



What's in the basket?

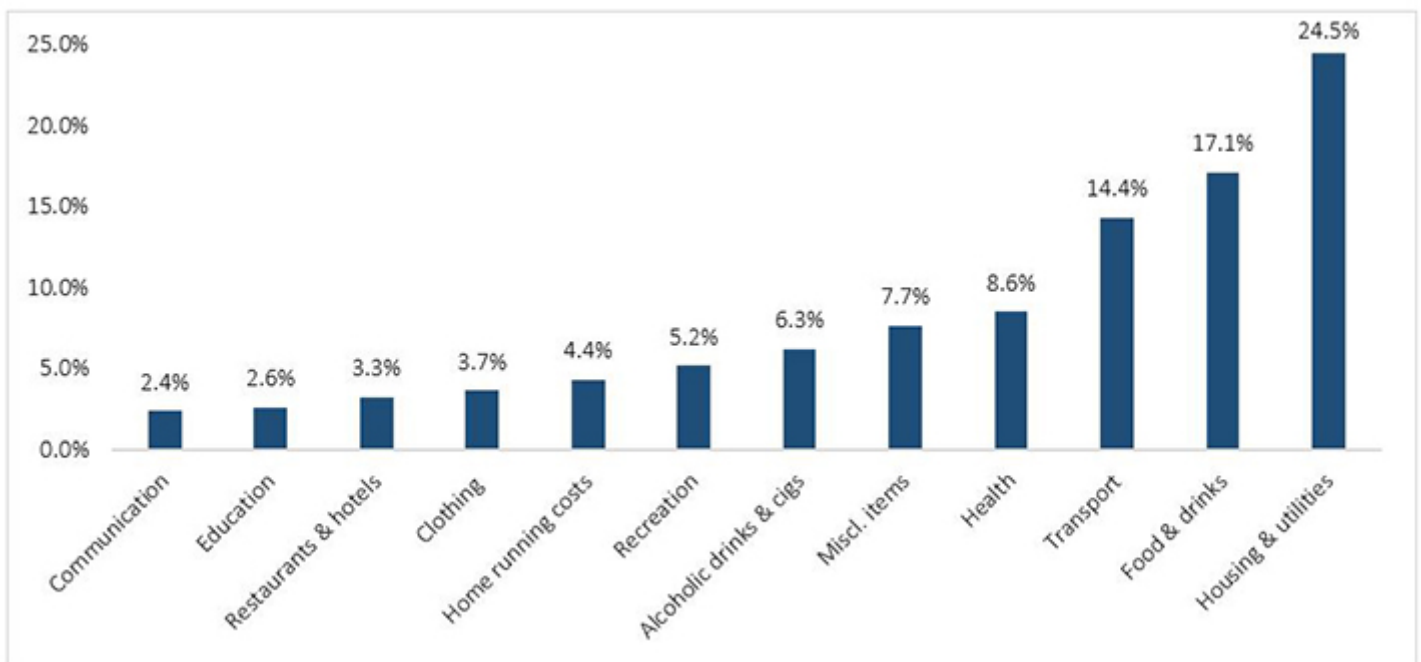
The consumer price index (CPI) is a commonly used benchmark to judge the performance of many portfolios and wealth objectives in the financial services industry. This is because it is seen as a proxy for the growth path of an investor's future spending needs. As a result, many investment portfolios are built with the intention to outperform CPI.

In this article, we explore the composition of the CPI basket and whether this basket represents the investor's future spending needs. This in turn has important implications for the building of investment portfolios which could end up taking more or less risk than is required to reach the investor's financial goals, impacting the ultimate success of their financial plan.

Breaking down the South African CPI basket

The inflation basket is designed to represent the average consumer's spending habits on goods and services. CPI is therefore designed to model how the average consumer's spending evolves over time. The basket comprises several broad categories and weights as detailed in the chart below.

Chart 1: Consumer Inflation Basket Weights 2022



Source: Stats SA

The inflation basket includes 416 individual items, which are surveyed for price inflation on a monthly basis. Stats SA updates the mix of goods and services every four years, keeping within the five-year norm of international best practice, to ensure that it remains relevant. Part of the exercise involves removing products from the basket, while others are added, to reflect changes in consumer spending patterns.

For example, utility bills such as electricity and municipal rates have become an increasingly larger component of the basket, while items such as DVDs and blank CDs have been replaced by cloud computing costs and USB sticks. Other consumer items that have been removed from the basket were tennis balls, automated pool cleaners and spreads such as Marmite and Bovril, all of which have become less important to the average South African consumer^[1].



However, even with the recent adjustments to the basket, you may notice that it does not represent your household budget, and therein lies the problem.

How does Stats SA construct the basket?

Stats SA follows a set of international standards to build the inflation basket using data they source from a nationwide survey (Living Conditions Survey). This allows them to identify products and services on which households spend their money^[2].

The survey covers a sample of 3 080 households in an attempt to capture household expenditure across a broad cross-section of demographic and income levels.

Why does CPI attract so much focus?

What authorities fear most is when the price of goods and services rises faster than the growth of people's incomes. This can lead to political unrest and exacerbate poverty.

For investors, inflation is the baseline over which they want their investments to grow. An investment that grows in excess of inflation leads to wealth creation as the investor has more to spend in the future.

CPI is typically used to estimate this target growth objective, which becomes an important consideration in selecting the type of instruments to include in an investment portfolio. There is a matching risk here however if the CPI basket isn't reflective of the investor's actual lived inflation rate.

This could result in their investment portfolios' growth path diverging and potentially missing the investor's longer term financial objective.

Does the CPI basket represent the average investor's spending needs?

The average consumer does not represent the average investor in South Africa. Recent research on wealth dispersion in South Africa shows that 85% of personal wealth in South Africa is held by the top 10% of the population representing roughly 3.9m individuals^[3].

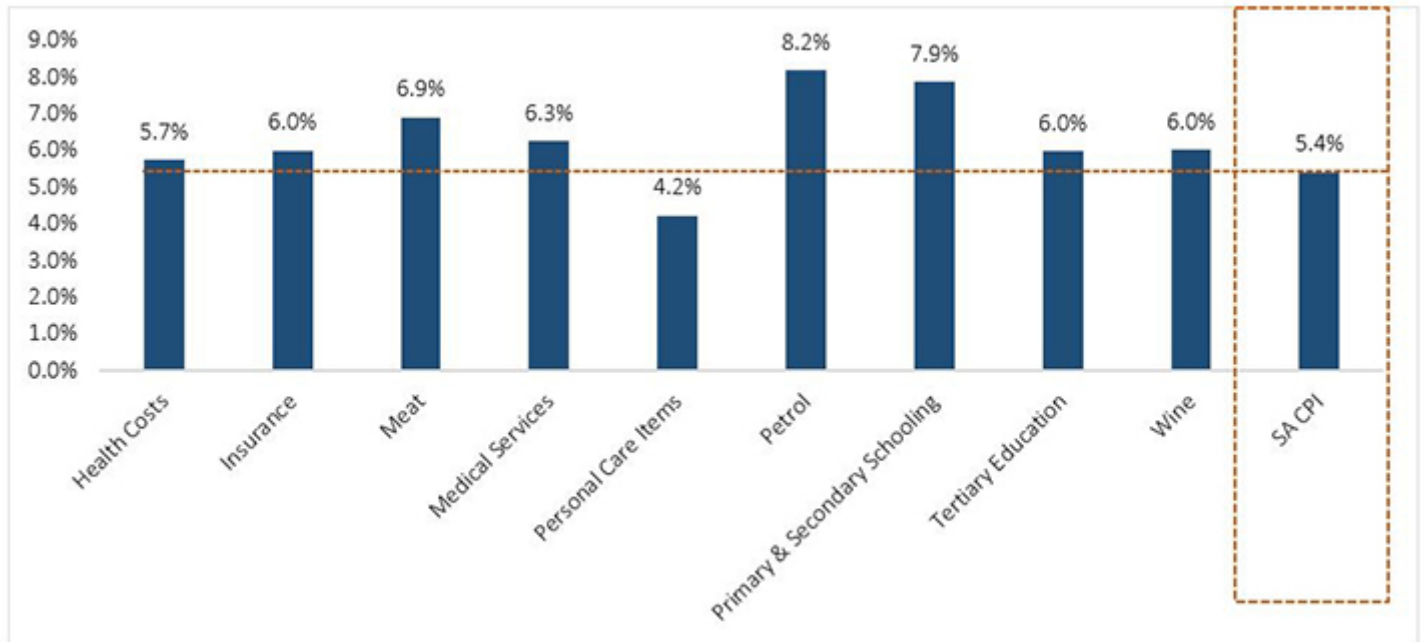
Stats SA publishes inflation data based on the expenditure level of consumers broken into 10 groups, with 1 being the lowest expenditure households and 10 being the highest. What becomes clear is the inflation basket for the 10th group looks different from the inflation basket of the average consumer. The average investor is more likely to reflect the spending habits of this top tier, and potentially an even smaller fraction of this top tier to reflect the higher net worth nature of investors serviced through independent financial advisers.

The 10th group has a higher preference for items like education, medical costs, insurance and recreational activities compared to the SA CPI basket^[4]. For example, Chart 2 shows the differing annual inflation rate of prevalent items in the top 10 group relative to the overall CPI.

It becomes very clear that the inflation rate on most of these items is above the broad measure of CPI inflation and by implication, the lived inflation of the average investor is likely to have been underestimated using CPI.



Chart 2: Annualised Price Changes Compared to SA CPI: 01 Jan 2002 to 31 Jan 2022



Source: Stats SA

This segment's higher level of wealth and a more advanced life stage are major factors that influence the deviation relative to CPI, which in turn increases the risk of a measurement error using CPI^[5].

It is also important to highlight the fact that investment returns are also net of fees and taxes in the hands of the investor. The changing trajectory for fees and taxes needs to be factored in to arrive at a final long term return expectation, which can then be used to spend on goods and services.

A revised approach to matching future spending needs

Investment portfolios are often built to grow in line with or above the SA CPI inflation rate. The risk that the investor does not closely fit the accepted definition of CPI inflation is a risk to the financial planning process.

To address the mismatch risk, we suggest considering the following during the financial planning process:

- Be aware that there can be a mismatch between the investor's financial goals and the CPI basket of goods and services because of their stage of life or wealth level;
- Estimate the likelihood that the mismatch will result in a higher or a lower inflation rate than CPI – for example, items like medical insurance, education and travelling costs have the potential to grow faster than CPI;
- Consider how this might impact the risks associated with the investment portfolio, which may need to be adjusted higher or lower than initially thought; and
- Account for the impact of costs such as taxes and investment management fees through a well-considered financial and estate plan.

Addressing these issues can be complex to implement and will need to be balanced with the requirement for consistency and feasibility when selecting an investment portfolio. However, being aware of the shortcomings of using CPI as a proxy for investor inflation can be the starting point in achieving a more considered financial outcome for investors.



^[1] The New Inflation Basket: what's in, what's out, 2016.

^[2] Classification of Individual Consumption According to Purpose (COICOP), 2018.

^[3] Estimating the distribution of household wealth in South Africa, 2020.

^[4] Consumer Price Inflation across the Income Distribution in South Africa, 2006.

^[5] Consumer Price Inflation across the Income Distribution in South Africa, 2006



MARKET REPORT

31/01/2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	19.6%	8.9%	11.8%	16.6%	9.8%	10.5%	17.1%	14.3%
FTSE/JSE SA Listed Property	ZAR	6.4%	-1.0%	2.4%	-2.7%	-5.5%	2.6%	27.4%	21.7%
SA All Bond Index (ALBI)	ZAR	7.6%	3.0%	6.4%	7.7%	8.1%	7.4%	8.1%	8.0%
SA Cash Index (SteFI)	ZAR	1.7%	0.6%	5.5%	4.8%	5.8%	6.2%	0.4%	0.4%
Balanced Benchmark	ZAR	12.6%	6.8%	8.5%	12.3%	9.4%	10.2%	11.8%	9.6%
SA Inflation (1 month lag)	ZAR	1.0%	0.4%	7.2%	5.4%	4.9%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	9.8%	7.1%	-7.0%	8.1%	7.0%	9.6%	18.2%	14.6%
Emerging Markets Equity (Datastream EM)	USD	22.3%	7.9%	-11.7%	1.8%	-1.1%	2.4%	18.8%	16.9%
Global Property	USD	14.2%	9.2%	-11.2%	0.5%	3.6%	5.3%	18.4%	15.5%
Global Bonds (Barclays Global Bond Index)	USD	8.7%	3.3%	-11.7%	-3.9%	-1.3%	0.0%	8.2%	7.2%
Global Cash	USD	1.2%	0.4%	2.8%	1.1%	1.6%	1.1%	0.4%	0.3%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	19.6%	8.9%	11.8%	16.6%	9.8%	10.5%	17.1%	14.3%
Global Equity (Datastream World)	ZAR	4.1%	9.7%	4.8%	13.6%	15.6%	17.2%	17.2%	15.4%
Emerging Markets Equity (Datastream EM)	ZAR	15.9%	10.5%	-0.6%	7.0%	6.8%	9.5%	14.4%	13.6%
Global Property	ZAR	8.3%	11.9%	0.0%	5.6%	11.8%	12.6%	18.3%	15.8%
SA All Bond Index (ALBI)	ZAR	7.6%	3.0%	6.4%	7.7%	8.1%	7.4%	8.1%	8.0%
Global Bonds (Barclays Global Bond Index)	ZAR	3.1%	5.8%	-0.5%	1.1%	6.6%	6.9%	15.2%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	17.7%	6.2%	7.3%	6.7%	7.5%	1.5%	13.4%	14.7%
Gold (Rands)	ZAR	11.6%	8.8%	20.9%	12.2%	16.1%	8.5%		
CURRENCIES									
Rand / Dollar	ZAR	5.2%	-2.4%	-12.7%	-5.1%	-8.0%	-6.9%	15.7%	14.9%
Rand / GBP Pound	ZAR	-1.4%	-4.8%	-3.4%	-2.8%	-4.9%	-4.2%	14.0%	14.6%
Rand / Euro	ZAR	-4.2%	-4.2%	-9.1%	-4.4%	-5.1%	-4.6%	13.9%	13.4%

Spot Rates		31-Jan-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	17.3	17.0	15.5	12.0	8.9	8.5
Rand/GBP	Rand	21.5	20.4	20.7	16.8	14.2	14.0
Rand/EUR	Rand	18.9	18.2	17.3	14.8	12.1	9.2
RATES							
Libor 6m \$	US\$	5.1	5.1	0.5	2.0	0.5	1.3
Repo Rate	Rand	7.25	7.00	4.00	6.75	5.00	13.50
Prime	Rand	10.75	10.50	7.50	10.25	8.50	17.00
All Bond Index Yield	Rand	10.6	11.0	11.6	9.3	7.1	9.7
COMMODITIES							
Gold (\$/oz)	US\$	1 924.6	1 815.6	1 796.7	1 338.4	1 663.9	368.0
Platinum	US\$	1 013.0	1 031.0	1 022.0	1 011.0	1 672.0	667.0
Oil (Brent Crude) \$	US\$	85.9	84.9	91.4	69.3	115.9	31.5
INFLATION							
SA Inflation	%	7.2	7.2	5.7	4.3	5.4	9.4

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