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LEARNER GUIDE

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Demonstrate knowledge and understanding of risk in a Financial Services environment

Introduction

In this module, we will look at the following:

- The concept of risk in a financial services environment.
- The relationship between investment instruments and financial markets.
- Current global economic issues.
- A group investor profile.
- The principles of risk to make a financial decision

Module 1

The concept of risk in a financial services environment

This Module deals with:

- The concept of risk in financial services in terms of appetite for risk
- The factors that influence the level of risk of a financial instrument or product with examples
- The concept of probability using historical examples
- The importance of interpreting risk in relation to the investor or client with examples

1.1 The concept of risk in financial services in terms of appetite for risk

No universal definition exists for risk. Sometimes the meaning of word “risk” varies depending on context e.g. it is commonly used in insurance to refer to insured items like cars, buildings etc. Risk has also been defined as:

- A combination of hazards measured by probability.
- A condition in which losses are possible.
- Uncertainty of loss.

Statisticians and economists associate risk with variability. From this we define risk to mean the variation of actual outcomes from expected outcomes e.g. in an investment decision-Expected outcome = profit; actual outcome=loss hence risk.

‘Risk appetite’ is a term that is frequently used throughout the risk management community, but it seems that there is a lack of useful information on its application - outside of financial risk areas or other risks that can easily be translated into financial terms. Risk appetite, at the organisational level, is the amount of risk exposure, or potential adverse impact from an event, that the organisation is willing to accept/retain.

Once the risk appetite threshold has been breached, risk management treatments and business controls are implemented to bring the exposure level back within the accepted range.

To define your organisation's risk appetite and determine the acceptable level of risk, you should answer the following questions:

- Where do we feel we should allocate our limited time and resources to minimise risk exposures? Why?
- What level of risk exposure requires immediate action? Why?
- What level of risk requires a formal response strategy to mitigate the potentially material impact? Why?
- What events have occurred in the past, and at what level were they managed? Why?

Each question is followed by a 'Why' because the organisation should be able to articulate the quantitative and/or qualitative basis for the appetite, or it will come off as backwards-looking (based only on historical events) or even arbitrary.

1.2 The factors that influence the level of risk of a financial instrument or product with examples

Matching an investor's risk profile with the appropriate investment has always been a cornerstone of the investment advisory process. But it's also the hardest thing to do because while most people accept that risk is a part of life, they spend most of their life trying to avoid it.

When it comes to investments, however, most investors do realise that they do need to take on some risk to achieve their financial goals – and it's up to their financial adviser to determine how much they can bear.

With effect from 1 October 2004 it also becomes a legal requirement in terms of part 8 (1) c of the Financial Advisory and Intermediary Services (FAIS) General Code of Conduct which states: "A provider must, prior to providing a client with advice – identify the financial product or products that will be appropriate to the client's risk profile and financial needs"

That shouldn't be too much of a problem because there are plenty of risk profile questionnaires around and it is standard practice for clients to go through some form

of screening process before an investment is placed. But doubts are starting to be raised about their accuracy and the perfect solution doesn't seem to be forthcoming.

- **Factors influencing a Risk Profile**

Risk profiling questionnaires come in various shapes and sizes. The rationale for calculating risk appetite like this is simple – if you have a big buffer to absorb unexpected losses then you can afford to take risks.

So if you are a young, healthy, high-earning person with few dependents then you can make up for any losses in years to come. However if you are old, of ill health and totally dependent on your investments to cover you and your dependents' living costs then there is very little margin for error.

The different factors influencing risk profile are usually given different weightings so that, for example, the age factor might contribute towards 35% of the final risk profile, whereas the acumen factor may only count for 8%.

Once an investor has answered all of the questions in the risk profiler, the numbers are all added up and the resulting total will indicate where the investor fits on the investment spectrum. But how accurate are the results?

1.3 The concept of probability using historical examples

Probability is a way of expressing knowledge or belief that an event will occur or has occurred.

Two major applications of probability theory in everyday life are in risk assessment and in trade on commodity markets.

There are various types of probability that can be used in the measurement of risk.

These are:

- Objective or *a priori* probabilities.
- Subjective probabilities.
- Relative frequencies and empirical probabilities.

A priori probabilities (also known as objective probabilities) are those that are known in advance e.g. when a coin is tossed the probability of it landing either heads or tails are 50%.

Subjective probabilities are based on the decision maker's judgment and estimation. Subjective probabilities are used where the decision maker has insufficient information to determine the probability in any other more reliable manner. Experience has shown that people tend to underestimate well-known events and overestimate rare events. This is because the more a risk occurs the more the information we have about it.

Empirical probabilities are based on observation and experimentation. This is the most common method in practice. Thus one cannot use a *priori* probabilities to determine the likelihood of death. Probability of death can be more accurately estimated from past events.

- **Probability Distributions**

Are useful for evaluating risk.

- The binomial distribution deals with two parameters e.g. loss or no loss. The binomial distribution has two parameters describing the total number of events and the probability that the event will take place. Thus we can use the binomial distribution to determine the probability distribution of the number of accidents which can take place in a fleet of N vehicles that are independently exposed to loss.
- The normal distribution is also a two-parameter distribution. It uses the mean and the standard deviation. The normal distribution is bell-shaped and under certain circumstances other distributions like the binomial distribution can be approximated by the normal distribution.
- The Poisson distribution is a single parameter distribution. It approximates the binomial distribution where the number of exposure units (N) is very large each facing a very small chance of a loss (p)

Module 2

The relationship between investment instruments and the financial markets

This Module deals with:

- The inherent risk in the different asset classes and/or insurance products with examples
- The concept of a financial market with local and international examples
- The economic factors that can influence financial markets and an indication of how these can influence the investor to make an investment decision

2.1 The inherent risk in the different asset classes and/or insurance products with examples

Traditional investment classes are cash, equities, bonds, property and exotics. They have different risks inherent to an investment into each class.

Investment risk is the chance that an investor may lose all, or part of, their capital invested. It is measured by the volatility of the investment, i.e. how much the price of the investment fluctuates, for example, the constant increase and decrease in share prices or unit trust prices. Unlike risk, which is the increase and decrease of one's chances of losing money, volatility indicates a share or unit trusts vulnerability to market trends.

The greater the risk, the greater the expected return to compensate for this additional risk. Risk can be regarded as a spectrum, with bank deposits at the very safe end and equities at the other extreme.

- **Risk & Suitable Investors**

The most suitable investment product for a particular investor will depend on their needs, wants, tolerance for risk, time horizons, tax rates, etc. It is therefore essential for investors to have a clear understanding of their risk profile when deciding on where to invest.

Product	Investor Profile
Call, Notice, Fixed Deposit and Money Market Unit Trust	Conservative <ul style="list-style-type: none"> • Low tolerance for risk • Older in age • Requiring income • Lower tax rate • Short term time horizon
Bond Unit Trusts	Moderate <ul style="list-style-type: none"> • Medium tolerance for risk • Requiring capital growth and/or income • Medium time horizon
Equity Unit Trusts	Aggressive <ul style="list-style-type: none"> • Medium to high tolerance for risk • Younger in age • Wanting Capital growth • Higher tax rate because less tax onerous • Longer time horizon
Endowment Policy	Depends on underlying investment portfolio, whether smoothed bonus or market related.

Liquidity

A major consideration when investing is how soon the investor needs to access their money (i.e. Liquidity). A non-liquid investment takes time to sell and money can be lost if a sale is rushed when there is no demand.

When considering the liquidity of an investment, one must take account any penalties that may be incurred if it is cashed in earlier than agreed. There could be significant charges for doing so.

It is suggested that Investors hold a portion of their investments in stable, liquid instruments, such as money market unit trusts, in the event that they unexpectedly require access to cash. This will protect them from having to sell shares at what may be an inopportune time.

Tax Implications

Different investment products have different tax implications. The taxable portion of the income distribution in the hands of the investor depends entirely on how that income was derived.

2.2 The concept of a financial market with local and international examples

In economics, a financial market is a mechanism that allows people to buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient-market hypothesis.

Both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded) exist. Markets work by placing many interested buyers and sellers in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

In finance, financial markets facilitate:

- The raising of capital (in the capital markets)
- The transfer of risk (in the derivatives markets)
- International trade (in the currency markets)

and are used to match those who want capital to those who *have* it.

Typically a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends.

Types of financial markets

The financial markets can be divided into different subtypes:

- Capital markets which consist of:

- Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
- Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
- Commodity markets, which facilitate the trading of commodities.
- Money markets, which provide short term debt financing and investment.
- Derivatives markets, which provide instruments for the management of financial risk.
- Futures markets, which provide standardized forward contracts for trading products at some future date; see also forward market.
- Insurance markets, which facilitate the redistribution of various risks.
- Foreign exchange markets, which facilitate the trading of foreign exchange.

The capital markets consist of primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy existing securities.

The following table illustrates where financial markets fit in the relationship between lenders and borrowers:

Relationship between lenders and borrowers			
Lenders	Financial Intermediaries	Financial Markets	Borrowers
Individuals Companies	Banks Insurance Companies Pension Funds Mutual Funds	Interbank Stock Exchange Money Market Bond Market Foreign Exchange	Individuals Companies Central Government Municipalities Public Corporations

2.3 The economic factors that can influence financial markets and an indication of how these can influence the investor to make an investment decision

In investment decisions, economic factors are very important.

Example:

The trends in interest rates and industrial production are items of concern for the investor. Interest rates can be directly influenced by government policy but other questions arise, such as trends in consumer sales and capital investment, as the different aspects are all intertwined.

From an investment viewpoint the purpose of studying economic data is, however, usually to forecast the future. Consequently the greatest care is essential, bearing in mind that forecasts are necessarily based on assumptions, and this raises questions as to the validity of the assumptions made.

- **Money Supply**

The money supply is regarded as being relevant. One view is that many economic problems, including inflation, can be traced to excess in money supply, although others doubt this. Most, however, probably feel that the supply of money affects the fixed interest market more directly than the general equity market.

- **Balance of Payments**

South Africa trades internationally, therefore the balance of payments figures are of great importance. Trade depends on imports and exports and, while internal policies can influence both, external influences, such as a recession in other parts of the world, and particularly the state of the economy of the USA, have significant effect.

- **Commodity prices**

The balance of payments and the economic welfare of South Africa are greatly impacted by the gold price. The world prices of platinum, diamonds and other minerals that are exported, such as coal, also have a significant effect, while the

importance of the oil price is not to be forgotten. Commodity prices and their effect on the general economy can have an impact on interest rate decisions.

- **Reserves**

The figures relating to the level of South Africa's reserves, which are published by the SA Reserve Bank, must be monitored closely as they are of importance to investors and can also result in interest rate changes.

- **The Consumer Price Index**

The Consumer Price Index shows the movement of retail prices and is the measure used for inflation. There is typically quite a strong correlation between the rate of inflation and interest rates, since interest rates are often raised in order to dampen inflationary pressures in the market.

- **Other Indicators**

Figures are also published by the SA Reserve Bank when there is a new issue of stock to investors for cash. In times of heavy new issue activity, large sums of money can be taken out of investor's pockets, and this usually has an effect of raising interest rates.

- **Currencies**

The stability of the rand against major international currency also has a direct effect on our market. A foreign investor would require a currency to be stable to obtain maximum benefit from the return received in Rands.

- **Political Stability**

Political stability plays an important role in setting the climate for business confidence in a country and also supporting positive sentiment towards the region within the country is situated.

- **Climate**

Even the country's climate can have an effect on the economy.

The South African Bond Market is well established with about 75% of the bonds traded are government bonds with a term of to 20 years. Offshore players is now also an important player and at our interest rates very attractive for foreign investors if the currency remains stable against the main currencies of the world.



Module 3

Current global economic issues

This Module deals with:

- Global economic issues that affect investment markets and an indication of the probability that these will impact on the South African investor
- Global political issues that affect investment markets and an indication of the probability that these will impact on the South African investor
- Global environmental issues that affect investment markets and an indication of the probability that these will impact on the South African investor
- Health related issues that affect investment markets and an indication of the probability that these will impact on the South African investor

3.1 Global economic issues that affect investment markets and an indication of the probability that these will impact on the South African investor

The current global financial and economic crisis is the worst economic setback since the Great Depression of 1929-32. No policy maker, banker or economic and financial analyst has experienced anything as serious as this before.

African economies mostly do not have fully developed financial systems and are less integrated into the global financial market, hence the initial expectation in some circles that these economies would be isolated from the contagion of the crisis.

The crisis was triggered by developments in the American credit market. Contagion set in when American and foreign banks found that investment grade securitized loans in which they invested turned out to be distressed assets since a major component represented loans to less creditworthy home owners, the so-called subprime loans.

The outcome was that credit markets in the major industrialized economies foundered with a break in the relationship between banks as the suppliers of credit and business and households in need of credit.

The outcome was inevitable. The often imagined gap between the financial sector and the so-called real economy was bridged with the financial woes being transformed into real economic regression; again the world was reminded that the dichotomy between the financial and real world does not exist.

Economic activity in a modern economy is credit driven, and with the supply of credit impacting on real economic activity it stumbled and went into decline to recessionary levels in the major industrialised economies.

Confidence levels declined sharply as uncertainty increased acutely. The gloomy views on future economic prospects were reflected in rapid falls in property and financial asset prices, with the exception of those perceived to be safe havens in times of economic crises such as gold and US Treasuries.

The decline in economic activity and expectations of further falls led to a drastic drop in commodity prices, ranging from oil to industrial minerals such as copper and tin, with commensurate cut-backs in fixed investment by mining companies.

Under these conditions the diagnosis of Keynesian economics has come into its own.

Aggregate demand was falling because negative expectations impacted on investment spending and consumption. The latter is the mirror image of increasing savings, which means that in the spirit of Keynes's 'paradox of thrift' savings was having the perverse effect of lowering demand for goods and services to levels that drove production down to below full employment capacity. Output has fallen, and with it, real income and employment levels.

- **Global recession and foreign trade**

The transmission of the economic crisis in the industrialised world to developing countries depends on trade and financial integration in the global economy, a world in which no market-oriented economy can claim to be isolated from the rest of the world. The questions that feature in evaluations and inter-government discussions on the causes of the crisis, its impact and the steps that will be required to prevent a recurrence in the future often deal with issues of trade and the regulation of financial markets.

A concept that is central to these considerations is that of 'liberalisation'—both financial liberalisation and trade liberalisation. It is widely accepted that the financial crisis can in some sense be ascribed to failures in regulatory systems and that an excessive emphasis on deregulation of financial markets has contributed to the problem or, formulated differently, that more effective regulation could have prevented the excesses of speculative, high-risk and insufficiently transparent financial operations.

Currently, the focus of governments and financial authorities fall on the recapitalisation of the banking system and on efforts to restart the flows of credit, but it is quite clear that in time attention will shift to designing regulatory systems that could prevent a recurrence of the recent experience.

Financial regulation is not an issue of concern in this paper. Suffice it to observe that the prosperity of nations the world over will not be served by over-regulation of financial markets and banks. Financial intermediation and the provision of banking services must be prudent but also sufficiently flexible and free of excessive regulation to allow them to serve as an effective conduit in channeling credit to whom and where it can most productively be used. The current crisis and its social costs should not conceal the benefits that can be derived from a market-driven financial system subject to adequate prudential arrangements.

While difficult to envisage a broad and explicit preference for protectionism it is possible to anticipate increased protectionism by stealth. When constituents take to the streets in protest against insufficient support of domestic industry by government and when 'buy local' becomes a public mantra it will be difficult for democratically elected governments to be the leading exponents of expanding trade liberalization and this is also to avoid intervention to keep domestic industries in business through subsidisation.

For example, keeping General Motors afloat as an enterprise might be seen as wise policy in view of the social and political costs of having such a large corporation going bankrupt, but regardless of how such assistance is packaged, it remains blatant protectionism and contrary to the spirit of trade liberalisation.

Economic development without foreign trade is incomprehensible, but current experience demonstrates that trade is the linking mechanism of a global economic slow-down, inclusive of African countries. How deep and long will the slow-down be; in other words, when can African economies expect an end to the decline associated with the recession in the industrialised world?

This is a complicated question which cannot be answered with any degree of confidence. The fate of African economies will be decided in the industrialised world.

It is clear that unless the contraction in demand in the developed world is turned around, the crisis will prevail. To counter the recessionary demand conditions with their serious impact on real economic activity, a fundamental element of modern economies will have to be restored, namely functioning credit markets.

This in turn will require a substantial lowering of uncertainty through a restoration of confidence in the financial system, in investment markets in the broader sense of the word, and in the economy in general. Firms and households that face uncertain economic conditions, that have no access to credit and lack confidence in financial institutions will not invest and consume. Confidence, unfortunately, does not take long to destroy but it takes time and wise policy to restore.

But governments do not only rely on monetary policy and a restoration of the banking system and credit flows as an economic cure. If aggregate demand is too low because of low investment by private firms and household consumption, the classic Keynesian prescription is for government to step in by increasing its expenditure, which in poor economic times causing falling tax revenues can only come about through growing budget deficits.

Restoring confidence in the financial system and credit flows and increasing government expenditure typically do not have an immediate impact and will take time to work through to real economic activity, including growth in the demand for Africa's export commodities.

But demand management has to be complemented by maintaining and expanding open trade and investment strategies and a serious commitment to assist the developing world in coping with the reversal in international capital flows.

For African economies, which represent the majority of LDCs, a maintenance and expansion of aid payments will also be necessary. Most of these economies do not have the capacity to inflate their economies through government deficit spending and depend on foreign assistance to maintain macroeconomic and social stability.

3.2 Global political issues that affect investment markets and an indication of the probability that these will impact on the South African investor

3.2.1 War, Terrorism and Conflict

These events impact on all sub-sectors of the insurance industry. When soldiers are away fighting and trying to survive, and civilians are in shelters or refugee camps they have no ability to make payments or purchase insurance.

War risks to property are excluded other than under Life, and Personal Accident policies, and have been severely restricted under Marine and Aviation covers since the attack on the World Trade Centre in September 2001.

War in itself obviously has a negative influence on the insurance industry, but during and after the event, there is always much expansion or rebuilding to be done. This releases money back into the economy, where it is spent on factory works, manufacturing and new and important processes needed for the war or reconstruction effort.

In many circumstances, governments fund these projects, but often grants are made or private financing used. These activities lead to an upsurge in the need for insurance risk protection, and consequently more is spent on insurance products.

The effects of terrorism are profound on the insurance industry. In the wake of the attack on the World Trade Centre (WTC):

- Insurance covers previously available, such as terrorism, kidnap and ransom cover were restricted, and premium was increased for this limited cover.
- Previously where ambiguity existed in wordings, these have been refined to be more precise.
- Reinsurance capacities have been reduced, and the costs of reinsurance have risen.

- A greater focus has been placed on the risk assessment process, with acceptance limits and retentions more clearly defined.
- Many companies have been made to pay out vast sums of money as claims, across many lines of business – fire, combined, business interruption and office contents for those companies with offices in WTC; Life, Pensions and Personal Accident for those that lost their lives; motor in respect of vehicles damaged; aviation covers for the aircraft and liability.
- Some insurance companies will not have enough funds to pay, and will be forced into liquidation.
- In addition, the attacks have a marked effect on global travel, with fewer people willing to take risks.
- This has caused a crisis within the travel and associated industries, with carriers forced to close or cut back on operations, and individuals not needing to have travel insurance cover. The risks available to insure have reduced – BA have cut back their fleet, Swissair and Sabena have closed, and other airlines remain in financial difficulty, faced with mounting costs and reduced customer levels.

The Great Depression and World War II stimulated the demands for economic reform. Laws were implemented to stabilise stock markets, and economic leadership openly assumed responsibility the supply of money with a view to stabilising market economies. The laws were also put into effect that governed such industries as insurance and Financial Services.

Political events are those that affect the State, or its government, and these events have a wide impact on the insurance industry. Often the insurance industry is nationalised by governments, which means that the government acts as the risk carrier, under the name of a national insurer.

Countries in Southern Africa that have nationalised the industry include Lesotho and Swaziland. All countries have legislated regulations that govern the insurance industry; such the Short Term and Long Term Insurance Acts in South Africa.

Political disagreements often lead to wars (see above) but in many instances also lead to the imposition of economic sanctions on a nation that is deemed to follow political ideals that conflict with more powerful nations' ideology. In recent years, these sanctions have affected South Africa and Zimbabwe, Cuba, Iraq, Taiwan, China and others to varying degrees.

The impact on the economic environment and particularly insurance, is that trade curtailments reduce the need for insurance cover, particularly for Marine cover and export and import risks. Conversely, insurance *needs are enlarged*, when carriers are refused overly rights and had to make longer journeys to reach destinations.

Sanctions also affect the economy of the country they are imposed on as a whole. Without international trade opportunities being available, gross revenues are reduced, and these impacts again include the knock-on effect to insurance.

Mostly, however the people of the nations are the ones who suffer most. Deprivation, poverty and suffering are increased by these factors, and so political events also affect the

3.3 Global environmental issues that affect investment markets and an indication of the probability that these will impact on the South African investor

The Kobe earthquake of 1995 thousands of people died when an earthquake measuring on the Richter Scale devastated a highly populous city in Japan, damaging buildings and bridges, and causing massive fires.

Frequent earthquakes in central Southern Asia and Europe (Turkey and Greece)

A snow slide and avalanche that destroyed the Prince of Wales's villa a Klosters in Switzerland and killed his secretary.

The volcanic eruption in the Democratic Republic of Congo in January 2002, resulting in massive damage and loss of life. The lava destroyed whole villages.

A series of hurricanes that have damaged the east coast of the USA, and parts of South East Asia, where they are known as cyclones. To this day, Hurricane Andrew, which struck the south-eastern USA in 1992, remains the most catastrophic of all natural disasters, in terms of total insured damages.

The recent tsunami in the East that caused shockingly high numbers of people dead and caused billions of rands worth of damage. On 26 December 2004 an earthquake caused a tsunami that left billions of dollars of devastation and the tragic loss of lives in its wake. The United Nations estimates that up to 5 million people have been left without food, water, medical attention or basic sanitation and are facing the imminent threat of cholera and typhoid epidemics.

In South Africa, the flooding to Limpopo Province, Mpumalanga and Mozambique in early 2000 and on for some month major rivers such as the Limpopo and Crocodile burst their banks causing devastation of crops and farmlands, losses to industry and commerce from damaged or destroyed structures and buildings; losses to thousands of heads of wildlife and livestock; the loss of the lives of hundreds of people.

In January 2013 a heavy storm in the Free State injured 105 people near Sasolburg. In February 2013 heavy rainfall caused flooding in Jozi of South Africa.

The potential impact of these occurrences on the insurance industry is immense, as there are a number of factors which could require the provision of insurance cover to return the area and people to previously held positions.

Obviously those who have died cannot be recompensed, other than by means of payments to their families or dependants, but the full effects could impact in the following ways:

- Fires, floods, earthquakes, hurricanes or cyclones and hailstorms are insurable perils in South Africa for commercial short-term risks.
- Losses caused by volcanoes and drought are not.
- Loss of life is covered under life and personal accident policies, in respect of all perils arising from the Physical environment, other than the deliberate

placing of oneself in danger, or suicide.

It is important to always remember to apply the principle of proximate cause under these covers, as death or injury must arise from a physical accident.

Death by fire under personal accident covers would result in claims being admitted, whereas smoke inhalations may not be.

Challenges facing the short-term insurance industry

3 July 2009

Santam : info@fanews.co.za

Ian Kirk, Chief Executive of Santam

Against the background of South Africa's first recession in 17 years and the increasing socio-economic challenges the country faces such as the high levels of personal debt and security concerns, the local short-term insurance industry is facing a testing time.

The challenges faced by the industry should however be addressed through a collaborative approach with consumers, government and policymakers so as to ensure the long term sustainability and growth of the sector.

This was the message from Ian Kirk, Chief Executive of SA's leading short-term insurance company, Santam. Kirk delivered the key note address at The Insurance Institute of South Africa's (IISA) annual conference held at Sun City in the Pilansberg over the past weekend. (28-29 June 2009)

Kirk emphasised that the industry is operating in very difficult underwriting conditions and that a new way of thinking is required.

"Collaboration on risk management will be a key trend in the future. Not only are we as the industry facing a subdued growth outlook over the next two years, but we are facing considerable increases in claims, costs and frequency. The level of risk often correlates directly with the economic health of the country and this is where the industry should ensure that it engages with policy makers. Commercial and personal lines policyholders are under financial pressure and accordingly it is difficult for insurers to appropriate premium for the risk on the ground.

“For the insurance industry to that grow and flourish in the future, it is necessary to work with all stakeholders – government, the regulator, the wider community and its clients - to pro-actively manage risk on all levels,” he said.

Commenting on Santam specifically and how it tackled the task of collaboration, Kirk focused on the environment which is the ultimate risk management challenge. Kirk announced that Santam had joined ClimateWise, a global insurance industry initiative aimed at influencing debate and decision-making on climate change which the industry sees as a critical global challenge. “Trough ClimateWise, Santam will now have a voice at the UN climate change negotiations in Copenhagen in December 09,” Kirk said.

“Climate change cannot be ignored or avoided and there are limits as to how much of the climate risk can be transferred to the insurance industry. As a society we need to reduce and attempt to avoid catastrophes in the longer term. We at Santam are therefore serious about our journey. We believe every small act is important, as it all adds up and we are keen to learn from like-minded peers in the ClimateWise group. We will be working with them and the rest of the industry players to address the risks, share the opportunities and update our clients on our concerns around climate change.”

“A few years ago the focus was only on managing the risk – it’s now on influencing the risk so as to proactively decrease it. To do this, we need to understand the problems our markets face, promote loss prevention on all levels, align our business terms with risk reducing behaviour and ultimately craft new insurance solutions.”

In conclusion Kirk added the following as general advice to the industry, “Cut costs, but not quality. Increase your staff productivity so as to restore consumer confidence and on an ongoing basis reassess the buying factors of your segmented customer base. As an industry we can, and should, influence and bring about significant change to ensure the long-term sustainability of our industry.”

- **Impact on the Insurance Industry:**

Apart from the severity of the losses arising from risk in the physical environment, and the associated costs, the occurrences cause the industry to:

Refocus its underwriting criteria and risk acceptance rules.

Where previously risks were not considered as hazardous, underwriters must be

aware of the extent of a catastrophic event. Steps must be taken to manage the risk, and to offer solutions to meet the insurance need.

Inform the insuring public of the effects

On the industry and the risks facing them.

Work closely with other organisations

Such as government and police, relief agencies and organisations in physical event management and control.

Ensure that reinsurance protection (Treaty of Facultative) is obtained

At a level necessary to deal with losses.

Arrange appropriate wordings and clauses

That clarify covers available and events excluded.

Inform their partners in the risk transfer

Brokers, marketers and other financial institutions of its amended focus.

Ensure its systems are capable of dealing quickly

With the settlement of claims arising – claims, reporting, statistical and networking with other insurers.

Balance its staff complements with the immediate needs

Arising from disasters and catastrophes, to ensure speedy and effective assistance to those affected by the occurrences.

3.4 Health related issues that affect investment markets and an indication of the probability that these will impact on the South African investor

3.4.1 HIV/AIDS:

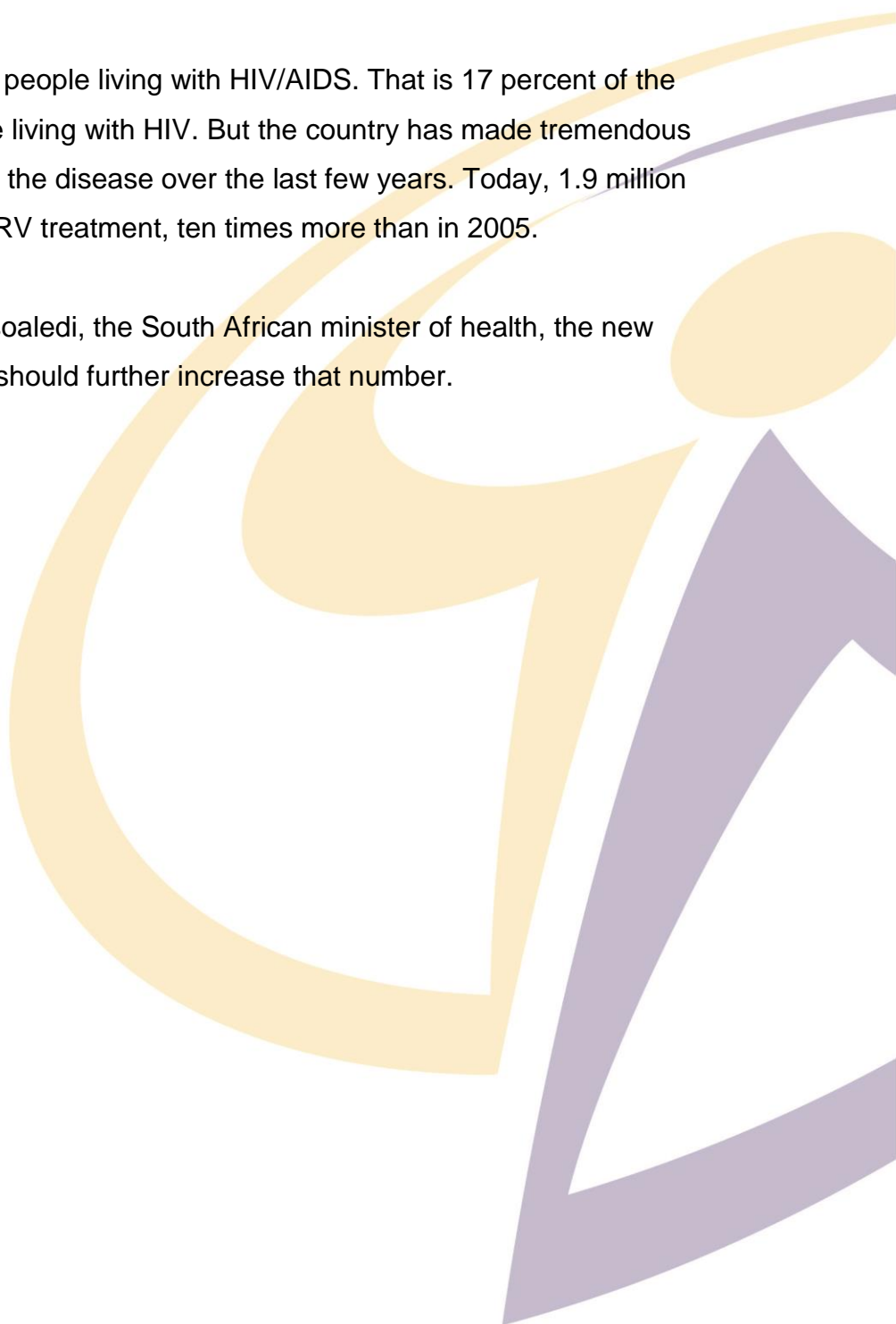
The newest and most far-reaching pandemic, caused by a virus that attacks the immune system of sufferers, and transmitted by sexual contact, contaminated blood and drug use, currently affects 100 million people worldwide, most of them in sub-Saharan Africa.

In some areas of Africa the disease has wiped out entire villages and communities. No cure exists, although some drugs have been found to manage the disease.

In April 2013 the South African government rolled out a new single pill to treat HIV/AIDS, claiming it is the cheapest such treatment in the world. The country has the world's largest number of people living with the virus and it hopes this new pill will allow it to treat more patients. Instead of taking 3 tablets a day, twice a day, HIV positive patients now only have to take 1 small pill per day. The new pill also is supposed to reduce side effects compared to other combined tablets.

South Africa has 5.6 million people living with HIV/AIDS. That is 17 percent of the world's population of people living with HIV. But the country has made tremendous progress in the treatment of the disease over the last few years. Today, 1.9 million South Africans are under ARV treatment, ten times more than in 2005.

According to Dr Aaron Motsoaledi, the South African minister of health, the new fixed-dose combination pill should further increase that number.



Module 4

A group investor profile

This Module deals with:

- The kind of information required to develop a group investor profile and an indication of why each item of information is required of an investor
- An investor profile compiled based on the available information about the investor
- The investor profile matched to available investment options (covered in formative assessment)

4.1 The kind of information required to develop a group investor profile and an indication of why each item of information is required of an investor

If your question relates to establishing a group risk profile in preparation to making investments then it is possible, with some strong brokers / representatives.

All you really need to do is have each member of the group complete a risk profile questionnaire then amalgamate the answers.

You, as broker / representative would probably need a good understanding of everyone's personal and financial situation before considering how to amalgamate the answers as there may need to be a certain amount of weighting given to certain answers, from certain people within the group.

The other big issue is that the more people in the group you have then the more likely you are to end up with an average response, which is to have a middle-of-the-road risk profile.

If you are open enough to discuss this as a group then that might be the best way to go, whether or not you complete a risk profile questionnaire.

Step 1: Investment planning

An expert and scientifically constructed plan to manage your investments. Completing the Investment Profile Questionnaire with your Consultant will help you determine your comfort level with risk combined with the time horizon needed to reach your financial goals.

Step 2: Selecting a customized portfolio

You choose the investment portfolio that reflects the risk comfort suitable for your specific goals. Based on your risk profile you and your Consultant are presented with three similar yet distinct investment portfolio selection options tailored to your specific goals.

Step 3: Risk controlled investment

Your portfolio has been expertly designed and diversified to control investment risks. The weighting you receive for each asset class and management style within an asset class was scientifically developed and tested to help provide the highest expected returns (over time) for your risk level.

Step 4: (3Rs) - Report, review and regroup

Report: offer a series of checks, balances and opportunities for portfolio review. Each quarter you will receive a statement outlining your investment performance and overall asset allocation shifts.

Review: Compare your statement to the Investment Strategy Report that was produced at the outset of your investment. The money managers in the program are continually reviewed and may be replaced if they are under performing.

Regroup: You will always have the opportunity to work with your Consultant to decide if it is best to regroup and rebalance your portfolio back to its original asset allocation. Remember that you can do this at anytime.

4.2 An investor profile compiled based on the available information about the investor

Your investment profile will help you work out the type of investment you should consider.

There are four factors in your investment profile:

- *Duration* - How long do you want to invest for?
- *Returns* - Do you want income or growth?
- *Liquidity* - Do you need to get to your money easily?
- *Risk* - Understanding the nature of risk involved in different forms of investment and taking account of your views on risk.

It might be that you have a couple of different investment goals. You might be saving for an overseas holiday, and saving for your retirement at the same time. You'd have separate investment profiles to match each goal, and the best investments for you will be different in each case.

- **Duration**

Duration means how long you want to invest for.

Short term - 1 to 3 years

Medium term - 3 to 10 years

Long term – over 10 years

Money you are saving to go overseas in two years time is a short term investment. So you need to make sure you'll be able to get it when you need it. Money you are putting away for your retirement can be a long term investment. Over a longer period of time you'll be more interested in 'capital growth'. This is when the value of your investment (your capital) grows.

It is however common to have different investments of different durations.

- **Returns - Income or growth?**

The following questions will assist in working out the type of returns that will suit you:

- Ask yourself if you're more interested in income or growth?
- Do you want to use the money your investment earns as income to live off during the duration of the investment?
- Do you want to reinvest it with the original lump sum, and grow your lump sum as much as possible?

If you need short term income from your investment, it's probably best to put your money where you can guarantee how much money it will earn - such as a bank deposit paying a fixed amount of interest for a set period.

If, on the other hand, you don't need the income in the short term and you want to grow your lump sum as much as possible, you could consider investments that don't guarantee the return from year to year, such as shares.

- **Liquidity**

Liquidity means the speed you can convert your investment into money before the end of your investment period, without taking a loss.

High liquidity investments mean you can get at your investment anytime, without losing any of your investment. A bank savings account is the classic example of a high liquidity investment.

In a low liquidity investment, it may take time to find a buyer at a price which is acceptable to you. Property is usually a low liquidity investment. Shares in public companies generally have a reasonable liquidity. An interest in a forestry syndicate will probably have low liquidity.

Some investments maybe illiquid - you can't get your money until a certain date or event (e.g. retirement). It is important you understand and are comfortable with the risk.

- **Risk**

Risk and reward is the classic investor's balancing act.

The higher the risk you take the higher returns you could receive, but the more chance you have of taking a loss.

With a low risk investment, you generally know the return you will receive right up front. A low risk investment would be a bank savings account - you know the return (the interest rate), but compared to riskier investments, like shares, it isn't great.

Higher returns are only available with higher risk. The risks come in two types, volatility, which is the possibility that the value of your investment will go up and down, and performance, which is the possibility that the investment could be a flop and you lose all or part of your money. Or, the investment gives you a lower return than you expected or needed.

If you are considering high risk investments, you can balance your risks with other investments in lower risk areas, like short term deposits or cash and bonds.

You can generally recognise high risk investments because the potential returns are also sky high (the promise of too-good-to-be-true returns is probably just that, not true).

For a guide to how much risk you can tolerate in your investments, try the Risk Recommender

To find the type of investments that could suit your investment profile check out our Investment Recommender.

- **Investment and the Needs analysis**

Investors have to keep in mind what the goal of the investment is and the time frame within which they would like to achieve their goals. Investments can range from long term such as planning to buy a house or short terms in terms of planning an overseas trip.

Now let's look at the factors that need to be considered when considering an investment:

- The period of investment
- Capital protection
- The risk involved
- Whether the yield required is to be of a capital nature or a regular income
- The return offered in total
- Tax implications
- Costs and charges
- Liquidity and the cost of early termination

The needs analysis should identify needs and requirements on the part of the investor.



Module 5

The principles of risk to make a financial decision

This Module deals with:

- The risk of a specific investment option in order to explain the consequences of the suggested investment option
- The level of volatility for a specific financial option
- Possible options to reduce risk and a strategy is developed that could reduce a specified risk
- Possible investment options selected and presented to a potential client
- The consequences of making a poor investment decision or recommendation with reference to the impact on future benefits and legislated accountability

5.1 The risk of a specific investment option in order to explain the consequences of the suggested investment option

Within the context of financial planning, three life stages have been identified; Accumulation, Preservation & Prosperity. These life stages are influenced by the 7 life stages of a person's life but also can change due to various factors, the most common is age. As you physically age, it is natural that your life stage will gradually or dramatically change.

There are however, other factors that can cause change as well:

- Employment;
- Social Norms;
- Political factors;
- Economic factors;
- Status.

Generally, age will determine in which of the following three financial life-cycle stages you belong to:

5.1.1 Accumulation stage

During the first years of career when your incomes tend to increase you accumulated investments mostly in the form of pension, and retirement plan.

Generally, the amount of debits increase due to mortgages, loans to buy cars or others; nevertheless within this stage you also gain debts in order to accumulate assets that in time will be paid off. In this stage the focus is trying to increase your capital.

5.1.2 Preservation stage

In this stage your invested assets are starting to grow, and generally your incomes will exceed your expenses. Here the investment emphasis includes not only capital, but how to generate incomes.

5.1.3 Prosperity stage fade away

This stage starts with the retirement stage in which the pension (retirement plan), social security and investments replace salary. In this stage priorities are focused on making your investments last throughout the whole retirement stage, and to keep having a comfortable life style.

This stage mainly emphasizes the need to preserve capital and generating earnings, but to improve life expectancy one should divert some of the investments to increase capital.

Your current situation will generally determine the risk level you may take on in choosing a certain type of investment. Usually, young investors can afford a higher risk level due to a longer –at least 20 years- life expectancy, or more until retirement. Bert Whitehead constructed a diagrammatical depiction of financial planning for each life stage.

When considering investments, the investment companies have identified three portfolios applied during different life stages:

1. Aggressive Portfolio;
2. Moderate Portfolio;
3. Conservative Portfolio.

It is important to note that each person enters the different life stages at a different age. However, as can be seen in the example below, it could be generalised depending on the objectives.

Life Stage	Age Group	Risk Profile	Objective
1	<50 Years	High	Capital growth (100%)
2	50 to 60	Medium	Capital growth (45%) Capital protection and Income enhancement (55%)
3	60 to 65	Low	Capital protection and Income enhancement (100%)

Life stages are just some of the events and time horizon tools used in financial planning to determine what the financial needs of a person could be at a particular time in their lives.

When an individual is faced with a decision, whether it is to buy an ice cream or to make an investment, their choice is directly impacted by their wants and needs at that moment as well as their attitudes and values.

When the individual is faced with a difficult decision and requires advice, the majority of South Africans turn to friends and family.

- **Wants and Needs**

One of the most basic concepts of economics is want vs. need. What are they exactly?

A need is something you have to have, something you can't do without. A good example is food. If you don't eat, you won't survive for long. Many people have gone days without eating, but they eventually ate a lot of food. You might not need a whole lot of food, but you do need to eat.

A want is something you would like to have. It is not absolutely necessary, but it would be a good thing to have. A good example is music. Now, some people might

argue that music is a need because they think they can't do without it. But you don't need music to survive. You do need to eat.

These are general categories, of course. Some categories have both needs and wants. For instance, food could be a need or a want, depending on the type of food.

You need to eat protein, vitamins, and minerals. How you get them is up to you (and your family). You can eat meat, nuts, or soy products to get protein. You can get fruits and vegetables to get vitamins and minerals. You can eat yogurt or cheese to get other vitamins and minerals. You can eat bread to get still more vitamins and minerals. These basic kinds of foods are needs.

Ice cream is a want. You don't really need to eat ice cream to survive. You can eat it to get some vitamins and minerals, but other foods like cheese and yogurt give you more of those same vitamins and minerals without giving you the fat that ice cream does. Still, ice cream tastes good to many people. They like to eat it. They want it, but they don't need it. They like it, but they don't have to have it to survive.

Only 4% of the men in this study followed all five habits, even though they were all highly educated professional health care workers. The men who followed all five habits experienced a full 87% reduced risk for cardiovascular disease than men who followed none of the healthy habits. And men who adopted two or more of the five healthy habits experienced a 27% reduction in coronary events.

Alcohol is an addictive substance that has a myriad of dangerous side effects, including heart disease, hypertension, liver, kidney, and brain disease, and that catalyzes untold numbers of tragedies on our highways.

Far more lives would be saved if alcohol did not exist than would be saved if doctors told their patients to consume moderate amounts (1 or 2 servings a day) to help prevent heart disease. Indeed, because many individuals cannot stick to 1 or 2 servings a day, and because 3 or more servings is associated with increased (instead of decreased) mortality, doctors generally do not so instruct their patients.

Therefore an individual should consider whether they need or want the particular financial service. A good example is credit, do I really need another pair of shoes, or do I want a new pair of shoes? Equilibrium between needs and wants should be established and the needs and wants evaluated during any financial transaction.

In conjunction with needs and wants, attitudes and values influence our decisions.

- **Attitudes and values**

Values represent basic convictions that a specific mode of conduct or end-state of existence is personally or socially preferable to an opposite or converse mode of conduct or end-state of existence.

Values are about the perceptions of the individual of what is right and wrong and it thus implies that values have a judgmental element. For example, we judge others according to our own beliefs, principles and preferences. Values are usually very stable and enduring over time.

Attitudes are predispositions to respond to some class of stimuli with certain classes of responses. Attitudes serve as a good indicator of what behaviour can be expected within a certain context.

Psychologists believe that changing attitudes is a good manner to modify behaviour.

Robert Kyosaki identified the influence of attitudes and values and described in his book: "Rich Dad's Guide to Investing" what he identified as procedures that people follow when choosing financial products, specifically, investments based on their attitudes and values.

The following are some of the different types of investment procedures:

1. Buy, hold, and pray (long)
2. Buy and sell (trade)
3. Sell then buy (short)
4. Option buying and selling (trade)
5. Cost averaging (long)
6. Brokering (trade no position)
7. Saving (collecting)

He continues by explaining there are different types of investors, with their own product specialties and their investing procedures based on their attitudes and values.

All of this adds to the confusion on the subject of investing because under the banner of investing there are people who are really:

- Gamblers
- Speculators
- Traders
- Savers
- Dreamers
- Losers

Therefore, attitudes and values influence the choice we make based on risk, product supplier, advice from various sources, etc.



5.2 The level of volatility for a specific financial option

	Bank Deposit	Bonds	Equity	Endowments
Term	Short term	Medium term	Medium to long term	Minimum 5 years
Potential Return	Relatively low. Provides income in the form of interest. This can be reinvested and added to the capital value	Should outperform cash and underperform shares over the long term Provides both interest income and potential for capital growth if the price of the bond strengthens	Should provide the greatest potential for gains over cash and bonds over time. Provides potential income in the form of dividends, but this is not guaranteed and the investment return is more in the form of capital growth if the share price increases.	The return will depend on the underlying investments
Risk	Low	Medium	Medium to High	The level of risk will depend on the underlying investment
Tax	All growth is in the form of interest, which will incur income tax	Both the coupons (i.e. Interest earned) and any increase in the capital value are considered to be income and will therefore incur income tax.	Dividends do not attract tax in the hands of the investor. Any capital growth made since October 2001 will incur Capital Gains Tax (CGT)	Taxed at a rate of 30% within the fund

Liquidity	Depends on whether call account, notice, or fixed deposit	High - although may incur capital losses	High - although may incur capital losses	Minimum 5 year term, can surrender early, but at a penalty
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5.3 Possible options to reduce risk and a strategy is developed that could reduce a specified risk

It is a misconception that hedge funds all use a similar investment strategy. In fact, "hedge" (or alternative strategy) funds employ a wide range of approaches, with risk profiles that range from conservative to speculative.

While there is no universal agreement on how these styles should be classified, the following broad groupings highlight the main differences.

Global macro managers follow an opportunistic "top-down" approach designed to profit from global economic shifts.

They generally take positions in a variety of bonds, currencies and equities using derivatives and leverage to maximise the outcome. As a result their returns are generally higher, but more volatile, than other strategies.

Active traders utilise trading strategies employing futures and options across a broad range of financial, agricultural, industrial and natural resource markets. Their trading may be systematic or opportunistic and tends to be short-term. Volatility can be low or high.

Event-driven managers seek to profit from investing in the securities of companies which are expected to be affected by a major event, such as a merger, takeover, divestiture, emergence from bankruptcy or other special situation.

They generally profit in two ways:

5.3.1 Distressed securities

Investments are made both long and short in the securities of companies undergoing bankruptcy or reorganisation. This requires in-depth analysis of the underlying value of the company as well as the financial and intellectual capacity to precipitate change in the target company.

5.3.2 Risk (or merger) arbitrage

Long positions are taken in companies being acquired and/or short positions are taken in the buyer. By doing so these funds are able to profit from

changes in the share price as the final date for the merger approaches or from a counter-offer. There is, of course, the risk of a loss if the merger fails.

These funds may also profit by investing in securities undergoing restructuring. Classic hedge managers use an in-depth "bottom up" approach to stock selection, being both "long" on undervalued equities and "short" on overvalued equities. In doing so, they rely more on the skill of the manager to produce returns than on the general direction of the market.

They may vary the long proportion of the portfolio (between about 50% and 80%) and the short proportion (between about 20% and 50%) depending on market trends.

Value managers concentrate on buying securities which are priced at a significant discount to their intrinsic value. Undervalued securities are attractive for the margin of safety provided by this price discount. In time, the market usually recognises this value and the price of the security rises.

Value investing requires patience over a three- to five-year market cycle. Even though these investments are generally unhedged, they provide scope for superior returns, while protecting capital during market declines.

Growth managers typically invest in companies and industries expecting above-average growth. Shorting or the writing of call options may be used to provide downside protection.

Yield arbitrage managers take leveraged positions in fixed-interest securities and related derivatives to benefit from interest rate spreads.

Emerging markets managers invest in securities of companies located in developing markets. This tends to be a long-only strategy as many of these markets are not sufficiently developed to enable shorting. Results can be volatile.

To conclude, for investors wary of twitchy markets both locally and abroad it's wise to allocate funds to a reputable hedge fund. This will decrease the risk without jeopardising strong returns.

5.4 The consequences of making a poor investment decision or recommendation with reference to the impact on future benefits and legislated accountability

Recently The Wall Street Journal ran an article entitled, "Training the Brain to Choose More Wisely." It opened with the sentence, "The human brain is wired with biases that keep people from acting in their best interest." In the last forty years a field of inquiry has emerged called behavioral finance that has shed new light on how we make investment choices.

Young people aren't the only ones who fall prey to unwise choices. We adults tend to think of ourselves as sound decision makers; we make hundreds of decisions each day. Yet we are busy people in a complex world. We cannot possibly give in-depth consideration to every choice.

The current financial mess affords no shortage of examples of poor decision-making. Didn't we learn anything from our mistakes in the dot-com era? Shouldn't we be getting better at making decisions about our investments?

We consider ourselves rational thinkers but according to researchers in the field of behavioral finance, we often demonstrate irrational and predictable biases that can result in poor decisions. This article will examine some of the common biases that can adversely affect our investment decisions.

Many people believed real estate values would keep going up as they had for many years; they were convinced that real estate was still a good investment. This belief, based on a prior set of conditions which turned out not to be sustainable, constituted a biased assessment of risk. Many investors wanted to buy more property because it appeared that everyone else was making money at it. They were motivated in part by a bias to follow the herd. Now that the tide has turned on stocks and real estate, investors may have a hard time selling investments that have declined in value, even though lower prices may also present better opportunities for buying. Investors in this

case may have loss aversion. In each of these situations, the tendency to act on unexamined assumptions leads us away from making good decisions.

A biased assessment of risk occurs when the brain takes a shortcut in evaluating a risky situation. The example of a risk that comes readily to mind, such as unsafe teenage driving, seems to present a greater threat than something which may actually be more likely to cause harm, such as suffering a stroke. Yet because of a bias in assessing these two risks, I might overestimate the risk involved in loaning my son the car for the evening. Yet the truth is I am more likely to have a stroke than to be hit by a teenage driver.

If it is easy to recall an example of something, we give it greater weight in our thinking. This tendency contributes to the bias of underestimating risk as well. Buying property two or three years ago represents acting on the bias of underestimating risk. We could readily think of so many instances in which people did well with real estate. There were so many examples of price appreciation; we concluded homes were a good investment, when in fact that was no longer true. Our bias influenced us to judge the true probability of an event incorrectly (price declines.)

When it comes to investment decisions, others often influence us, even when following in their footsteps is not necessarily rational or in our best interest. Upon seeing others do something, we tend to ask whether the same might be good for us. We hear that our neighbor got out of the market last November and think maybe we should do the same. Most investment ideas are profitable for a limited period of time. Recognizing trends early is essential. Predicting the trend is even better.

People do like to go along with the crowd. Most people come to think the optimistic view is correct just because everyone else seems to accept it as true. Given this inherent behavior, it is easier to see how following the herd might lead us to suspend critical thinking in evaluating complex investment decisions.

It should come as no great surprise that people hate losses. Loss aversion, however, can elicit unproductive and irrational behavior. People have an extremely hard time selling a stock or fund that has sustained a loss. Recognizing a loss is equivalent to

acknowledging having made a mistake. This leads to the crafting of excuses. We cling to the fond hope that the investment will return to its previous value. If it could just get back to where it was when we bought it, then we would sell. We hope the market will validate the original purchase.

This however seldom plays out and instead creates inertia, a strong desire to keep our current holdings – i.e., to do nothing. We forego making trades or choices of greater benefit to us. People tend to make poor decisions here because they fear losing or giving up something, even though change is very much in their best interest.

The brain uses shortcuts that can lead to erroneous perceptions or conclusions about risk. This doesn't mean we are bad at making decisions. It just points to the need for better understanding of tendencies we bring to the decision making process. As in so many aspects of investment strategy, knowledge is power. Knowing oneself is a vital aspect of successful investing. Investing entails risk. Knowing our own temperament for risk – our tolerance for risk and our biases in approaching it – are wonderful tools to ensure that we take only the risks that are right for us. If we can understand our risks in investing, we lessen the chance we will end up shooting ourselves in the foot.

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