: DRW Investment Research

Wessels suggests that there should be little difference in returns from either option if you are going to make a long term commitment. However, if you rely on the income from this capital it is important to note that the initial income from the fixed rate option is much higher than the inflation linked option. Over the life of the fixed rate option, your income will remain the same whilst the income from the inflation linked option will increase with the inflation rate. In addition, your capital will also increase with the inflation linked option. So, if immediate income is your main priority, you should seriously consider the fixed rate option. If you are more interested in preserving your capital with minimal risk over the very long term, the inflation linked option might be better.

WHAT SHOULD YOU DO?

I think it is important to understand that these investments should only ever form ***part*** of your portfolio. They do not have the ability to provide long term, real capital growth, especially if you are in a high income tax bracket. For those who need income immediately and are in a low tax bracket, I think the fixed term option is great, especially now that you can reset the investment if rates change unexpectedly. If you are absolutely paranoid about stock markets and would only ever leave your money in a bank account, consider the inflation linked option; at least you will get some inflation protection although it will not be enough.