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Investing for a
world of change

When selling, what about capital gains tax?

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The fast view

- The capital gains tax (CGT) impact of making changes to a discretionary investment portfolio should be carefully considered and quantified.
- The early payment of CGT can set a portfolio back and should therefore be evaluated against the expected benefit of the portfolio change.
- The additional return required from switching into another fund depends on factors such as the respective funds' return profile, the investment time horizon and the point at which the investor decides to switch.
- We strongly recommend that you consult with a qualified financial advisor and seek expert tax advice, as required.

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The impact of capital gains tax (CGT), often overlooked

In a recent article[1] we made the point that while investors are encouraged to remain invested through the cycle, there are several warning signals that should trigger the re-evaluation of their investment in consultation with their financial advisor.

For discretionary investors, even if a warning signal triggers a re-evaluation of their investment, a further consideration is the early payment of CGT when making portfolio changes. Or is it?

While often considered, the CGT impact is seldom quantified. However, this is an important exercise because when an investor disinvests intra-term and pays CGT, there is the compounding opportunity cost of the tax paid. Simply put, an investor in the maximum marginal tax bracket who realises a capital gain of a R100 000 pays CGT of R18 000 (if he has already used his annual capital gains exclusion of R40 000). The opportunity cost to the investor is then the difference between the future growth on the full R100 000 (if he did not realise the investment) versus the growth on only R82 000. This opportunity cost is often missed in the investment planning process because the CGT on a portfolio rebalance is generally paid later in the year, and often from an investor's other liquid assets.

Quantifying the CGT cost of portfolio changes

Now that we understand that the early payment of CGT may carry an opportunity cost, we have tried to answer the following question: "If an investor switches out of fund A and into fund B at some point during their investment term, what additional return is required from fund B to compensate the investor for the early payment of CGT?"

The answer to this question is not straightforward and depends on multiple factors. These include the return profile of fund A and fund B, the investor's investment time horizon, and at which point in the investment time horizon the investor decides to switch.

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1. When to re-evaluate your investment? May 2024.

As an example, let's compare the experience of two investors, Jack and Jill who invest a similar amount in fund A at the same time, and have an investment time horizon of ten years. Fund A delivers a consistent return of 10% p.a. and Jack remains invested for the full ten years, at which time he disinvests and pays his CGT liability. Jill, on the other hand, identifies a warning signal and decides to switch out of fund A after five years. After paying CGT, Jill invests the remainder of her proceeds into fund B. Table 1 sets out the excess return per annum that fund B must deliver over the following five years so that Jill has the same fund value as Jack at the end of the ten-year term.

Table 1: Excess return required from fund B

Fund A return	Fund B required return	Fund B excess required return
6% p.a.	6.25% p.a.	0.25% p.a.
8% p.a.	8.42% p.a.	0.42% p.a.
10% p.a.	10.60% p.a.	0.60% p.a.
12% p.a.	12.81% p.a.	0.81% p.a.

Source: Ninety One.

Table 1 shows that for an annual return of 10% p.a. from fund A, fund B needs to produce an additional 0.60% p.a. so that Jack and Jill finish on the same fund value after ten years. This difference in return represents the opportunity cost of paying CGT after five years.

Fairly intuitively, our analysis indicates that:

- The required additional return from fund B increases as the return from fund A increases (as seen in the table)
- The longer the investment time horizon, the greater the additional return required from fund B (e.g. doubling the investment term to 20 years increases the excess return required on fund B from 0.60% p.a. to 0.81% p.a.)
- The earlier into the investment term horizon you switch, the lower the additional return required from fund B and vice versa.

Conclusion

The CGT impact of making changes to an investment portfolio should be carefully considered and quantified. The CGT impact can set a portfolio back and should therefore be evaluated against the expected benefit of the portfolio change. Given the multiple factors that will affect this decision, we strongly recommend that you consult with a qualified financial advisor and seek expert tax advice, as required.

For longer-term, higher marginal tax-paying investors, it may prove beneficial to hold their underlying local investments in the Ninety One Life Portfolio and their offshore investments, in the Ninety One Global Life Portfolio. They will benefit from the lower CGT effective rate of 12% (for maximum marginal tax-paying investors).

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