# Our final update for the year

This note considers how to evaluate the opportunity cost of settling debt versus remaining invested, especially for those whose income has been reduced as a result of the pandemic. It also explains the importance of an emergency fund and how these funds should ideally be used to avoid having to make decisions that can have a high opportunity cost associated with them in future.

## Remaining invested or settling debt: which is best?

When your income is under pressure or has dried up, you will need to decide on the best use of your funds: remaining invested vs. settling debt. When faced with this dilemma, you should consider the opportunity cost of your decision: the outcome of the option you have chosen compared to the potential outcome you have sacrificed by foregoing the alternative option available.

**Weighing the cost of withdrawing from your retirement funds**

For many people, their retirement savings are the only significant savings they have available, and therefore they tend to turn to this as their first option when faced with a monetary squeeze. Retirement funds are not ordinarily accessible before retirement, but if you have a preservation fund, have recently been retrenched or have resigned, you may be able to access all or part of your savings. Before considering withdrawing from your retirement funds, however, you should first approach your debtors and determine if short-term refinancing arrangements can be put in place. Only thereafter should you consider accessing investments if your immediate cash position is likely to be impacted in the longer term. Before initiating this process, you should also realise that the money will not be available immediately, as a tax directive will first be required before it will be paid out to you. Therefore, this should not be viewed as an immediate solution to short-term cash problems.

The tax implications of accessing these funds must also be considered upfront, as well as the long-term impact it may have on your overall financial plan. For example, the lump sum you take from your preservation fund will be taxed at the following withdrawal benefit tax rates:

| Taxable Income (R) | Rate of tax (R) |
|---|---|
| 1 – 25 000 | 0% |
| 25 001 – 660 000 | 18% of taxable income above 25 000 |
| 660 001 – 990 000 | 114 300 + 27% of taxable income above 660 000 |
| 990 001 and above | 203 400 + 36% of taxable income above 990 000 |

To illustrate the opportunity cost of your decisions, let's look at Brian (age 45) who had a salary reduction due to Covid-19. He is now cash strapped and needs to fund his bond instalment. Brian has a preservation fund of R1 000 000 and he is considering withdrawing R500 000 as a lump sum. Assuming Brian still wants to retire at age 65 his options can be considered as follows, assuming an investment return of 9% per annum (after fees):

| | Choice 1 – Stay invested | Choice 2 – Make a withdrawal |
|---|---|---|
| Preservation fund value at present | R1 000 000 | R1 000 000 |
| Less withdrawal benefit taken to cover immediate need | - | (R500 000) |
| Withdrawal benefit tax payable on withdrawal made | | (R85 500) |
| Amount available for immediate need – after tax | | R414 500 |
| Amount to be kept invested for retirement - next 20 years | R1 000 000 | R500 000 |
| Preservation fund value at age 65 (in nominal terms) | **R5 604 410** | **R2 802 205** |

The opportunity cost that Brian will need to consider is paying taxes of R85 500 now and only having R414 500 available for his immediate needs versus considering the long-term impact of having to retire with R2 802 205 instead of R5 604 410 at age 65 because of the withdrawal. It should also be noted that due to their typical long-term nature, retirement funds are often invested in funds with a higher equity weighting, meaning that they can be subject to some market volatility. This in turn also impacts the potential amount available, should you need to withdraw from the investment unexpectedly.

Where drawing on your retirement savings become unavoidable, you need to actively plan for your future retirement and aim to make up lost ground, to avoid facing hardships further down the line. In addition, after having stabilised your financial obligations, its is important to reassess your financial plan and aim to build an emergency fund to avoid incurring such financial difficulties again in future.

Making use of an emergency fund should ideally be your first option for settling any debt, if it is available. However, for many of us the pandemic has highlighted that our emergency savings is non-existent, or inadequate. Many who did have emergency funds available, have now seen their funds depleted and may need to rebuild them. If you find yourself in this situation, the guidelines below can help you get on track.

- **The importance of an emergency fund**
  The primary purpose of an emergency fund is to cover your expenses for a period of at least six months in case of your retrenchment, dismissal, or any other situation that can prevent you from earning an income. In other words, it is a fund established for the purpose of ensuring that your expenses are covered for a certain period, until such time as you can return to your full income generating ability.

- **How does an emergency fund differ from other investments?**
  Cash for an emergency fund is usually saved in a savings account, or in a money market-linked account at a bank. The funds should (preferably) be available at short notice, which makes the abovementioned products ideal for this purpose. Growth is earned in the form of interest and your capital is protected against market volatility. While a fixed deposit or a notice deposit account may offer a higher interest rate, these products may not necessarily be the best vehicle to use for your emergency fund. They won't be accessible at short notice without paying additional penalties for their early release.

- **How to start building an emergency fund if you don't already have one**
  Probably the first and most important step, is to compile a comprehensive budget outlining your monthly income and expenses. The next step would be to determine how you will be funding your emergency fund. If you already have the capital available, the process is relatively simple in that you invest it in the product you have chosen. If you don't have the capital readily available, you will have to work this into your budget through regular contributions.

- **Do not underestimate the importance of an emergency fund**
  An emergency fund shouldn't be an investment that you simply dump whatever is left of your income into at the end of each month. Rather set up a debit order or a regular withdrawal from your bank account if you can, so that a fixed amount can be allocated to your emergency fund every month. Of course you can transfer any surplus you might have at the end of the month to your emergency fund to get to your initial target quicker, but only as long as such contributions are made in addition to your fixed monthly contributions, and they are not the primary source of funding for your emergency fund.

- **Emergency fund as part of comprehensive financial plan**
  It is extremely important to understand that an emergency fund forms part of a comprehensive financial plan. Because of their short-term focus, emergency savings are not recommended for growing or building wealth as these types of investments are unlikely to outpace inflation in the long run. An emergency fund is an investment goal in its own right and shouldn't be confused or combined with any other investment saving goals, such as saving for an overseas holiday, retirement or a new car.

**Understanding the roles of different types of savings and investments in your portfolio is crucial**

While it is always important to save, it is also important to understand that different types of investments serve different purposes in your portfolio. While retirement funds can sometimes be accessed in a pinch, this should never be your first option since the opportunity costs may be higher than you realise. A financial planning professional can help you to structure your financial portfolio optimally, by ensuring all your financial planning needs are considered upfront.

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