



Career Ready Academy

# TEXTBOOK

**Portfolio Selection**

Intermediate Module



[virtualclc.co.za](https://virtualclc.co.za)



010 597 0835



14 Vermooten Street Alberton

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For permission, email the author a request: [anna@virtualclc.co.za](mailto:anna@virtualclc.co.za)

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If you would like to order the publication, please contact the author at [anna@virtualclc.co.za](mailto:anna@virtualclc.co.za)

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## INTRODUCTION

An FSP must ensure that it, its key individuals and representatives are proficient in respect of, understand, and have completed adequate and appropriate class of business training and product specific training relevant to, the particular financial products in respect of which they render financial services or manages or oversees the rendering of financial services.

Class of business training, where appropriate must include training on the following:

- The range of financial products within the class of business.
- The general characteristics, terms and features of financial products in the class of business and any specialist characteristics, terms and features in respect of financial products in the class of business.
- The typical fee structures, charges and other costs associated with products in the class of business.
- General risk associated with investing, purchasing or transacting in the products in the class of business.
- Investment and risk principles, options and strategies in respect of products in the class of business.
- The appropriateness of different products or product features in the class of business for different types of clients or group of clients.
- The typical role players or market participants in respect of products in the class of business, including their legal structure.
- The impact of applicable legislation, including taxation laws, on product in the class of business.
- The impact of applicable economic and environmental factors on the products in the class of business and the performance of those products including:
  - The economic and business environment and cycles.
  - Inflation.
  - Government monetary and fiscal policy.
  - Interest rates and exchange rates.
- Any inter-relationship within and between particular classes of business.
- Industry standards and codes of conduct relevant to class of business

This module forms part of the Class of Business Training for Business Class 3, 7 & 8: Long-term insurance | Investments | Forex investments

It is a prerequisite to complete and pass this module before completing one or all of the following modules:

- COB Module 3 – Long-term Insurance: Class 3
- COB Module 3 – Pension Fund Benefits: Class 4
- COB Module 3 – Structured Deposits: Class 6
- COB Module 3 – Investments: Class 7
- COB Module 3 – Foreign Investments: Class 8

# Topic 1 Classes of Investment Assets

## LEARNING OUTCOMES

After study the topic, the learner should be able to-

- Name the different asset classes.
- Outline the general features of the different type of asset classes including tax implication, volatility and inflation considerations.
- Describe the different financial products through which products the different asset classes can be accessed.

## 1.1 INTRODUCTION

The characteristics of investors and the circumstances that confront them are diverse and complex. Each investor's financial profile and attitude to return and risk are unique. Each has a different set of constraints related to liquidity, taxes and time horizon and a set of preferences in respect of social and environmental responsibility. To meet the varied risk/return objectives, requirements and preferences of investors a wide range of investment and financial products have been developed and are available to retail and wholesale investors.

Investment products can be categories into different asset classes which will be considered in the sections following.

## 1.2 ASSET CLASSES

An asset can be defined as any possession or investment that has potential value when exchanged. Examples of assets that could be included in this definition are property, stocks or shares (equities), cash investments at the bank, bonds, etc. Note that this definition focuses on assets in the investment sense (i.e. with the potential of having a growing future value), so we would not include possessions here that we use in everyday life, such as cars or furniture, unless these possessions are assets that gain in value due to their scarcity for example, antique collectible furniture, or collector cars.

Asset classes are therefore, groupings of assets (or investment instruments) used for investment purposes that share common characteristics, are subject to the same laws (for example tax laws) and behave similarly in the marketplace.

Traditional asset classes	Non-traditional/ Alternative asset classes
Cash	Currencies, e.g. US dollars, euros, etc.
Money Market Instruments	Commodities, e.g. crude oil, gold, silver
Bonds, e.g. Eskom bonds, Government bonds, RSA retail bonds	Derivatives, e.g. futures and options contracts
Shares/ Equities listed on a licensed stock exchange	Collectibles, e.g. stamp collections, artworks
Property, e.g. houses, shopping malls, office blocks	Private equity, e.g. shares/ equity in private companies not listed on a stock exchange including venture capital which the financing of small, emerging businesses
	Hard assets

Table 1. 1: Summary of Different Asset Classes

Therefore, all assets in a particular asset class tend to have somewhat similar levels of performance in given market conditions, whereas assets in different asset classes may perform differently in relation to each other under the same given market conditions i.e. different asset classes may have low performance correlations.

### **1.2.1 Correlation between Different Asset Classes**

When interest rates are high, cash performs well. Equities, on the other hand, tend to perform well when the outlook for growth in corporate profits is good, and this is often when interest rates are low. These two asset classes thus tend to have a low performance correlation in a given interest rate market environment. If invested only in equities, the investment would tend to perform poorly in a market environment where interest rates are too high and restrictive for companies to expand and increase their growth. However, if you invested partly in cash as well, the overall risk profile of the investment would be reduced, since, if interest rates increased, then the cash investment would perform better, and thus be able to offset some of the losses experienced in the equity investment.

Categorising assets into classes assists investors or asset managers to choose an appropriate mix of assets in these different classes, in order to reduce exposure to the risk associated with any one asset class, and to maximise returns in changing market conditions.

### **1.2.2 Investment Portfolios**

Investors can invest directly into the different asset classes and assets/ instruments by, for example, accessing these through a stock broker registered with the Johannesburg Securities Exchange.

However, financial advisors mainly advise clients on financial products which are structured by the product supplier around a certain collection of asset classes and assets. This collection is what we refer to as the investment portfolio or fund.

Collective investment schemes (CISs) is a generic term for any scheme where funds from various investors are pooled for investment purposes with each investor entitled to a proportional share of the net benefits of ownership of the underlying assets.

In this guide we will mostly refer to collective investment schemes as the example to illustrate the link between a financial product, investment portfolios and asset classes. However, the same principles will equally apply to other financial products, such as investment funds of endowment policies, sinking funds, retirement annuities, exchange-traded funds, etc.

## **1.3 CASH**

Cash can be held as notes and coins or deposited with a bank.

Holding cash has the advantage of immediate liquidity. However, there are two problems with holding cash. Firstly, cash earns no or little interest and its real value will be eroded by inflation and secondly large cash holdings may attract criminals.

### **1.3.1 Returns On Cash**

Returns from assets in cash instruments are received in the form of interest, which is generally paid in line with prevailing interest rates. The interest is simply added to a bank deposit which can then either be drawn as income or be re-invested in the underlying investment fund.

### 1.3.2 Tax Implications of Cash

Interest earned (or income distributions received) on cash/ fixed-interest investments is fully taxable, less the general annual interest exemption. Note that on investments into tax-free investment products investors are exempt from paying tax on the interest earned within the fund – terms and limitations apply. At the moment (2018), the tax-free investment threshold is R33 000 per year.

### 1.3.3 Volatility of Cash

Cash instruments typically come with a guarantee on the capital and a fixed interest rate; therefore, they are seen as safe investments with limited volatility. They are generally considered to be low-risk investments.

### 1.3.4 Inflation And cash

There is no real growth on capital invested in cash over the longer term, as the net after-tax returns on fixed-interest investments are historically below inflation or just a few basis points above inflation.

### 1.3.5 Accessing Cash Investments

Cash deposited with a bank will be held in non-interest-bearing or interest-bearing accounts.

Non-interest-bearing accounts such as cheque accounts are used to meet immediate expenditure requirements. Cash can be withdrawn by cash or cheque at any time without notice. Since cheque accounts generally do not pay interest they are not strictly-speaking investments. Rather they are a convenient way to store cash and make transactions.

To choose an interest-bearing account such as a demand deposit, fixed deposit, money market account or notice deposit account, an investor should consider the following factors:

- Interest rate:* Interest rates may be fixed or variable and may be paid at different times e.g. monthly, quarterly, semi-annually or annually. Investors should ensure that when evaluating interest rates offered, these are comparable
- Term to maturity:* Term to maturity indicates the set period for which the cash is to be invested. The longer the term to maturity, the higher the interest rate
- Period of notice:* Period of notice is the amount of time that must be given by investors to withdraw the invested funds in an account. Some accounts can be withdrawn on demand; others require a notice period for example 30 days' notice
- Cost:* Some accounts attract fees such as monthly maintenance fees. Since these eat into the return and perhaps capital of the deposit, investors should ensure they are receiving value for money.
- Security:* Security relates to the risk of default by the bank. Investors should consider the financial strength of the bank before placing their funds with it. In addition, they should consider diversifying i.e., having accounts with several different banks. Some countries have deposit insurance, which provides compensation to small retail depositors in the event of a bank failing. Deposit insurance has been proposed in South Africa but has not yet been introduced.

There are many deposit accounts. These include the following:

- Savings accounts:** Deposits that pay interest and can be withdrawn on demand. The amount of interest will depend on the balance in the account. The higher the balance, the higher the interest rate

- Notice deposit accounts:** Deposits that pay interest and are subject to a period of notice to withdraw the funds. The longer the period of notice, the higher the rate of interest. Immediate access to funds is generally available on the penalty of forgoing the interest
- Money market accounts:** Accounts that pay interest rates closely related to money market rates such as JIBAR. Generally, such accounts have a relatively high minimum balance and upfront fees. These accounts can be withdrawn on demand
- Negotiable certificates of deposit (NCDs):** Negotiable certificates of deposits are issued by banks for a specific period at a stated interest rate. They are negotiable (tradeable) but have a minimum balance of R1 million.

## 1.4 MONEY MARKET INSTRUMENTS

### 1.4.1 Features of Money Market Instruments

Money market instruments are marketable (tradable) debt instrument issued by a private company, government or semi-government institution that contains a promise to repay a loan over a period of shorter than 1 year – the most common maturity being 3 months.

Money market instruments include the following:

- Bankers' acceptances
- Commercial paper
- Negotiable certificates of deposits (NCDs)
- Treasury bills
- Repurchase agreements
- Reserve Bank debentures (RBDs)

Money market instruments are either discount or interest-add on securities:

Discount instruments are securities such as treasury bills that are sold at a discount to face or par value and redeemed at face and par value on maturity date. For example, assume an investor buys a 91-day treasury bill with a face value of R1 million for R975 000. In 91 days the investor will receive R1 million when the National Treasury redeems the bill. Thus, the investor earned interest of R25 000 over the period of 91 days.

Interest-add-on securities are securities such as NCDs and RBDs that are sold at face or par value and redeemed at face value plus interest on maturity date. For example, assume an investor buys a 91-day NCD with a face value of R1 million. The investor will pay R1 million for the NCD. In 91 days the investor will receive R1 million plus interest when the issuer redeems the NCD.

The money market is mostly a wholesale market but retail investors can access the money market through money market accounts at a commercial bank or by investing in a money market collective investment scheme (CIS).

### 1.4.2 Returns on Money Market Instrument

The return on a money market instrument is from the following sources:

- The interest paid
- The price appreciation/depreciation of the bond if sold in the secondary market



### 1.4.3 Volatility of Money Market Investments

If the interest return is benchmarked the issuer is exposed to interest rate risk which can mean some volatility.

The security of a money market instruments depends on the issuer. Treasury Bills is issued by the government which is usually considered to be a risk-free investment.

### 1.4.4 Inflation and Bond Investments

Money Market instrument usually offer better returns over time than cash.

## 1.5 BONDS INSTRUMENTS

### 1.5.1 Features of Bonds

A bond is a marketable (tradable) debt instrument issued by a private company, government or semi-government institution that contains a promise to repay a loan over a long term, ranging from 1 year to 30 years.

The principal of a bond is the amount the issuer agrees to repay the bondholder on maturity date. It is also called the nominal, face, maturity, or redemption value.

The coupon rate is the rate of interest (usually fixed) that the issuer agrees to pay the bondholder each year. The interest payment is called the coupon. It is calculated by multiplying the principal by the coupon rate. For example, a bond with a 12% coupon rate and a principal of R1 000 will pay an annual coupon of R120 ( $R1\ 000 \times 0.12$ ).

All bonds make periodic coupon payments except zero-coupon bonds. The coupons paid by variable-rate bonds (floating-rate notes) vary according to a specified benchmark such as the effective ruling interest rate on South African treasury bills or JIBAR (Johannesburg Inter-Bank Acceptance Rate).

The term to maturity of a bond is the number of years over which the issuer has agreed to meet the conditions of the debt. The maturity date (redemption date) is the date on which the issuer is due to redeem the bond by paying the principal.

Term to maturity indicates the life of the bond i.e., the period over which the bondholder can expect to receive coupon payments and the number of years before the principal is repaid.

### 1.5.2 Returns on Bonds

The return on a bond is from the following sources:

- The coupon paid periodically
- The interest earned on the coupon
- The price appreciation/depreciation of the bond if sold in the secondary market

### 1.5.3 Volatility of Bond Investments

If a person directly purchases a traditional (plain vanilla) bond and holds it to maturity, there is little volatility, as the return is fixed (the interest paid) and the capital will be repaid at the end of the term. However, bonds other than RSA Retail bonds can be volatile if purchased after they are issued and then sold before maturity.

Interest rate movements affect the value of bonds, and this may result in significant fluctuations in value that could lead to possible capital gains or losses when these instruments are sold before the maturity date.

The security of a bond depends on the issuer. Government bonds (previously known as gilts) and bonds issued by semi-government companies (such as Eskom) are generally considered secure, whilst corporate bonds, which are often issued as unsecured bonds (debentures), may be less secure. Bonds are generally considered to be medium-risk investments.

#### **1.5.4 Inflation and Bond Investments**

Bonds usually offer better returns over time than cash/ money-market assets, and hence many investment portfolios include bonds.

## **1.6 PROPERTY**

### **1.6.1 Features of Property**

Property or real estate is the primary financial asset of many companies and individuals and is an important part of the economy involving thousands of businesses and jobs. The property market can be divided into residential and commercial properties.

Buying a house is often the largest single transaction for a household, and the property its largest asset. Fluctuations in house prices have a large impact on households' net wealth, and their propensity to spend. Residential property generally includes all types of housing - new and existing dwellings, single family houses and flats.

Property (together with the land on which it is situated) is considered to be commercial if the underlying purpose of ownership is generating profits. Commercial properties may include properties rented out, those under construction for future sale and those used in the production of goods and services for example, retail premises, offices, factories and warehouses.

Investors can choose to invest directly or indirectly in property. Direct investments in property are direct ownership of property by individuals, joint ventures, partnerships or companies.

Indirect investments in property are through property securities, which include listed property entities such as real estate investment trusts (REITs), exchange-traded funds (ETFs) and unlisted property holding and development companies (property syndications).

### **1.6.2 Returns on Property**

Returns are received in the form of rental income, or capital gains on the proceeds of the sale of the property.

### **1.6.3 Tax Implications of Property Investments**

Rental income earned (or income distributions received) on property investments is generally fully taxable as income. Note that on ownership of a direct property, any expenses in the production of the income can be deducted. If a capital gain is made on the sale of the property, or on the sale of units in a collective investment scheme that invests in property, capital gains tax may be payable, subject to the annual capital gains tax exclusion.

Note that on investments into tax-free investment products, investors in the fund are exempt from paying tax on the rental income earned or capital gains made – terms and limitations apply.

#### **1.6.4 Volatility of Property Investments**

Property prices are cyclical and move in both directions (up and down). Over the short-term, the volatility in property investments are lower than in equities, therefore property investments are considered less volatile than equities in the short-term.

The perceived safety in property investment depends on a number of factors, such as interest rates, location, price range, supply and demand, whether the property is to be used for residential or commercial purposes, and the method of investment. Property is generally considered to be a medium- to high-risk investment.

#### **1.6.5 Inflation and property investments**

Property has traditionally outperformed inflation over the long term.

### **1.7 EQUITY/SHARES**

#### **1.7.1 Features of Equities/ Shares**

A share can be defined as a part ownership in a business. When an investor buys a share in a private business or public company, the investor essentially becomes a shareholder of the company. In return for the shareholder supplying part of the capital of the company, he/ she acquires certain rights. One of these rights is the right to a cash dividend when it is declared (usually annually), and the right to share in the growth of the share price of the company. A shareholder is also entitled to a share in the assets if the company dissolves, once the company's debts have been paid.

Public companies make portions of their shares available for sale to the public. The buying and selling of public shares is managed via a stock exchange, e.g. the Johannesburg Stock Exchange (JSE).

Shares make up a major portion of many investment fund portfolios as they have the highest probability of achieving real returns, i.e. returns above the inflation rate over the medium- to long term. Examples of share instruments used in the equity market include ordinary shares, preference shares and cumulative preference shares.

#### **1.7.2 Returns on Equities**

Returns are received in the form of dividends when declared by the company, and capital gains made on the proceeds of the sale of the equities.

#### **1.7.3 Volatility of Equity Investments**

The price and performance of a share is affected by many factors, including global market conditions, local market conditions, political events, the economic cycle, and the performance and management of the particular company. Shares are high-risk investments. There are many different types of companies listed on the JSE and other stock exchanges, with varying levels of profitability and stability.

#### **1.7.4 Inflation and Equity Investments**

Equities are expected to deliver better real returns (after taking inflation into account) over the longer term, compared to other asset classes.

### **1.8 NON-TRADITIONAL / ALTERNATIVE ASSET CLASSES**

#### **1.8.1 Features of Non-Traditional/ Alternative Asset Classes**

Non-traditional or alternative assets offer the client an opportunity to invest in other investments whose risk and return characteristics differ from those of equities, cash, bonds and property.

Dealing in non-traditional or alternative investments generally requires specialised knowledge and skills as all of these types of investment are considered high-risk investments. Investments in the non-traditional space include the following:

- Currencies e.g. US Dollars or Euros
- Derivatives e.g. futures contracts in an underlying financial instrument or commodity
- Private equity which is shares in unlisted companies
- Hedge fund Collective Investment Schemes
- Commodities such as gold
- Collectibles, such as rare stamps and oriental rugs
- Hard assets, such as tank containers

Investment portfolios mainly invest in traditional asset classes; however, some investment portfolios may also invest in alternative asset classes.

#### **1.8.2 Returns on Alternative Investments**

The return on the investment will depend on the specific type of the investment. It may be in the form of dividends or a capital gain.

#### **1.8.3 Tax Implications of Alternative Investments**

Taxation will depend on the type of return generated, and regulations such as customs duty and exchange control may reduce profits on certain types of alternative assets.

#### **1.8.4 Volatility of Alternative Investments**

The volatility will again depend on the type of the investment. For example, an investment in private equity or in venture capital may be extremely volatile over the short term. Alternative assets are generally considered to be high-risk investments, not least because some of these assets (such as stamp collections) may be dependent on availability of buyers, and the investor may not be able to sell the asset when the funds are needed.

### 1.8.5 Inflation and Alternative Assets

This will depend on the type of investment. An investment in Kruger Rands, for example, can be used to protect the client's investment from inflation.

## 1.9 INDIRECT INVESTMENT IN DIFFERENT ASSET CLASSES

Different product can provide an investor access to investing in one or more investment classes. Some of these products are considered in the subsections following.

### 1.9.1 Collective Investment Schemes

Collective investment schemes (CISs) is a generic term for any scheme where funds from various investors are pooled for investment purposes with each investor entitled to a proportional share of the net benefits of ownership of the underlying assets. A CIS consists of the following:

- Pooling of resources to gain sufficient size for portfolio diversification and cost-efficient operation
- Professional portfolio management to execute an investment strategy.

CISs can be categorised as open-end funds or closed-end funds.

- Open-end funds publicly offer their shares or units to investors. Investors can buy and sell the shares or units at their approximate net asset value. The shares can be bought from or sold to the fund directly or via an intermediary such as a broker acting for the fund.
- Closed-end funds offer their shares or units to the investing public primarily through trading on a securities exchange. If closed-end fund investors want to sell their shares, they generally sell them to other investors on the secondary market at a price determined by the market.

CISs make it possible for investors, including small savers, to obtain diversified investment portfolios with professional management at reasonable cost and to execute a widening range of investment strategies. In other words, the main benefits of CISs are:

- Diversification i.e., spreading the risk of investing over a range of investments.
- Professional expertise to manage investors' portfolios.
- Reasonable cost due to reduced dealing costs due to bulk transacting and cost-effective administration.
- Choice in that there are increasing numbers of alternative funds from which to choose.

In addition, CISs generally exist in a set of legal, institutional and market-based safeguards to protect the interests of investors.

The disadvantages of investing in CISs are generally held to be as follows:

- Costs in respect of funds management and advice could be avoided if investors managed their own investments. This assumes investors have the expertise to so self-manage their investments.
- Although investors have a large variety of funds to choose from, they have no control over the choice of individual holdings within their portfolios.
- Investors have none of the rights associated with individual holdings e.g. right to attend the annual general meeting of a company and vote on issues impacting the company.

## **1.9.2 Products Made Available by Long-Term Insurance Companies**

There are two kinds of insurance – short-term and long-term insurance. Short-term insurance insures possessions such as household goods or vehicles against events such as fire, theft, personal liability. Long-term insurance covers major events in life such as death, retirement and disability.

Life insurance companies offer a variety of life policies and variants thereof. A life policy is a contract between the insurance company and an individual or individuals, where payment by the insurance company in return for premiums paid, depends in some way on the duration of the life/lives of the individual/individuals.

There are essentially three classifications of life policies: term insurance, whole-life insurance and endowment.

A term insurance policy is a policy for a specified number of years in terms of which, in return for premiums paid, a fixed benefit is payable on the death of the policyholder any time before the specified term of the contract. The policy provides no further protection if the insured person lives beyond the specified term of the contract. It has no surrender or cash-in value.

Whole-life and endowment policies, in return for a premium paid, provide a mix of life cover and investment. Such policies have a surrender value and can be with-profit policies i.e., the return on the investment portion of the policy is linked to the investment performance of the insurance company. In the case of a whole-life policy the benefit is paid out on the death of the insured regardless of the date of such event. The endowment policy will pay out the benefit after a fixed period or on earlier death.

### **I) Annuities**

Insurance companies offer annuities to investors. An annuity is a contract to pay a set amount every year while the person on whose life the contract depends – the annuitant - is alive. Annuities may be immediate or deferred.

An immediate annuity provides, in return for a single premium, an annual payment starting immediately and continuing for the rest of the annuitant's life. The contracts are often purchased by retired people who want an income that is guaranteed to last the rest of their lives. The income received depends largely on prevailing interest rates and life expectancy.

A deferred annuity is a contract that provides for an annuity to be payable commencing at some future date. The period between the date of the contract and the date of commencement of the payments (also known as the vesting date) is referred to as the deferred period. Regular premiums are payable throughout the deferred period. If the annuitant dies during the deferred period, the insurance company will return the premiums paid. The annuity is payable from vesting date until the annuitant dies.

There are many types of annuities including a compulsory purchased annuity (CPA), a voluntary purchased annuity (VPA), a living annuity and a composite annuity.

A compulsory purchased annuity (CPA) must by law be bought with a portion of the funds received from a matured retirement annuity or pension fund. A CPA is paid to the annuitant for life.

A VPA can be purchased by anyone wanting guaranteed income. It can be taken for life or for a fixed term e.g. 10 years.

The biggest disadvantage of a CPA and VPA is that the income dies with the annuitant unless insurance cover is taken out for the capital (at a cost) or a guarantee is placed on the annuity.

In terms of a living annuity, the annuitant's capital is invested in equities or bonds to achieve growth, and an income of between 5% and 20% of the investment value is withdrawn annually. The annuitant bears the risk of a capital loss on the investment if the equity or bond markets weaken. The advantage of a living annuity is that when the annuitant dies, the balance of the investment goes to the heirs.

Composite annuities are a combination of CPA/VPA annuities and living annuities. Composite annuities offer flexible income from the living annuity part and a guaranteed income from the conventional annuity part.

### **1.9.3 Retirement Funds**

A retirement fund is an independent non-profit legal entity that collects, invests and administers funds contributed to them by individuals and companies. The exclusive purpose of a retirement fund is to finance retirement plan benefits i.e., provide an income for an individual after retirement. There are three basic types of retirement funds: government pension schemes, personal retirement funds and occupational retirement funds.

#### **I) Government Pension Schemes**

Government pension schemes pay a state pension to elderly citizens. The pension is funded out of taxes. In South Africa it comprises a social old age grant to elderly people (men over 65 and women over 60) who do not have sufficient income from other sources. About 75% of South African elderly rely on the old age grant.

#### **II) Personal Retirement Fund**

Personal retirement funds are funds entered into by individuals to provide for their retirement. Such funds are funded by contributions from the individual. Retirement annuities can be used for this purpose.

#### **III) Occupational Retirement Funds**

Occupational retirement funds (or simply retirement funds) are run by employers for the benefit of their employees. They are funded by contributions from the employee or employer or both. The main role-players in a retirement fund are the sponsor (the employer or a group of employers), the beneficiaries (the employees who participate in the fund), the fund manager (who manages the assets in the fund) and the trustees who govern and monitor the retirement fund on behalf of the beneficiaries.

Retirement funds in South Africa are categorised as provident funds or pension funds. A pension fund provides for at least two thirds of the final retirement benefit to be paid as a life-long pension after retirement. One third of the final benefit may be taken in cash, subject to tax. A provident fund provides for the full amount of the final retirement benefit to be taken in cash, subject to tax.

There are two broad fund structures: defined benefit funds and defined contribution funds. In a defined benefit fund the retirement benefit is determined according to a formula linked to the beneficiary's final salary. This means that the employer is exposed to the investment risk of the fund i.e., if the investments of the fund are insufficient to fund retirement benefits, the employer must contribute the shortfall. If the fund's investments perform better than expected, the employer may contribute less to the fund and may even make no contribution i.e., take a contribution holiday.

In a defined contribution fund the retirement benefit is the sum of the total contributions made plus the net (i.e., after costs) return on investment. This implies that the employee is exposed to the investment risk of the fund. If fund investments perform worse/better than expected, the beneficiary's retirement benefits are reduced/increased. Retirement benefits are dependent on the investment return of the fund.

### 1.9.4 Real Estate Investment Trusts

Real estate investment trusts (REITs) are listed property investment securities that aim to provide investors with a rental income stream while also providing capital growth from sales of underlying properties.

In South Africa REITs that trade on the JSE must comply with the following criteria:

- Have minimum assets of R300 million, which can comprise direct interests in immovable property. (such as land and buildings), interests in leases relating to immovable property, interests in property subsidiaries or holdings in other REITs.
- Pay out at least 75% of their distributable earnings to investors as dividends.
- Earn at least 75% of their income from rental income.
- Have debts below 60% of their gross asset value.

Since REITs can be bought and sold on an exchange they offer liquidity and low minimum investment.

There are two types of REITs: company REITs and trust REITs.

#### I) Company REITs

As with all other listed companies company REITs are subject to the Companies Act and JSE regulations. The main difference between company REITs and other listed companies is that company REITs issue linked units rather than shares. A unit in a company REIT is part share and part debenture (called a dual-linked structure), with most of the value of the unit attributable to the debenture. The debenture is not redeemable and earns interest at a variable rate.

The interest comes from income that the company REIT earns from one of the following:

1. Rental incomes received from the properties in which the company invests.
2. The sale of properties in which the company has invested and that have appreciated in value since purchase.
3. Fee income from property management services.

Company REITs usually distribute all their net profits, mainly through debenture interest with the balance being paid out as dividends. Distributions are paid quarterly, semi-annually or annually. These regular distributions provide investors with a steady cash flow.

#### II) Trust REITs

Trust REITs (more correctly the managers of the trust REITs) are registered by the Financial Sector Conduct Authority (FSCA) in terms of the Collective Investment Schemes Act. The FSCA limits trust REITs to investments in listed immovable property assets, shares in property companies; and liquid debt-related investments. The FSCA requires a trust REIT to be listed on the JSE and as such be subject to all the regulatory requirements imposed by the JSE for listed securities.

The management companies of trust REITs are responsible for the day-to-day operation of the portfolio of properties and for the investment strategy of the trust REIT. The affairs of the management companies are governed by a trust deed between the management company and the trustees of the trust REIT.

The JSE offers several FTSE/JSE indexes as benchmarks that only include property companies. Research has shown that such indexes follow market trends rather than the value of property. This means that REITs share prices fluctuate with market conditions, sometimes related to the value of property, sometimes not.



### **1.9.5 Unlisted Property Holding and Development Companies**

Unlisted property holding, and development companies are more commonly known as property syndications. These are unlisted investment schemes that enable a group of investors to buy property and become part owners of it, either directly or but more usually, indirectly. Property syndication is typically structured in one of the following ways:

- A public company owns the property directly.
- A private company owns the property and is itself wholly owned by a public company.

The units (shares and debentures) in the public company are sold to investors. The investment can either be solicited with a prospectus registered with the Registrar of Companies or by way of private placement with catalogue.

In South Africa many investors have lost their investments in property syndications for various reasons including substantial falls in property prices. In addition, property syndications, because they are unlisted and loosely regulated, have been used to fleece investors.

## Topic 2 Economic fundamentals

### LEARNING OUTCOMES

- After study the topic, the learner should be able to-
- Define the different economic systems.
- Describe the flow of economic activity.
- Explain the different types of economic policy used by governments to influence the economic.
- Understand the characteristics of the different phases of the business cycle.
- Describe the impact of the different phases on different asset classes.
- Outline the most basic economic indicators.

### 2.1 ECONOMIC SYSTEMS

The approach to resource allocation – the assignment of scarce resources to the production of goods and services - allows a distinction to be made between those economies that are centrally planned and those that operate predominantly through market forces.

In a centrally planned or command economy most of the key decisions on production are taken by a central planning authority, usually the state and its agencies.

The state normally-

- Owns and/or controls resources.
- Sets priorities in the use of the resources.
- Determines production targets for firms, which are largely owned and/or controlled by the state.
- Directs resources to achieve the targets.
- Attempts to co-ordinate production to ensure consistency between output and input.

In the free-market or capitalist economy firms and households interact in free markets through the price system to determine the allocation of resources to the production of goods and services. The key features of the free-market system are:

- Resources are privately owned, and the owners are free to use the resources as they wish companies, which are also in private ownership, make their own production decisions
- Production is co-coordinated by the price system - the mechanism that sends prices up when the demand for goods and services is more than their supply and prices down when supply is more than demand. In this way the price system apportions limited supplies among consumers and signals to producers where money is to be made and consequently what they ought to be producing.

In a mixed economy the state provides some goods and services such as postal services and education with privately-owned companies providing the other goods and services.

The economic problem of resource allocation has a political dimension. The link between a society's economic system and political regime is illustrated in Figure 2.1.

Just as economic systems can extend from free market to centrally planned, depending on the level of state intervention in resource allocation so political systems can range from democratic to authoritarian given the degree of state involvement in decision making.

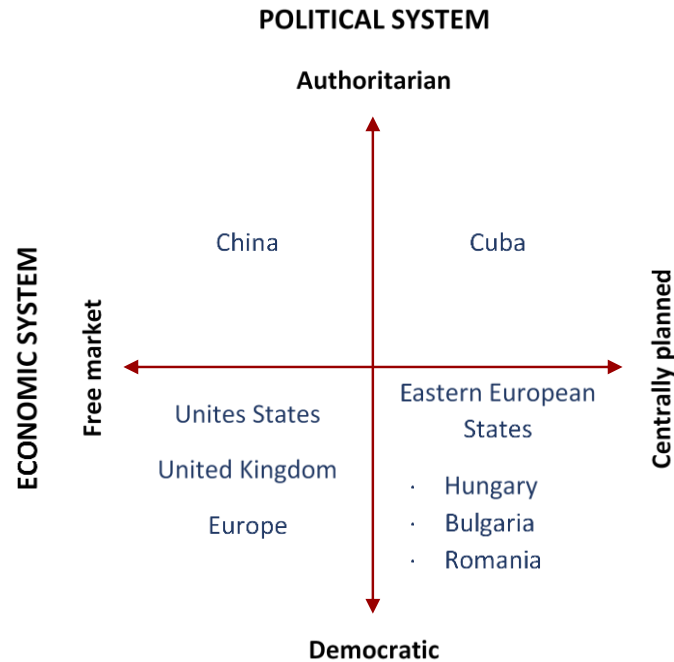


Figure 2.1: Political-Economic Systems

## 2.2 THE FLOWS OF ECONOMIC ACTIVITY

The major participants in an economy are households, firms, the government and the foreign sector. How these interact within an economy can be described by a circular flow diagram.

In its simplest form - see figure 2.2 - the economy consists of two groups: firms and households.



Figure 2.2: Simplified Circular Flow of Income Diagram

In reality the economy is more complicated. There are leakages from the circular flow:

- Savings:** Money is received by households but not spent on consumption of goods and services
- Imports:** Money flows to foreign firms as households consume imported goods
- Taxes:** Money flows to the government.

At the same time as the leakages are taking place, additional forms of spending occur that represent injections into the circular flow:

- Investment spending:* Firms use capital in the production process.
- Exports:* Firms sell their production to another country in exchange for foreign exchange. The difference between a country's exports and imports of goods is known as the trade balance and reflects the country's basic trading position
- Government spending:* Governments use taxation to spend on the provision of public goods and services such as defence and education.

Inherent in the circular flow of income concept is the equality of total production, income and expenditure for the economy as a whole. Production gives rise to income. Income is expended on production.

The total of all expenditure within an economy is referred to as aggregate demand. The main categories of aggregate demand are the following:

- Consumer or household spending
- Government spending or public expenditure
- Investment spending on capital goods
- Exports of goods and services less expenditure on imports of goods and services.

Consumer spending is regarded as the most important factor in determining the level of aggregate demand.

Aggregate supply is the total of all goods and services produced in an economy.

## 2.3 ECONOMIC OBJECTIVES

The performance of an economy is generally judged in terms of the following economic objectives:

- An acceptably high rate of non-inflationary economic growth.
- A high and steady level of employment of the labour force.
- A stable general price level i.e., the avoidance of undue inflation and deflation.
- A favourable and stable balance of payments.
- Equitable distribution of income.

## 2.4 ECONOMIC POLICY

Recognition that market forces alone cannot ensure that an economy will achieve the economic objectives has resulted in state intervention occurring to some degree in all countries. The intervention can take the form of fiscal policy, monetary policy and /or direct controls, collectively economic policy.

### 2.4.1 Fiscal Policy

Fiscal policy is the use of government spending and taxation policies to influence the overall level of economic activity.

Fiscal policy is said to be loosening if tax rates are lowered or public expenditure is increased – inject income into the circular flow and stimulate aggregate demand.

Fiscal policy is said to be tightening if tax rates are increased or public expenditure is reduced – weaken aggregate demand.

In South Africa National Treasury is responsible for the execution of fiscal policy.

Taxation and government spending are linked in the government's overall fiscal or budget position. A budget surplus exists when taxation and other receipts of the government exceed its payments for goods and services and debt interest. A budget deficit arises when public-sector expenditure exceeds public-sector receipts. A budget deficit is financed by borrowing.

Expansionary fiscal policy is usually associated with a budget deficit and contractionary fiscal policy with a budget surplus.

The public or national debt is the total sum of all budget deficits less all budget surpluses over time. National debt incurs interest costs and must be paid back. It is financed by taxpayers and is a transfer between generations.

### 2.4.2 Monetary Policy

Monetary policy regulates the economy by influencing the monetary variables such as:

- The rate of interest.* Lowering interest rates encourages (i) companies to invest in capital as the cost of borrowing falls and (ii) households to increase consumption as disposable incomes rise on the back of lower mortgage and overdraft rates. Rising interest rates will typically have the opposite effect
- The money supply* (notes, coins, bank deposits). If the money supply is increased, interest rates tend to fall.

The most important tools of monetary policy are:

1. Reserve requirements
2. Open-market operations
3. Bank or discount rate policy.

#### I) Reserve Requirements

The central bank requires banks to hold a specified proportion of their assets as cash reserves - typically against their depositors' funds. By changing the reserve requirement, the central bank can influence the money supply and credit extension. For example, if the central bank lowers the cash reserve requirement the money supply will increase as banks extend additional credit on the back of their increased lending capacity.

#### II) Open Market Operations

Open market operations involve the purchase and sale of government and other securities by the central bank to influence the supply of money in the economy and thereby interest rates and the volume of credit.

A purchase of securities – expansionary monetary policy – injects reserves into the banking system and stimulates growth of money supply and credit extension.

A sale of securities – contractionary monetary policy – drains reserves into the banking system and weakens money supply and credit extension.

### III) Bank or discount rate policy

The bank or discount rate is the interest rate at which the central bank lends funds to the banking system. In South Africa this rate is called the repurchase rate (repo rate). Banks borrow from the central bank primarily to meet temporary shortfalls of reserves.

By varying the interest rate on these loans, the central bank can affect market interest rates e.g. increasing the bank rate raises the cost of borrowing from the central bank and banks will tend to build up reserves. This will decrease the money supply and reduce credit extension.

An accommodative or expansionary monetary policy reduces the bank (or repo) rate at which the central bank provides credit to the banks.

Monetary policy is restrictive or contractionary when the central bank increases the bank (or repo) rate.

The South African Reserve Bank (SARB) is the central bank of South Africa. The SARB applies monetary policy in South Africa within an inflation targeting framework. An inflation targeting framework has the following four elements:

- A monetary policy goal of price stability
- A numerical inflation targets to make the price-stability objective operational
- A time horizon to attain or return to the inflation target
- Ongoing review as to whether the inflation target will or has been met.

### IV) Direct Controls

Examples of direct controls are:

- Prices and incomes policies attempt to control inflationary pressures by restraining price and wages increases
- Import controls endeavour to correct balance of payment deficits by placing restrictions such as quotas and tariffs on the importation of products into the country.

## 2.5 BUSINESS CYCLE

Economic expansion and development does not occur smoothly. Rather than growing steadily year after year, economies experience cycles in economic activity i.e., intervals of economic expansion followed by times of recession. These cycles are termed business cycles and are defined as recurrent but non-periodic fluctuations in the general business activity of an economy.

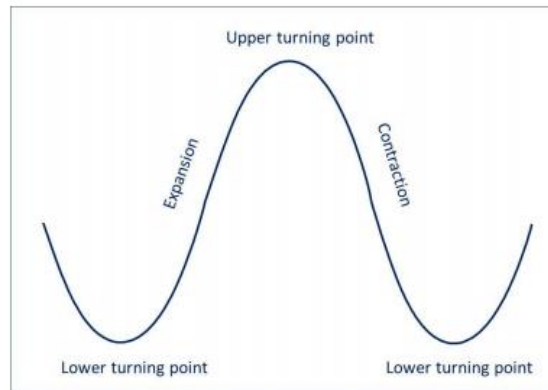


Figure 2.3: Phases of the Business Cycle

The typical behaviour of economic variables in the different phases of the business cycle is outlined in table 2.1.

Many economic indicators also display cyclical patterns. These can lead, coincide with or lag (turn after) the business cycle. Leading indicators can be used to predict economic developments. The indices indicate the direction of change in economic activity, not the level.

	<b>Lower turning point (recover / early expansion)</b>	<b>Expansion</b>	<b>Upper turning point (early contraction)</b>	<b>Contraction</b>
<b>Businesses</b>	Tend to be more liquid and less geared with higher profit expectations	Start borrowing to finance expansion. Profits rise rapidly	Profits weaken	Profits weaken further
<b>Production capacity</b>	Production capacity is at high level. Idle capacity	Idle capacity is rapidly absorbed. Requirements to expand production capacity	Full utilisation	Utilisations falls
<b>Production &amp; sales</b>	Start to increase.	Increase rapidly.	Limited by capacity constraints	Decline substantially
<b>Inventory levels</b>	Low	Rise	Rise or remain high	Decrease
<b>Prices</b>	Relatively low	Rise rapidly	High	Fall Slowly
<b>Inflation</b>	Relatively low	Increases	Increases further	Decreases
<b>Employment</b>	Relatively low	Increases	High	Fall slowly at first
<b>Salary and wage income</b>	Low	Rise slowly at first	High	Fall slowly
<b>Credit demand</b>	Relatively weak	Increase strongly	Weakens	Weak
<b>Interest rates</b>	Relatively low	Rise	Rise or remain high	Decline
<b>Investments</b>	Low	Starts to rise	High	Decreases
<b>Fiscal policy</b>	Stimulation e.g. tax concessions	Restraint e.g. higher taxes and/or lower spending	Further restraint	Borrowing increases to finance higher expenditure
<b>Exchange rate</b>	Relatively stable or tending stronger	Tends to strengthen	Tends to weaken	Stabilises or tends stronger
<b>Imports</b>	Relatively low	Rise sharply	Remain high	Decrease

	<b>Lower turning point (recover / early expansion)</b>	<b>Expansion</b>	<b>Upper turning point (early contraction)</b>	<b>Contraction</b>
<b>Exports</b>	Increase	Weaker (to supply local demand)	Decrease or remain weak	Increase
<b>Balance of payments: Current account</b>	Surplus	Surplus becomes smaller or negative	Deficit or small surplus	Deficit becomes smaller or surplus become larger

Figure 2. 4: Phases of the Business Cycle

Different asset classes tend to perform differently during the phases of the business cycle.

- Shares tend to perform best during both the recovery and expansion phases when economic conditions are improving, and company revenues are increasing. Share prices are volatile at the upper turning point of the cycle as investors become less certain about the future. Share prices decline during the contraction phase of the cycle when economic conditions are deteriorating, and corporate profits are falling.
- Bonds are likely to perform best during the contraction phase and lower turning point when interest rates generally decline. Bonds tend to perform less well during the late expansion phase and upper turning point when interest rates are apt to rise.
- Property tends to perform well during recovery and expansion when interest rates are relatively low and employment and economic conditions are improving. Property does not perform as well during the contraction phase when economic conditions are deteriorating, and employment is declining.
- Cash is generally more attractive during the contraction phase when economic conditions are worsening and there is widespread pessimism, particularly in the business sector.
- Commodities are likely to perform well during the expansion phase of the business cycle when production is increasing rapidly; production capacity is at or near full utilisation and demand for commodities is high. Commodities do not perform well during contraction when manufacturers are reducing production and operating at less than full capacity.
- Precious metals tend to perform best during the upper turning point when the demand for precious metals like gold, platinum and silver rises for industrial purposes and as a hedge against inflation. During the contraction phase, when industrial demand is low, and inflation is declining, precious metals may not perform as well.

## 2.6 ECONOMIC INDICATORS

Economic indicators provide insights into how economies and markets are performing. Their interpretation is important to various market participants and observers for many reasons.

Economists and other market analysts use economic indicators to

- Assess the performance of an economy.
- Judge the effectiveness of a government's economic policy.
- Compare the economic performance of different countries.
- Form economic and market forecasts and views.

Investors use economic indicators to attempt to obtain the best investment return given risk.

Businesses use economic indicators to determine if the time is right to undertake new capital investment projects; takeovers or mergers; or entry into new markets.



### 2.6.1 Expenditure indicators

The expenditure indicators indicate the economic growth in an economy and are as follows:

1. Gross Domestic Product (GDP)
2. Consumption expenditure by households
3. Consumption expenditure by government
4. Investment spending

All these indicators are presented as quarterly and annual total.

GDP focus on percentage changes – annual or over four quarters – while the other expenditure indicators concentrate on real growth rates.

All the expenditure indicators are coincident indicators of the business cycle, except investment spending which is a leading indicator of the business cycle.

The expenditure indicators are likely to have the following impact on economic element:

- Interest rate:* High growth can be inflationary if the economy is close to full capacity. This will lead to rising interest rates as market participants expect the central bank to raise interest rates to avoid higher inflation.
- Bond prices:* Higher interest rates mean falling bond prices.
- Share prices:* High growth rates lead to higher corporate profits – this supports share prices. However, inflationary fests and higher interest rate usually impact share prices negatively.
- Exchange rate:* Strong economic growth will tend to appreciate the exchange rate as higher interest rates are expected.

#### I) Gross Domestic Product (GDP)

The Gross Domestic Product (GDP) is the total value of all goods and services produced in a country in a particular period (usually one year).

Real (constant price) GDP reflects total economic activity after adjusting for inflation.

There are three approached to estimating GDP:

1. Production or output method: Sums the value added (production minus input costs) by all businesses.
2. Expenditure method: Add all spending – private consumption, government consumption, investment, and net exports (exports minus imports)
3. Income method: Add all income – income from production, profits, income from self-employment, rental income, trading surpluses of government enterprises and corporates.

Theoretically all three methods should deliver the same results.

In practice, discrepancies exist due to shortcomings in data collection, timing differences and the lack of informal sector data.

*Interpretation:* Interpretation of GDP number depends on business cycle timing. Strong economic growth after an economic recession usually indicates the utilisation of idle capacity. During the expansion phase it may suggest the installation of new and additional capacity to add to future production while at the peak it may imply inflationary pressures.

## II) Consumption Expenditure by Households

Consumption expenditure or spending by households is the total amount of money spent by household in an economy. Consumption expenditure is divided into the following categories.

- Durable goods*: Goods expected to last more than 3 years
- Semi-durable goods*: Goods expected to last 3 years or less
- Non-durable goods*: Foods & Clothing
- Services*

Consumption spending by households represents the largest proportion of GDP.

*Interpretation*: A change in consumption spending by households has a large effect on total production as it is the largest component of aggregate demand.

After a recession growth in Private Consumption Spending is a precursor to a general recovery. However, if consumption grows faster than the economy's productive capacity demand for imports will increase and inflation will rise.

## III) Consumption Expenditure by Government

Consumption expenditure by government or government spending is the total amount of money spent by government on goods and services but excludes transfer payments such as pensions and unemployment benefits. It also excludes government investment spending.

Consumption spending by government represents around 15% of GDP in industrialised countries.

*Interpretation*: Government consumption expenditure tends to be a stable percentage of GDP. It generally has less impact on the market and asset prices than the budget deficit/surplus. Short-term increase in government spending can provide a stabilising boost to the economy.

## IV) Investment Spending

Investment spending is made up of:

- Gross fixed capital formation**: Includes spending on residential and non-residential building, construction works and machinery and other equipment.
- Change in inventories**: Change in inventory is erratic and can be positive or negative – it falls when demand is growing more than production and rises when demand slows. It represents only a small proportion of investment spending.

Investment spending is a key component of GDP and represent around 20% of GDP in industrialised countries.

*Interpretation*: Investment spending is highly cyclical. Firm's investment decisions are based on expectation of future aggregate demand, corporate profits and interest rates. Firms are the most likely to invest if interest rates are low, they are operating at almost full capacity and if they expect demand to remain high.

### 2.6.2 Price Indexes

Price indices measure levels of and changes in particular basket of prices. Price indices provide information on inflation. Inflation is the persistent increase in the general level of prices and is devaluing of the worth of money.

Inflation has the following three main negative effects:

- Distorting the behaviour of households and firms because it obscures relative price signals, i.e. it is difficult to differentiate changes in relative prices and changes in the general price level.
- Creating uncertainty and consequently discourages investment because it is not precisely predictable.
- Redistributing income from creditors to debtors and fixed-income earners to variable-income earners.

There are two price indexes: the consumer price index and the producer price index.

Both indicators are presented as monthly index numbers.

Both also focus on percentage changes and distinguish between the level of prices and the rate of increase. If the rate of increase declines but remains positive, prices are still increasing.

Price indexes are coincident indicators of the business cycle.

The price indexes are likely to have the following impact on economic element:

- Interest rate:** Larger than expected increases or an increasing trend is considered inflationary. Interest rates will tend to rise.
- Bond prices:** Higher interest rates mean falling bond prices.
- Share prices:* Higher than expected price inflation should negatively impact share prices as higher inflation lead to higher interest rates.
- Exchange rate:** The effect is uncertain. The exchange rate may weaken as higher prices lead to lower competitiveness. However, higher inflation typically leads to tighter monetary policy and higher interest rates, which leads to appreciation.

### I) Consumer Price Index (CPI)

The Consumer Price Index (CPI) is a weighted average of the prices of a representative group of goods and services purchased by households.

Interpretation: The CPI is used to calculate and monitor inflation.

### II) Producer Price Index

The Producer Price Index (PPI) tracks prices at the first stage of distribution or at the point of the first commercial transaction. Prices of domestically produced goods / imported goods are measured when they leave the factory / arrive in the country and not when they are sold to consumers.

The PPI measures the cost of production and as such reveals cost pressures affecting production.

## 2.6.3 Balance of Payments

The Balance of Payments (BoP) is a tabulation of a country's transaction with foreign countries and international institutions over a period.

The BoP consist of the following three accounts:

1. Financial (capital) account: reflects international capital or financial flows. I.e. it records international transaction in assets and liabilities for example, a country's financial outflows represent the acquisition of foreign assets or the repayment of foreign liabilities.
2. The current account balances the following records:

- Sales of goods (including gold) to the rest of the world (exports)
  - The purchases of goods from the rest of the world (imports)
  - Service receipts from and payment for services to the rest of the world – this include shipping, travel & tourism and financial services.
  - Income receipts from and income payments to the rest of the world such as compensation paid to employees and investment income including interest, profit and dividends.
3. The gold and other foreign reserves account: This reflects the overall balance of payments position of a country. A country receives foreign currency for exporting goods and services and from inflows on the financial account or capital inflows. A country pays out foreign currency when importing goods and services and for outflows on the financial account or capital outflows. If receipt of foreign currency is more (less) than the payment of foreign currency, the country's foreign reserves increase (decrease). As payments and receipts of foreign currency rarely coincide, foreign reserves ensure a smooth flow of international trade and finance.

The Balance of Payments are presented as monthly money values. The Balance of Payments focus on trends and size in relation to GDP and is a coincident indicator of the business cycle.

The current account balance reflects international payments that must be matched by financial flows or changes in official reserves. A current account deficit must be financed by inward financial flows (foreign investment or loans) and/or the depletion of official reserves.

A current account deficit may indicate that a country is spending more than it is earning. However, a deficit may also imply that a country has strong growth potential that is leading to higher imports and that other countries are willing to fund that growth.

A current account surplus may indicate a competitive economy or that policy measures are in place e.g. import tariffs to keep import low.

## Topic 3 Risk and Return Relationships

### LEARNING OUTCOMES

After study the topic, the learner should be able to-

- Describe the risk-return relationship of different asset classes.
- Outline the different types of risks inherent to investments and the degree to which these risks are applicable to the different asset classes.
- Define active and passive investment management.
- Outline the advantages and disadvantages applicable to active and passive investment management.

### 3.1 INTRODUCTION

As previously considered, different asset classes tend to be associated with different levels of risk. In the investment sense, risk can basically be understood as the uncertainty associated with the future return. The higher the uncertainty about the future return (positive or negative), the riskier the investment can be said to be.

#### EXAMPLE OF RISK

Patrick uses R1 000 to purchase lotto tickets. His chances are about 1 in 100 000 000 that he may be a winner. This could be said to be a very risky investment.

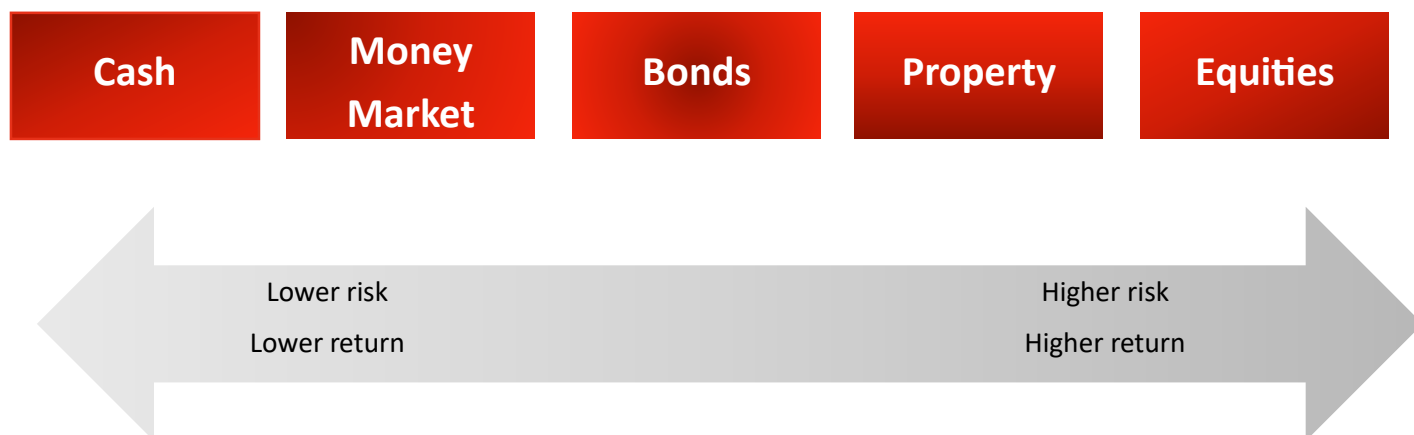
On the other hand, Jane puts her R1 000 into a fixed deposit at the bank that pays her a guaranteed 6% interest per annum. This is a low-risk investment as the bank will, in all probability, be able to repay Elizabeth's capital with interest. However, there is, of course, a small chance that the bank could go bankrupt, in which case Elizabeth could lose a part or all of her capital – but this chance is likely to be much lower than that of John losing his capital.

### 3.2 RISK-RETURN RELATIONSHIP

If we look at the example discussed above, we can say that Patrick has made a high-risk investment with potential for a high return, but there is also a very high potential that he could lose everything; whilst Jane has made a low-risk investment with a potential of a low return, but the potential to lose her capital is also very small. Why would Patrick take on this level of risk in his investment?

The answer to this is that although Patrick probably knows his chances of winning are low, he also knows that if he did happen to win, he would get an absolutely huge reward in return for the risk taken on. This is also how the risk-return relationship operates, i.e. there is a direct relationship between the amount of risk an investor takes on and the potential return he or she may expect to get. Generally, the higher the risk taken on, the higher the potential return should be.

Note though, that we talk about a potential return not a guaranteed return, since there is also a greater risk that the investor could lose his/ her money. Taking this a step further, each of the asset classes has its own level of risk and return, based on the amount of certainty/ uncertainty regarding the return. There is thus a direct relationship between the type of assets held, and the risk and potential return (investment earnings).



*Figure 3.1: Risk-Return Relationship of Different Asset Classes*

Figure 3.1 indicates that cash (on the left-hand side) carry the lowest risk of loss and also offer low return prospects. At the other end of the spectrum are equities. The initial capital invested in equities is not protected, nor are the returns guaranteed. Furthermore, the equity market is volatile, which means the tendency is to vary in value often and to vary widely. However, over time, equities tend to offer higher returns than other asset classes.

The subsections following considers some of the risks present in the investment environment and how they impact on the different asset classes. This will provide a better understanding of why certain asset classes are more volatile and therefore, riskier than other asset classes.

### **3.3 MARKET RISK**

Risk in the investment environment includes both systematic risk and unsystematic risk. Systematic risk (also called market risk) is the risk of losing investment value due to broad macro-economic and socio-political factors, for example uncertainty about economic conditions, inflation, interest rates, wars or recessions, that affect the performance of an entire market or even the entire global market.

Asset managers often use diversification and hedging (i.e. taking out an investment to limit the risk of another investment) in order to protect their investment portfolios from systematic risk.

The economic factors in a country can be broadly explained by the business cycle. The business cycle also provides a broad explanation of performance of asset classes in certain economic environments. The business cycle is discussed in the Economics topic.

### 3.4 POLITICAL RISK

Aside from market factors, investments are also impacted by political decisions. There are a variety of decisions governments make that can affect individual businesses and the overall economy. These include taxes, spending, regulation, currency valuation, trade tariffs, labour laws such as the minimum wage, and environmental regulations. The laws, even if just proposed, can have an impact. These decisions are called economic policy. Economic policy is considered in the Economics topic.

Political risk is the risk an investment's returns could suffer as a result of political changes or instability in a country. Instability affecting investment returns could stem from a change in government, legislative bodies, other foreign policy makers or military control. Political risk is also known as geopolitical risk and becomes more of a factor as the time horizon of an investment gets longer.

Political risks are notoriously hard to quantify because there are limited sample sizes or case studies when discussing an individual nation. Some political risks can be insured against through international agencies or other government bodies. The outcome of a political risk could drag down investment returns or even go so far as to remove the ability to withdraw capital from an investment.

Some of the political risks may be found in a company's filings with the Securities and Exchange Commission (SEC) or a prospectus if it is a collective investment scheme.

### 3.5 INFLATION RISK

Inflation can be defined as a sustained and significant increase in the general prices of goods and services. Inflation, therefore, has the effect of decreasing the buying power of your money, which means that, in total, fewer goods can be bought for your money.

#### EXAMPLE OF INFLATION

Imagine that you want to buy a motor vehicle which, today, costs R750 000. If you wait another five years, you will have to pay more for the same car. The amount you pay more is the inflation on the price. If the average yearly inflation over the next five years is, say, 6%, the price of the vehicle will increase to R1 003 700 in five years. This means that you will have to pay R253 700 more for the same car in five years' time.

Alternatively, you could buy a cheaper car; one that will only cost R750 000 in five years' time. You would thus be buying less car for your money. Therefore, we say that inflation decreases the buying power of your money.

The example above shows how inflation impacts on the buying power of your money over time.

If we consider the risk-return on the different asset classes, we see that although the asset classes on the left of the diagram may have low levels of risk over the short term, the inflationary risk increases over time. For example, in the case of the money-market investment, over time the risk inherent in this asset class increases as the low returns mean a higher risk that the value of the capital is eroded by inflation.

With the equity investment on the other hand, it is very volatile in the short term and thus risky over the shorter term. However, over time the growth in equities tends to outpace inflation, and equities have in the past been proven to yield real growth in excess of inflation, over terms of 10 years or more.

The interest rate or return on an investment after adjusted for inflation is referred to as the real interest rate or real return.

Table 3.1 is based on an investment of R100. The values have been adjusted for inflation over the periods measured. In other words, the amount under each asset class is the value of R100 invested plus investment growth in the particular market, less inflation.

Period up to 31 December 2015	Equities	Bonds	Property	Cash
5 years	R141	R103	R155	R100
10 years	R213	R112	R252	R115
15 years	R455	R191	R469	R153

*Table 3.1: Real Future Value of R100 Invested in Different Investment Classes Over 5 Years*

### 3.6 INTEREST RATE RISK

The interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Such changes usually affect securities inversely and can be reduced by diversifying or hedging

Interest rate risk is most relevant to fixed-income securities whereby a potential increase in market interest rates is a risk to the value of fixed-income securities. When market interest rates increase, prices on previously issued fixed-income securities as traded in the market decline, since potential investors are now more inclined to buy new securities that offer higher rates. Only by having lower selling prices can past securities with lower rates become competitive with securities issued after market interest rates have turned higher.

Interest rate risk affects the value of bonds more directly than equity, and it is a major risk to all bondholders. As interest rates rise, bond prices fall, and vice versa.

For example, if an investor buys a five-year bond with a 3 percent coupon, interest rates may rise to 4%. In that case, the investor may have difficulty selling the bond when others enter the market with more attractive rates. Older bonds look less attractive as newly issued bonds carry higher coupon rates as well. Further, lower demand may cause lower prices on the secondary market, and the investor is likely to get less for the bond on the market than he paid for it.

The value of existing fixed-income securities with different maturities declines by various degrees when market interest rates rise. This is referred to as price sensitivity, meaning that prices on securities of certain maturity lengths are more sensitive to increases in market interest rates, resulting in sharper declines in their security values.

For example, suppose there are two fixed-income securities, one maturing in one year and the other in 10 years. When market interest rates rise, holders of the one-year security could quickly reinvest in a higher-rate security after having a lower return for only one year. Holders of the 10-year security would be stuck with a lower rate for 9 more years, justifying a comparably lower security value than shorter-term securities to attract willing buyers. The longer a security's maturity, the more its price declines to a given increase in interest rates.

Equities are less directly impacted by changes in interest rates but are impacted indirectly. For example, if interest rates increase, consumers will need to pay more money to service their loans and will have less disposable income to spend on products and services, which will lead to a decreased demand and thus lower growth in businesses, which would have the effect of decreasing the share prices. Businesses too, will tend to spend less, and may delay capital purchases due to the higher costs of servicing the loans they would need to take out to make the purchases – this could lead to less expansion, less production or slower growth, and ultimately a reduction in returns of the share price.



Property is also impacted indirectly. For example, if interest rates go up, consumers may decide to target a lower-priced property, as the higher-priced property may be too expensive (taking into account the higher interest costs), or they may decide against taking out a mortgage and buying property – leading to a lower demand. Both these factors will cause property prices to decrease. Property companies who make use of loans to buy properties for rent may also have to pay a higher percentage of their rental income to servicing debt, thereby decreasing their profits. Their customers, in turn, may also target lower-priced rental properties leading to decreased rental income.

### **3.7 CURRENCY RISK**

Currency risk, commonly referred to as exchange-rate risk, arises from the change in price of one currency in relation to another. Investors that have assets across national borders are exposed to currency risk that may create unpredictable profits and losses.

Let's say a foreign investor invests US\$1 000 currently worth R12 000 due to the dollar exchange rate being R12 to the dollar. Four years later, his investment has grown to R18 000. However, over the same period, the rand has depreciated to R18 to the dollar. Although the investor achieved a good growth over the term, in real terms he has made nothing as the R18 000 will only yield US\$1 000 when converted, due to the rand's depreciation in value against the dollar over the same period.

Of course, if the rand had strengthened to, say R10 to the dollar, over the same period, the investor would benefit from the positive investment return, plus the appreciation in the rand's value. His US\$1 000 investment which grew to R18 000 after four years would, in this case, yield \$1 800 when converted ( $R18000 \div 10 = 1\ 800$  US dollars).

For South African investors, currency risk can be reduced by diversification into offshore investments, or by investing in shares of companies that hold currencies other than Rands.

### **3.8 MARKET-TIMING RISK**

Market timing risk is the risk that an investor takes when trying to buy or sell a stock based on future price predictions.

In other words, the risk is that an investor or asset manager buying or selling assets to speculate on predictions of future market movements or hot market sectors, may get their predictions wrong and lose money in the process.

Market-timing risk is an unsystematic risk that can be reduced by investing smaller amounts, systematically over a period of time, to avoid getting the market-timing wrong. For example, most collective investment schemes allow for regular monthly contributions to provide a systematic option for investing, also known as rand-cost averaging.

### **3.9 MARKET-SPECIFIC / SECTOR SPECIFIC RISK**

Market-specific risk (and sector-specific risk) relates to risk that is specific to a business or small group of businesses, or to a specific business sector. This type of risk is another example of an unsystematic risk which will impact on the share prices of the business or group of businesses, or market sectors involved only. Depending on the event, the impact could be positive or negative.

A recent example is the impact of the 2018 listeriosis outbreak in South Africa on the share price of processed food companies such as Tiger Brands.

### **3.10 GEOGRAPHIC LOCATION RISK**

Geographic location risk is the risk to an investment as a result of being located in a particular geographic area. Being invested in a particular geographic location means that your investment will be sensitive to aspects that are specific to that geographic location, for example a drought that reduces production of crops, or floods and other natural disasters that may impact negatively on the entire market in that geographic location.

Geographic location risk is an unsystematic risk that can be reduced by diversifying into assets in different geographic locations.

### **3.11 Risk associated with active AND PASSIVE INVESTMENT PORTFOLIO MANAGEMENT**

Active and passive fund management are two different investment strategies used in the investment arena, and after decades, there is still ongoing debate about which approach is better.

The subsections following consider each style in more detail.

#### **3.11.1 Active Vs Passive Fund Management Style**

Active fund management means that a professional asset manager/ fund manager makes tactical decisions to buy or sell certain assets in the fund, based on his/ her view of opportunities in the market, in order to try and achieve superior growth in the fund (better growth than the average growth in the market); or to protect investors' capital by losing less value when markets fall, by opting out of certain assets and exposure to certain market sectors.

Passive fund management, on the other hand, means that your fund will simply track the market, which is often represented by a specific index, for example the FTSE/ JSE Top 40 index, which tracks the 40 biggest companies on the Johannesburg Securities Exchange. Passive funds are essentially run by computer and will replicate all of the assets in a particular market, or represented in a particular index, to give you a return that mirrors the return in the market.

This approach is based on the efficient market hypothesis, which proposes that markets are efficient, since investors have free access to information on share prices, companies, social and political environment, etc. and price these factors in already when deciding to buy/ sell shares at certain prices. Therefore, over time, it is virtually impossible to beat the market.

Increasingly, fund managers are also trying to make the best of both worlds using a blended approach, where parts of a portfolio may be passively managed, whilst other parts may be actively managed.

#### **3.11.2 Advantages and Disadvantages of Active Fund Management**

Some advantages of active fund management include the following:

- It can provide peace of mind to the investor, knowing that a knowledgeable person is managing their investments.
- Active fund managers who get their investment decisions right, can beat average market growth, especially in times of good market performance.
- Active fund managers can also shield investors from the full extent of a market downswing by for example, switching assets to create less exposure to equities.

Some disadvantages of active fund management include the following:

- Actively managed funds have high fees attached to them. Typically, the fees on an actively managed fund are at least twice as much as what you would pay for a passively managed fund. The risk is that, over time, the higher fees may have a significant negative impact on investment growth.
- Active fund managers may make bad investment choices or follow unsound theories in managing the fund, which will lead to poor investment returns (in addition to the higher costs).
- There have been numerous studies done covering different time periods to determine how successful active fund managers are at beating the market, and the majority of these studies have concluded that, although there are some funds that do tend to consistently beat the market, on the whole there seems to be more funds that underperform than outperform their benchmark index, especially over longer periods of time.

### **3.11.3 Advantages and Disadvantages of Passive Fund Management**

Some advantages of passive fund management include the following:

- It reduces costs due to the passive buy-and-hold strategy, and this can have a significant impact on real returns (after deduction of costs), over time.
- Passive fund management can be said to provide simplicity, in the sense that the investor knows what they are getting – a replica of all the shares in the market or index being tracked.
- Passive funds offer a low-cost method of diversification, since shares representing the entire index are bought.
- In a passive fund, the investor is not at risk of being exposed to bad management decisions.
- Since passive funds are invested in an entire market, investors automatically benefit from upswings in that market.

Some disadvantages of passive fund management include the following:

- With passively managed funds, investors cannot ever outperform the market and, when costs are included, a passive fund will effectively always underperform the market.
- When the market experiences a downswing, investors automatically experience the full extent of the downswing in their investment, since there is no active fund manager that could shield them from full exposure to the market.

### **3.11.4 When is Active and Passive Management an Appropriate Style for Investors?**

Active management is appropriate for investors who want to invest in specialised equity markets that require specialised knowledge and expertise, to take advantage of inefficient pricing. For example, emerging markets, small-cap stocks and companies involved in resources and metals mining. Active management may also be appropriate for investors who want an experienced professional to make tactical investment decisions to outperform the market, and to shield them from negative market volatility.

Passive management is appropriate for investors who want a well-diversified holding of well-known popular shares (such as large cap shares, for example, as tracked by the FTSE/ JSE Top 40 index), and who are comfortable to ride out the short-term market fluctuations.

## Topic 4 The Investment Portfolio

### LEARNING OUTCOMES

After study the topic, the learner should be able to-

- Describe the role of different asset classes in an investment portfolio.
- Outline the portfolio selection process.
- Explain the role of the asset manager and financial advisor in the portfolio management process.

### 4.1 INTRODUCTION

Different asset classes have different potential roles to play in a person's investment planning and can be used individually, or in combination, to achieve the investor's financial goals.

A discussion on the possible structuring of a person's investment by using one or more asset classes can, however, only meaningfully take place once the investor's goals for that investment are known, so that the funds can be structured in such a way that his investment goals are met.

There are many reasons why investors would want to invest; however, in essence, they are either looking for capital growth, or income (with capital preservation), or a combination of growth and income.

If we consider the features of asset classes and their risk-return relationship, it is clear that certain asset classes as individual components might be used to provide for capital growth, while other asset classes might be used to provide income, over a shorter or longer period.

The sections following consider how the individual asset classes can cater for these basic needs.

### 4.2 The role of DIFFERENT ASSET CLASSES IN AN INVESTMENT PORTFOLIO

#### 4.2.1 Cash

Cash, as an asset class, can be used in the short term for providing an income. Other uses for cash could include the following:

- Cash can be used as a parking area, where funds can be invested with absolute liquidity, until the investor is in a position to make an informed decision on the longer-term investment of the funds.
- For some investors, cash also provides a safe haven during volatile investment market conditions, where funds can be placed until the market has returned to more stable conditions.
- Investors can use a money market fund as a base fund from where they then phase payments into the actual investment portfolio over a period of time. This is done to utilise the benefits of rand-cost averaging

#### 4.2.2 Bonds

Bonds, as an asset class, are also used to provide income and generally offer superior returns over time when compared to cash/ money-market assets, at a risk level that is lower than that for equities.

Other uses for bonds could include the following:

- Bonds are generally perceived as less risky and less volatile than equity investments; they provide a measure of safety to an investment portfolio.
- The future nominal amount to be received at the end of the term of a bond is guaranteed, and this makes bonds a good choice as an underlying investment instrument when investing in a product that offers guarantees.

#### 4.2.3 Equities

Equities offer the investor capital growth and are therefore essential to any medium- to long-term (5 – 10 years) as well as long-term (10 years and longer) investment plan, as it has, over time, been the investment instrument which has offered the best returns with the best chance of beating inflation.

Equity investments often deliver really good exponential growth during the upturn cycles in the market, making them vital to the realisation (or even surpassing) of investment goals.

#### 4.2.4 Property

Property can provide both income (in the form of rental income) and potential capital growth over the longer term and is therefore a popular investment.

Property returns also tend to have weaker correlations with equity returns, especially in times of poor market returns, making this an ideal asset for diversification purposes.

Indirect property investments – such as listed property shares or collective investments investing in the property sector – are becoming more popular with investors, as they provide a greater degree of flexibility, are easier to trade than actual properties, and provide an effective and convenient means to diversify property exposure.

### 4.3 PORTFOLIO SELECTION

The portfolio selection process is an integrated, consistently-applied, process to establish and maintain an appropriate combination of assets to meet the interdependent risk and return objectives of the investor given any constraints imposed.

The following are the six steps in the portfolio selection process:

1. Risk profiling
2. Develop the investment policy statement
3. Establish capital market expectations
4. Matching the risk profile with an appropriate investment product
5. Monitor the investment

## 6. Adjust the investment

### 4.3.1 Risk Profiling

An investor's risk objective is a function of both the investor's ability and willingness to assume risk. Risk profiling is the process of determining the most advantageous level of investment risk for the investor, taking risk capacity, risk tolerance and the risk required into account. The objective is to identify a suitable investment portfolio for a client, in order to achieve a specific financial goal, within the required time horizon.

A financial advisor must use different methods and tools to arrive at the most suited investment recommendation for a particular client, given his/ her particular circumstances and financial goal.

Section 8 of the FAIS General Code of Conduct deals with risk profiling and makes this a legal requirement. The code states that, before a client is provided with advice, the advisor must:

- Take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives, to enable the provider to provide the client with appropriate advice.
- Conduct an analysis, for purposes of the advice, based on the information obtained.
- Identify the financial product or products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the provider under the Act or any contractual arrangement.

From the above it should be clear that the days of simply using any old tool to group investors into risk profiles or deciding on their behalf what their risk profile should be, are long gone. Instead, a detailed process must be followed to ensure that appropriate advice can be given.

The risk profiling process should include the following two steps:

1. Analysing the investor's financial needs, risk capacity, risk tolerance and risk required to achieve the financial goal.
2. Develop an investor risk profile.

#### **I) Step 1: Analysing the Investor's Financial Needs, Risk Capacity, Risk Tolerance and Risk Required to Achieve the Financial Goal.**

##### **Determine the Objectives, Constraints and Preferences**

The first activity in risk profiling is to ascertain and detail the objectives and constraints of the investor.

Objectives are the investor's desired investment outcomes. They should be unambiguous and measurable and specified in terms of risks and return. This will include finding out whether capital growth or income, or both, are required, as well as the actual monetary amount/s needed. This information then needs to be taken into account together with the client's risk capacity, risk tolerance and risk required (discussed below).

Constraints are limitations such as liquidity, time horizon, taxes and regulatory issues that restrict the investor's ability to use or take advantage of a particular investment. For example, the decision to sell a low-cost share could result in a large capital gain i.e., there could be friction between investment and tax timing.

Preferences are limitations imposed by the investor. For example, investors may prefer not to invest in tobacco shares or government bonds of countries with unacceptable human rights records.

## Risk Capacity

Risk capacity refers to the ability of an investor to take on risk, due to objective factors regarding his/ her financial circumstances, such as the following:

- Time Horizon:** This is the number of years available to invest in order to achieve the financial goal. For example, an investor with a longer time horizon may take on a riskier, or more volatile investment, because he/ she can wait out slow economic cycles and the inevitable ups and downs of the markets. By contrast, an investor saving up for a financial goal in three years' time would likely take on less risk, because he/ she has a shorter time horizon.
- Liquidity needs:** For example, an investor may not be able to afford to take high risks on an investment if he has no emergency fund in place, as this means he/ she might need to draw on the investment before the end of the investment term in case of an emergency.
- Existing wealth protection – such as having life and disability cover in place:** For example, if the client has no disability cover in place, he/ she may need to draw on the investment before the end of the investment term, in case of becoming disabled, and therefore cannot afford to take a high risk.
- Stability and future growth of the client's income:** For example, if an investor's future income prospects and his health are positive, he/ she may be able to take on more risk knowing that a stable income is available.
- Percentage of total investment portfolio represented by this investment:** For example, an investor may possibly take a higher risk with a small proportion of his money relative to the value of his total portfolio. A client would very likely have to be much more conservative if the investment to be made comprises the majority of his/ her investment portfolio.

It is very important to establish the investor's position on all of these factors since, regardless of his attitude or tolerance to risk (discussed below), these objective factors play an important role in selecting a suitable investment portfolio that will be flexible enough to adapt to the client's circumstances and accommodate change (for example should the investor need to draw on the investment before the maturity date).

This discussion and the investor's position on all of the above factors should be documented as part of the client advice record as this represents crucial evidence in case of any disputes in the future.

## Risk Tolerance

Risk tolerance refers to the willingness of the investor to lose some or all of his/ her original investment in exchange for greater potential returns. For example, an investor with a high-risk tolerance is more likely to risk losing money in order to get better results. An investor with a low-risk tolerance on the other hand, tends to favour investments that will preserve his or her original investment.

There are many tools available (good and bad) that can be used to measure the client's risk tolerance. These tools should be used as the start of a discussion on how comfortable the investor would be to take on a certain level of risk in order to reach his financial objective. The discussion should be documented as part of the client advice record.

Visit the following websites to view examples of risk tolerance questionnaires:

- <http://imi.co.za/wp-content/uploads/2015/03/IMI-Risk-Profiler-form-IMI.pdf>
- <http://njaes.rutgers.edu/money/riskquiz/>
- [IWT\\_CurrentReport\\_RiskToleranceQuest.pdf](#)

## Risk Required

Risk required refers to the level of risk that is required to be taken on to meet a specific financial goal within a specific timeline. For example, an investor who wants to double his capital in a period of five years in order to fund his teenager's university studies, will need to take on a high level of risk in order to achieve the average return of around 15% required to achieve this goal.

In discussions with the investor, it may surface that there is a misalignment between the risk required on the one hand, and the risk tolerance on the other hand. In other words, it may become clear that, to achieve a certain financial goal within a specific time horizon, the investor has to take on a level of risk that he/ she is clearly not comfortable with. If we look at the above example of the investor wanting to double his investment within five years, this goal is simply not achievable if he is only comfortable to invest in low-risk asset classes such as cash, since these cannot provide the investor with the required 15% growth (after-tax) needed to achieve the goal.

In this situation, an adjustment (or trade-off) needs to be made. For example, the investor could consider lowering or delaying the goal, increasing savings through earning more and/ or spending less, or by agreeing to take (somewhat) more risk than they would prefer. The choice is the investor's to either accept more risk than he is comfortable with or, to adjust his/ her investment goals.

The investor's final choice in relation to investment decisions (product and portfolio choice) should be documented as part of the record of client advice, as this represents crucial evidence in case of any dispute at a future date.

## II) Step 2: Develop an Investor Risk Profile

The results of the risk profile analysis are generally used to group investors into one of the following risk profiles for purposes of selecting asset classes and/ or suitable investment portfolios:

- Conservative/ low risk:** This investor is seeking capital protection above other objectives, and usually has a shorter-term investment objective or wants to earn an income through the interest payments. The portfolio may comprise mainly interest-bearing assets, i.e. cash/ money-market instruments and bonds. Over time, this investor carries an inflation risk, as returns might not beat inflation.
- Moderately conservative:** This investor is seeking capital protection, but also a return above inflation. The portfolio may comprise cash/ money-market instruments, bonds and perhaps a small level of equities and property.
- Moderate:** The moderate investor is seeking average returns, but without taking on too much risk. Typically, the investment term is five years or longer. A balanced portfolio comprising the different asset classes is suitable. The cash and bonds components offer a degree of protection, whilst the property and equity components offer capital growth without taking on too much risk.
- Moderately aggressive:** The moderately aggressive investor is seeking above average returns through capital growth. The portfolio may comprise mainly equities, with a portion invested in other asset classes to limit the investment exposure to the equity market to a degree.
- Aggressive:** The aggressive investor has a long-time horizon, and is actively seeking high returns over time, without capital protection. The portfolio will comprise mainly equities and possibly some alternative investments such as derivatives.

Note: For diversification purposes, international assets in any of the asset classes would be included as part of the investment portfolio for the above risk profiles.



### 4.3.2 Develop the Investment Policy Statement

Once the objectives, constraints and preferences of the investor have been established, the investment policy statement is crafted.

The investment policy statement is a written planning document that governs all investment decisions made for the investor. It is essential to the portfolio management process and should clearly state the investor's return objectives and risk tolerances as well as any constraints such as liquidity needs, the time period associated with the investment objectives, tax and regulatory considerations such as exchange control and requirements and any circumstances or preferences unique to the investor.

An investment policy statement is important because:

- The investor is better able to assess the appropriateness of any investment strategy implemented by the investment manager.
- It ensures investment continuity because it is portable. Should the investor wish to change investment managers or funds, the statement can be easily understood by another investment manager.
- As a document of understanding, it protects both the investor, advisor and investment manager. If execution or investor directions are in question, the policy statement can be referred to for clarification.

Depending on the complexity of the investor's portfolio, the investment policy statement may contain other important issues such as reporting requirements, the basis for portfolio monitoring and review and investment manager fees.

### 4.3.3 Establish Capital Market Expectations

Establishing capital market expectations involves forecasting the long-run risk and return characteristics of various capital market instruments such as bonds and shares.

Capital market expectations are combined with the investor's objectives and constraints to formulate an appropriate strategic asset allocation or choosing an appropriate fund. If capital market expectations are realised, the selected strategic asset allocation should achieve the investor's return objectives with an acceptable level of risk.

### 4.3.4 Matching the Risk Profile With an Appropriate Investment Product

As considered previously, collective investment scheme (unit trust) managers and insurers use asset allocation strategies to package asset classes into portfolios that have a specific objective and specific fund risk profile, which can then be matched to the investor's risk profile.

Collective Investment Scheme portfolio fact sheets, or the insurer's fund fact sheets, can be viewed to determine the asset classes used and the fund risk profile rating.

Visit any of the following websites (or the websites of any other long-term insurer or collective investment fund manager) and view one or more of the company's fund fact sheets:

- <https://www.allangray.co.za/what-we-offer/unit-trusts/>
- <https://www.oldmutual.co.za/personal/investments-and-savings/unit-trusts/funds/fund-table>
- <http://www.coronation.com/za/personal/complete-fund-range-fact-sheets>

### 4.3.5 Monitor the Investment

The investment should be monitored to assess progress towards the achievement of the investor's objective. Monitoring a portfolio has the following two components:

- Performance measurement: Performance measurement indicates how well the fund/portfolio is performing relative to the investor's objectives and entails calculating the rates of return for the fund/portfolio achieved over a specific time interval.
- Performance evaluation: Performance evaluation aims to establish the following:
  - If the fund/portfolio added value by outperforming the established benchmark.
  - How the fund/portfolio achieved the calculated return. This is done through portfolio attribution, which determines the sources of the portfolio's performance. Two common sources of performance are market timing (returns attributable to shorter-term tactical deviations from strategic asset allocation) and security selection (returns attributable to skills in selecting individual securities within an asset class).

### 4.3.6 Adjust the Investment

The results of portfolio monitoring will establish whether or not the portfolio needs to be adjusted to ensure that it continues to satisfy the investor's objectives and constraints.

Once the desired portfolio is constructed, the following could motivate revising it:

- Changes in the investor's objectives as a result of changes in the investor's circumstances
- Changes in capital market expectations.

Portfolio adjustments may be required without any changes to expectations or the investor's situation. For example, due to asset price changes, the portfolio's exposure to equities may be different from the strategic asset allocation. Suppose the strategic asset allocation calls for an initial portfolio mix of 70% equities and 30% bonds. If the value of equities rises by 40% and the value of bonds by 10%, the portfolio mix will be equities / bonds of 75% / 25%. The portfolio will need to be rebalanced to reflect the desired asset mix.

## 4.4 THE ROLE OF THE ASSET MANAGER'S AND FINANCIAL ADVISOR IN PORTFOLIO MANAGEMENT

It is also useful to distinguish between the role of a financial advisor and the role of an asset manager.

The asset manager's role entails, amongst others the following:

- The analysis of the market risk underlying an investment (measured as the standard deviation).
- Economic forecasting to determine which markets (worldwide) which market sectors are expected to deliver optimal performance in the short-, medium- and long term.
- Analysing the net present value of the return on investment in the shares of a company and conducting portfolio structuring aimed at the minimisation of risk.

This aim is achieved by investing in uncorrelated markets, market sectors, asset classes and currencies. Measurement of the betas of various assets in various markets ensures that uncorrelated assets are combined in a portfolio in order to reduce the volatility of such a portfolio.

The financial advisor, on the other hand, uses the portfolio selection process to help clients identify and address their financial goals by-

- Analysing the client's financial needs, risk capacity, risk tolerance and risk required to achieve the financial goal.
- Using this information to develop a client risk profile.
- Matching this with an appropriate investment product (e.g. collective investment scheme) and an appropriate investment fund(s), containing the correct mix of assets to achieve optimal growth within the level of risk specified in that fund.
- Documenting the outcome and discussions of the risk profiling process, as well as the recommendations made on the basis of the client's risk profile.