

CLASS OF BUSINESS TRAINING

Class: Investments

Study Guide

2021

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Class of business training legislative requirement

The Financial Sector Conduct Authority (FSCA) **Board Notice 194 of 15 December 2017: Determination of Fit and Proper Requirements** stipulates that a Financial Services Provider (FSP) and a representative must complete the class of business (CoB) training relevant to those financial products for which they are authorised, **prior** to rendering any financial service in respect of such products.

A key individual must, likewise, complete the CoB training in respect of the classes of business for which he/she is approved to act as key individual, **prior** to managing the rendering of any such financial services.

The Determination of Fit and Proper requirements define “Class of business training” as training in respect of a specific class of business and which training is provided and assessed by an accredited provider or an education institution.

The Class of Business training applies to the following:

- All FSPs, Key Individuals and Representatives appointed after 1 April 2018.
- FSPs, Key Individuals and Representatives who seek authorisation, approval or appointment for new financial product categories after 1 April 2018.
- Representatives working under supervision as at 1 April 2018, or appointed under supervision after 1 April 2018.
- Certain exemptions apply, depending on the type of business one does, and how it is conducted. Please contact your compliance officer if in doubt.

FSPs, KIs and Reps authorised prior to 1 April 2018, are considered to have completed the CoB training in view of their past experience and are therefore exempt from CoB training, unless they add new products to their licence.

2. ICONS



GLOSSARY OF TERMS

<p>Active Asset Management</p>	<p>An investment strategy that involves ongoing buying and selling activity by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions</p>
<p>Advice</p>	<p>Advice in terms of the FAIS Act is defined as any recommendation, guidance or a proposal of a financial nature, furnished by any means or medium, to any client Group of groups of clients, in respect of the following:</p> <ul style="list-style-type: none"> • The purchase of or investment in any financial product, • The conclusion of any other transaction aimed at incurring any right or benefit or liability in respect of any financial product (this includes loan or cession); and • The variation, replacement or termination of any financial product
<p>Annuitize</p>	<p>This is the exchanging of a lump sum at retirement for a series of periodic payments by an insurance company. The reason for doing this is to ensure that the retiree has an income during retirement years</p>
<p>Annuity</p>	<p>A scheduled payment that a retiree purchases from a life insurer using the portion of pension, provident and retirement annuity that has not been commuted as cash.</p>
<p>Articles of</p>	<p>A document that defines the purpose of a company and specifies</p>

Association	the regulations for its operations. The document outlines how tasks should be accomplished within an organization, including the preparation and management of financial records.
Asset Allocation	An investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance, and investment horizon.
Asset Class	A grouping of investments that exhibit similar characteristics and are subject to the same laws and regulations.
Bankers' Acceptances (Bas)	A Bankers' acceptance is a bill of exchange that entitles the holder of the instrument to a payment of the face value at maturity date by a Bank. The maturity period varies from 30 to 180 days.
Beta coefficient	A measure of the volatility, or systematic risk, of a security or portfolio, in comparison to the market as a whole.
Bond Market	A bond market is a market for fixed income securities that consist of a series of fixed payments to the investor on specified dates and repayment of the principal at maturity date. Bonds have maturities ranging from 2 to 20 years and trade in the Capital market.
Bond with a put option	A bond with a put option gives the bondholder the right to sell the bond to the issuer at a special put price.
Bond Yield	The yield of a bond is the interest rate that would make all future cash flows of the bond equal to the present value of the bond.
Bulking	The practice by an FSP of pooling together money from different clients in order to benefit from economies of scale, for example higher interest rates.
Business Cycle	Fluctuations around the long-term GDP Growth. The Phases of the Business cycle are Trough (the lowest point of a contraction), Expansion, Peak and Contraction.

Business Risk	This is the risk that a business, that an investor has invested funds in, ceases to be a going concern due to a collapse in its operating model and goes bankrupt.
Call Deposits	Call deposits are interest bearing accounts with banks that can be called at any time by the depositor. The interest rate earned is a function of the amount invested and is paid monthly but calculated on a daily basis.
Call option	Financial contract that gives the option buyer the right, but not the obligation, to buy a stock, bond, commodity or other asset or instrument at a specified price within a specific time period.
Call Risk	This risk pertains to bonds that have call options. When interest rates fall, there is increased risk that the issuer may recall the bond in order to take advantage of lower interest rates.
Callable Bond	A callable bond gives the issuer the right to buy the bond from the bondholder (the investor).
Capital Asset Pricing Model (CAPM)	A model that describes the relationship between systematic risk and expected return for assets, particularly stocks.
Capital Gain/Loss	Capital gain is the gain realized from an appreciation of an asset price relative to the purchase price. Capital loss is the loss realized from a depreciation of an asset price relative to the purchase price.
Capital Market	A market where savings and investments are channelled between the suppliers who have capital and those who are in need of capital for the long term.
Capital preservation	A conservative investment strategy where the primary goal is to preserve capital and prevent loss in a portfolio.
Cash Reserve requirement/structural liquidity requirement	A tool that the reserve bank uses to influence the supply of money in the economy by requiring all commercial banks to keep a prescribed percentage of their total liabilities as cash.
Central Securities Depository (CSD)	A central securities depository (CSD) is a specialist financial organization holding securities such as shares either in certificated or uncertificated (dematerialized) form so that ownership can be easily transferred through a book entry rather than the transfer of

	physical certificates.
Circular flow of income	Economic model that illustrates the equilibrium between income that is earned from production and the value of goods and services produced in an economy.
Coefficient of variation	A statistical measure of the dispersion of data points in a data series around the mean.
Collective Investment Scheme	A pooled investment that enables investors to share in the risk and return of the underlying assets in the fund.
Commodity	A basic good used in commerce that is interchangeable with other goods of the same type.
Consumer Price Index (CPI)	A measure of the general increase in the Price Level in the Economy measured through a representative Basket of goods and services in the Economy. This also known as Headline inflation.
Controlling stake	A controlling interest is an ownership interest in a company with enough voting stock shares to prevail in any stockholders' motion.
Conventional annuity	An annuity pays you a guaranteed annuity income for the rest of your life, regardless of what happens to interest rates or investment markets in the future.
Convertible Bond	A bond that gives the bondholder (the investor) the right to convert the bond into shares of the company that issued the bond. These types of bonds are issued by corporates as it is not possible to own shares in the government.
Convexity	A measure of the percentage change in the price of a bond given a change in interest rates.
Correlation	Measures how strong a relationship returns of assets are.
Coupon Bonds (vanilla or straight bonds)	Coupon bonds pay periodic interest payments (known as coupons) at agreed dates for example after every 6 months. The initial amount invested is paid on maturity date.
Credit risk	This is the risk of default by the issuer of a bond.

Depression	Long term sustained contraction of GDP in an economy often spanning several years.
Derivative	A financial security with a value that is reliant upon, or derived from, an underlying asset or group of assets.
Earnings per Share	The earnings per share is calculated as the net profit after tax, divided by the total number of ordinary shares. All things being equal, a higher earnings per share is desirable for investors.
Earnings Yield	The earnings yield is the inverse of P/E and is calculated as Headline earnings per share/Price of a share. A higher earnings yield indicates that the share is delivering higher earnings given its price and vice versa.
Equity Risk Premium	The difference between the expected return on the share and the return on a risk-free asset such as Treasury Bill.
ETF	An investment vehicle that invests funds in order to track the performance of an index.
Expansionary Fiscal Policy	The use of the government's budget to increase aggregate demand resulting in an increase in GDP in an economy.
Expansionary Phase of the Business Cycle	Phase of Business cycle characterized by increased business profitability, high money supply and low interest rates, increasing inflation, low unemployment, high consumer and business spending and high GDP Growth.
Expected Return	The profit or loss an investor anticipates on an investment that has known or anticipated rates of return.
Expected Return	The probability weighted average of return distribution.
Financial Life Cycle	A model that shows the changes in the needs of an individual caused by trigger events during their lifetime.
Financial Services Conduct Authority (FSCA)	The FSCA is the market conduct regulator of financial institutions that provide financial products and financial services, financial institutions that are licensed in terms of a financial sector law, including banks, insurers, retirement funds and administrators, and market infrastructures. This role was implemented on 1 April 2018, taking over from the Financial Services Board as part of the initiative in implementing the Twin Peaks model of Regulation.
Financial Services	A Financial services provider (FSP) is any person other than a

Provider (FSP)	person who furnishes advice, furnishes advice and an intermediary service or renders an intermediary service as a regular feature of their business.
Financial Services Regulation Act	Legislation signed into law on 21 August 2017 to bring into effect the twin peaks model of financial regulation.
Fiscal Policy	The use of the government's budget to influence economic variables.
Forward Contract	A customized contract between two parties to buy or sell an asset at a specified price on a future date.
Fundamental Analysis	A method of determining a security's intrinsic value by analysing economic and financial factors in relation to the security.
Futures Contract	A standardized legal agreement to buy or sell a particular commodity asset or security, at a predetermined price at a specified time in the future.
Gross Domestic Product (GDP)	Measure of production in an economy. It is made up of Consumption(C), Investment (I), Government expenditure (G) and net exports(X-M).
Hedge Fund	An alternative investment that pools funds and employs different strategies to earn active return, or alpha, for their investors.
Holding Period Return	Measures the return from holding a share over a period and is calculated as the capital gain/loss plus the dividend yield.
Income Replacement Ratio	The income that the retiree will receive during retirement compared to the income before retirement.
Inflation	Inflation is the sustained and continuous rise in the general price Level of an Economy.
Inflation Linked Bond	The inflation linked bond adjusts the initially invested amount. The coupon rate is calculated on a fluctuating par value that is adjusted for inflation.
Inflation Risk	In relation to bonds, this is the risk that inflation could go up and erode the value of fixed coupon payments for bonds that are not inflation linked.

Inflation Targeting	The SARB's target inflation range in order to achieve and maintain price stability in the interest of sustainable and balanced economic development and growth.
Initial Public Offering (IPO)	The process of offering the stock of a company on a public stock exchange for the first time.
Interest Rate Risk	The risk that bond prices may fall due to a rise in interest rates.
Intrinsic Value	An investor's perception of the inherent value of an asset, such as a company, stock, option or real estate.
Investment Horizon	Length of time an investor is aiming to maintain their portfolio before selling their securities for a profit. The length of time that the investor expects to be invested in an investment.
Investment Risk	The chance that an outcome or investment's actual gains will differ from an expected outcome or return.
Investment Vehicle	The mechanism through which an investor accesses or invests in an asset class.
JSE	The Johannesburg stock exchange. Its function is to facilitate the raising of primary capital by business. It also functions as a price determination and trading platform for listed securities.
Key individual (KI)	An appointee by an FSP who oversees the operations and activities of the FSP.
Leverage	An investment strategy of using borrowed money to increase the potential return of an investment.
Liquidity Risk	The risk that the bondholder may find it difficult to sell a bond in the market due to the deterioration of the creditworthiness of the issuer.
Living Annuity	An annuity that allows a retiree to invest in a selection of funds so that the capital generates an income, and adjustments can be made to retirement income each year, within prescribed withdrawal rate limits.
Market Capitalisation	The total rand market value of a company's outstanding shares of stock. It is commonly referred to as "market cap" and it is calculated by multiplying the total number of a company's outstanding shares by the current market price of one share.

Memorandum of Association	A legal document prepared in the formation and registration process of a limited liability company to define its relationship with shareholders.
Minority Stake	An ownership interest in a company with lesser voting stock shares to prevail in any stockholders' motion. Shareholding of less than 50% is regarded as a minority stake.
Monetary Policy	The framework that the SARB uses to manage the supply of money and interest rates in the economy.
Monetary policy Committee (MPC)	The committee within the SARB which makes decisions on the appropriate monetary policy stance. It has seven members and is chaired by the SARB Governor.
Money Market	The money market is a broad definition of liquid investments with maturities that are less than 12 months.
Needs Analysis	The process of analyzing a client's financial position and their personal and financial objectives in order to determine and draw up a financial plan that will steer the client to their desired goals.
Negative Pledge Clause	A condition that prohibits the issuer from issuing additional debt if this will result in the deterioration of the issuer's ability to repay debt.
Negotiable Certificates of Deposits (NCD)	An NCD is a receipt issued by a bank as acknowledgement that an investor has deposited funds with the bank. It offers a market related rate of return. Instead of holding the NCD to maturity, the holder or bearer of the NCD can sell the NCD in the secondary market.
Net Asset Value (NAV)	Represents the net value of a Collective Investment Scheme and is calculated as the total value of the assets minus the total value of its liabilities (costs).
Nominal GDP	GDP measured at current prices, without taking into account the effect of inflation in the computation of GDP.
Nominal Interest Rate	The cost of borrowing money without taking into account the effect of inflation.
Notice Deposits	A notice deposit is an interest-bearing investment that requires the investor to give notice of withdrawal in advance. The deposited funds earn interest based on the amount invested.

Occupational Retirement Fund	A retirement fund that a member belongs to as a result of an employer-employee relationship.
Passive Asset Management	A style of portfolio management where a fund's portfolio mirrors a market index.
Portfolio Benchmark	A standard or measure that can be used to compare and analyse the allocation, risk, and return of a given portfolio.
Price to Earnings Ratio	The P/E ratio is the price of a share divided by its headline earnings per share.
Primary Market	The primary market is the market for new securities.
Prime Rate	The lowest rate at which commercial banks lend money to the public after adding a profit margin to the repo rate.
Private Equity	An alternative investment class consisting of capital that is not listed on a public exchange.
Promissory Notes	A promissory note is a written promise by the issuer to pay another party a specified sum of money at an agreed date or on demand. The promissory note will contain the principal amount, interest rate, maturity date, date and place of issuance and the issuer's signature.
Prudential Authority	An arm within the South African Reserve Bank (SARB) responsible for regulation and monitoring of the financial soundness and safety of banks, insurers, cooperative financial institutions, financial conglomerates and certain financial infrastructures.
Put Option	Financial contract that gives the option owner the right, but not the obligation, to sell a stock, bond, commodity or other asset or instrument at a specified price within a specific time period.
Quantitative Easing	A deliberate central bank strategy to increase the money supply in order to increase Business activity and GDP growth.
Real Estate	Property made up of land and the buildings on it, as well as the natural resources of the land including uncultivated flora and fauna, farmed crops and livestock, water, and any additional mineral deposits.
Real GDP	GDP at constant prices that is GDP adjusted for inflation.
Real Interest Rate	The cost of borrowing money after adjustment for inflation.
Rebalancing	Resetting the weights of the portfolio to the desired levels.

Recession	A prolonged decrease in GDP Growth. A technical recession occurs when two GDP quarters record negative growth.
Reinvestment Risk	This is the risk that interest rates may be lower at the time that the bond is called by its issuer or at the time that a coupon is reinvested. If prevailing interest rates are lower, the proceeds from the callable bond are reinvested at a lower interest rate.
Repo Rate	The repurchase rate, better known as the repo rate, is the rate at which the SARB lends money to commercial banks.
Required Rate of Return	The minimum return an investor will accept for owning a company's stock, as compensation for a given level of risk associated with holding the stock.
Retirement Planning	The determination of one's income goals after retirement and establishing and implementing a plan to meet those retirement income goals.
Risk Aversion	The behaviour of human investors, who, when exposed to uncertainty, attempt to lower that uncertainty.
Risk Free Rate	The rate of return of an investment with no risk of loss, measured using the current Treasury bill, or T-bill, rate or long-term government bond yield as the risk-free rate.
Risk Tolerance	The ability and willingness of an investor to take risk of capital loss on their investments.
RSA Retail Bonds	The Fixed Rate Retail Savings Bond is a government issued bond which consists of bonds with 2-year, 3-year and 5-year terms.
SARB	The South African Reserve Bank is the central bank of the Republic of South Africa. The primary purpose of the Bank is to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa. Together with other institutions, it also plays a pivotal role in ensuring financial stability.
Sharpe Ratio	A ratio of the average return earned in excess of the risk-free rate per unit of volatility or total risk.
Sovereign Risk	Sovereign risk is the risk posed by the deterioration of a government's ability to repay its debt obligations.
Standard Deviation	A measure of the magnitude of the deviation from expected returns of an investment.

Subordinated Debenture Bond	This is a type of a debenture which ranks low in order of priority of repayments in the event of default, after senior debt, regular debentures and sometimes after general creditors have been paid.
Swap	A derivative contract through which two parties exchange the cash flows or liabilities from two different financial instruments.
Systematic Risk	Market wide factors that affect the pricing of an asset class.
Tax Free Savings	The new Tax-Free Savings Accounts (TFSA) introduced in 2015 are part of non-retirement savings and help to maximize tax relief. All proceeds, which include interest income, capital gains and dividends from these accounts, are tax free.
Technical Analysis	A trading discipline employed to evaluate investments and identify trading opportunities by analysing statistical trends gathered from trading activity, such as price movement and volume.
Time Value of Money	The concept that money is worth more now than the identical sum in the future, due to its potential earning capacity.
Total Expense Ratio (TER)	A measure of the total costs associated with managing and operating a Collective Investment Scheme.
Treasury Bills	Treasury Bills are government issued money market instruments in order to raise money for government programmes or as a way of implementing monetary policy. They have a maturity of either 91 days or 182 days.
Treynor Ratio	A risk measurement approach that describes the relationship between systematic risk and expected return for assets, particularly stocks.
Unsystematic Risk	Refers to company specific factors that can cause the actual return to vary from expected outcome.
Volatility Risk	This is the risk of an asset price going up and down in response to supply and demand, which are determined by company specific and market wide forces.
Yield Curve Risk	The risk of a change that could affect the yields of bonds of particular maturities, but not all bonds.
Zero Coupon Bond	Zero coupon bonds are sold at a discount and do not pay regular coupons. At maturity, the issuer pays the par value to the investor.



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Describe the different classes of assets for investment purposes
- Explain the key legislation that impacts on investments
- Outline the different types of investors and explain their respective risk profiles
- Describe the relationship between risk and return
- Define the key investment attributes for all major asset classes and explain the purpose of investment
- Distinguish between investment and speculation
- Describe portfolio management and explain how it relates to investments

Investments refer to the employment of funds with an objective of earning a favourable return on it. In other words, investment is a process, where money is being utilized with a hope of making more money.

There is quite a number of investment avenues, each associated with varied risk-return trade-offs. Every investment avenue is distinct in its characteristic, which makes the investment decision fascinating. The investor thus needs to carefully analyse each of its characteristics and build a basket of assets (called a portfolio) that suits his/her risk profile and complies with his objectives and goals. Hence, investment decision making is a fascinating task to the investor.

There are different categories of investors. The investment strategies differ from each other, with regard to size of the investment, time-period, objectives, risk appetite etc. The investors can be classified into,

- Individual investors
- Corporate
- Institutional investors – Domestic and Foreign
- Pension Funds
- Government.

Investments and portfolio decisions are taken within the framework provided by a complex of financial institutions and intermediaries which together comprise the capital market. It is this market which provides the mechanism for channelizing current savings into investments.

1.1 Methods of investments

A simple way of classifying investments is to divide them into three categories or “investment methods” which include:

- Debt investments (loans)
- Equity investments (company ownership)
- Cash equivalents.

a) Debt securities are financial instruments that represent a right to a determined stream of cash flows for a definite period of time, such as bonds. A bond is a loan someone makes to a company or government. When you purchase a bond, you’re allowing the bond issuer to borrow your money and pay you back with interest.

b) Equity securities are financial instruments that represent residual (ownership) interest in a company, for example, shares of common stock, or starting a business. A share or stock is an investment in a specific company. When you purchase a stock, you’re buying a share a small

piece - of that company's earnings and assets. Companies sell shares of stock in their businesses to raise cash; investors can then buy and sell those shares among themselves.

c) Cash Equivalents

These are investments are "as good as cash," which means that they can be converted back to cash easily and quickly. Examples include saving accounts, investment in foreign currency and money market accounts.

Investments that fall into any of the above categories are traded on financial markets. The investment instruments can also be called securities. They are called **securities** because there is a secure financial contract that is transferable, meaning it has clear, standardized, recognized terms, so can be bought and sold via the financial markets.

The **FSCA's Board Notice 194 of 2017** identifies investments into the following classes:

- Shares
- Money market instruments
- Debentures and securitised debt
- Bonds
- Derivative instruments, warrants and certificates
- Participatory interest in collective investment schemes
- Participatory interest in a CIS hedge fund
- Retail Pension Benefits.

For more detail on the classes, please refer to: <https://www.fsc.co.za/Notices/Board%20Notice%20194%20of%202017.pdf>

1.2 Key legislation impacting on investments in South Africa

Below is a brief discussion of legislation that impacts on investments and other financial services in South Africa.

a) FAIS Act 37 of 2002

The Act requires that competent and qualified persons render services and give advice (fit and proper requirements) so that the client receives sound financial advice, services and products that best suit their individual needs. The products covered under FAIS include investments, insurance, retirement funds, collective investment schemes, medical scheme and deposits among others.

b) Protection of Investment Act 22 of 2015

The Protection of Investment Act 22 of 2015 came into operation in 2018, providing a degree of protection to investors in relation to their investments and aiming to achieve a balance of rights and obligations that apply to all investors. The Act seeks to codify standard bilateral investment treaty (BIT) provisions and provide domestic legislation that deals with investor-state relations.

c) Financial Sector Regulation Act 9 of 2017

The Financial Sector Regulation Act split the regulating authorities of the financial services sector into two centres. The first centre is the Prudential Authority (PA), which falls within the Reserve Bank and supervises the safety and soundness of financial institutions. It is headed by the Governor of the Reserve Bank, and overseen by a committee that includes the Governor.

The second centre is the Financial Sector Conduct Authority (FSCA), which replaced the FSB, and supervises the manner in which financial institutions conduct business and treat their customers. The FSCA is a standalone institution, managed by an executive committee that includes a commissioner and deputy commissioners, with independent governance committees for issues such as remuneration, audit and risk.

d) Financial Markets Act 19 of 2012

The Financial Markets Act provides for the licensing and regulation of the activities of market infrastructures, namely exchanges, central securities repositories, clearing houses and trading repositories. It also prohibits three forms of market abuses namely; insider trading, market manipulation and market disinformation.

An insider who has inside information is not allowed to trade on that information and is obliged to disclose it publicly via appropriate channels should they then wish to trade.

1.3 Investment strategy

This entails creating a strategy that combines the investor's goals and objectives with current financial market and economic conditions. There are basically two methods of implementing strategy available:

- Active portfolio strategy and
- Passive portfolio strategy.

In an active portfolio strategy, the investor tries to earn superior risk-adjusted returns through market timing, sector rotation, securities selection and so on. On the contrary, passive investment strategy aims to hold a diversified portfolio and maintain a pre-determined level of risk-exposure.

1.4 Investor risk profile

Based on the risk tolerance level, investors can be classified into,

- Conservative
- Moderate
- Aggressive.

Conservative investors shall take lower risks and is basically risk averse. The conservative investor's basic priority is safety of the capital. He accepts minimal risks and is hence, prepared to receive minimum or low returns. Investors with such profile should allocate most of their money into fixed-income and money-market products.

Moderate investors are willing to take slightly higher risks as compared to conservative investors for a moderate level of return. Investors with this profile can allocate their money in debt as well as hybrid products like mutual funds, unit linked insurance plans (ULIPs) etc. so that they can earn a moderate level of income with moderate risks.

Aggressive investors are prepared to assume a high level of risk and expects high rate of return for over a period of 3-5 years. Such investors can park their savings in risky assets like equity, real estate etc. These instruments yield a high rate of return with a high degree of risk attached therein.

1.5 Risk profiles

A risk profile is an evaluation of an individual's willingness and ability to take risks. A risk profile is important for determining a proper investment asset allocation for a portfolio. Organizations use a risk profile as a way to mitigate potential risks and threats.

There are three key components that comprise a true risk profile, namely,

- Risk attitude
- Risk capacity
- Need to take risk.

Risk attitude is psychological willingness to take risks; **risk capacity** refers to the financial ability to take risks; and the **need to take risks** refers to assumption of risks with a view to meet an objective. Understanding the investor's tolerance helps the financial planner select investments that are appropriate for the investor and forms the foundation of an appropriate asset allocation process.

Demographics and risk profile

Parameters	Risk Profile
------------	--------------

	Conservative	Moderate	Aggressive
Age	50 and above	35 - 50	20 - 35
Dependants	Parents and kids	Kids	Spouse
Commitments	High	Moderate	Low
Liquidity needs	High	Moderate	Low
Loan/ Liabilities	Yes	-	No
Risk Appetite	Low	Moderate	High
Income stability	Unstable	-	Stable
Time horizon	Short	Moderate	Long
Financial Literacy	No	-	Yes

(Source: "Know your risk profile before investing", Times of India, dt-16th October 2012, p. 19)

1.6 Factors affecting risk tolerance

Risk tolerance level of the investor depends on a number of factors and shall change from time to time. The risk tolerance level need not be a constant. Following are the factors that determine the risk tolerance level of an investor,

- Age
- Family situation
- Wealth and income
- Psychological
- Financial literacy.

An investor may have lower risk tolerance as they get older. A young investor may take more risk and be more dynamic as against an elderly investor who may prefer to play safe.

The investor's family position may also play a role in the risk tolerance level. An investor who needs to finance his children's education or take care of his parents or have some domestic compulsions may have to take lesser risk. An investor who is free from such domestic compulsions may take higher degree of risks.

Wealth and income of an investor shall determine the risk tolerance level of the investor to a great extent. In case the investor has higher wealth or income, he shall start investing more

aggressively; and the investor whose wealth or income is relatively less would invest in more cautious manner.

A mere psychological factor shall also have an impact on the risk tolerance level of an investor. If the personality of the investor is such that, he is risk averse, he shall take lesser risk as against the aggressive investor who is ready for some calculated risks.

The level of financial awareness has certainly the impact on the risk tolerance level of an investor. A financially educated investor is bound to understand the intricacies and take more risk; whereas an investor who is not financial literate may be risk averse.

1.7 Risk – Return Relationship

Risk can be defined as the probability that the actual returns of a security deviates from the expected return.

There is a positive relationship between the amount of risk assumed in managing a portfolio of securities and the amount of expected return. In very general terms, the greater the risk, the larger the expected return and vice-versa.

The investor who is ready to take greater risks shall be compensated with higher returns. An investor with moderate risk would get moderate returns and the investor who is risk-averse and takes very little risk shall get only lesser returns. Hence the degree of risk-taking ability shall determine the level of returns.

A strategy has to be built which attempts to balance risk versus reward by adjusting the percentage of each asset in an investment portfolio according to investor's risk-taking ability, financial goals and investment time horizon.

1.8 Investment attributes

Following are the various investment attributes,

- Rate of Return
- Risk
- Safety
- Liquidity
- Hedge against inflation
- Tax Shield.

a) Return

Investors always expect a good rate of return from their investments. Rate of return could be defined as the total income the investor receives during the holding period stated as a percentage of the purchasing price at the beginning of the holding period.

$$\text{Return} = \frac{\text{Capital appreciation \& dividend (interest)} \times 100}{\text{Purchase price}}$$

b) Risk

Risk of holding securities is related with the probability of actual return becoming less than the expected return. Investment's risk is just as important as measuring its expected rate of return because minimizing risk and maximizing the rate of return are interrelated objectives in the investment management.

An investment whose rate of return varies widely from period to period is risky than whose return that does not change much. Every investor likes to reduce the risk of his investment by proper combination of different securities.

c) Safety

The selected investment avenue should be under the legal and regulatory frame work. If it is not under the legal frame work, it is difficult to represent the grievances, if any. Approval of the law itself adds flavour of safety. Even though approved by law, the safety of the principal differs from one mode of investment to another.

d) Liquidity

Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price. Cash is the most liquid of assets while tangible items are less liquid and the two main types of liquidity include market liquidity and accounting liquidity.

Marketability of the investment provides liquidity to the investment. The liquidity depends upon the marketing and trading facility. If a portion of the investment could be converted into cash without much loss of time, it would help the investor meet the emergencies. Stocks are liquid only if they command good market by providing adequate return through dividends and capital appreciation.

e) Hedge against inflation

Since there is inflation in almost all the economy, the rate of return should ensure a cover against the inflation. The return rate should be higher than the rate of inflation; otherwise, the investor will have loss in real terms.

The return thus earned should assure the safety of the principal amount, regular flow of income and be a hedge against inflation.

f) Tax shield

A tax shield is a reduction in taxable income for an individual or corporation achieved through claiming allowable deductions such as mortgage interest, medical expenses, charitable donations, investment in retirement annuities, amortisation, and depreciation etc. Tax shields lower the overall amount of taxes owed by an individual taxpayer or a business.

1.9 Investment objectives

The investor needs to define his objectives so that he moves in that direction. The main investment objectives are:

- Increasing the rate of return and
- Reducing the risk.
- Availing tax shield

a) Increasing the rate of return

Return is the ultimate objective in any investment program. Many investments have two components of return, namely,

- Capital Gain or Loss
- Some form of income – interest, dividend, etc

The returns shall be measured in any of the following form,

- Holding Period Return
- Return on Investment
- Expected Return.

The investor shall always intend to maximize the returns on the investment.

b) Reducing the risk

Risk assessment is one of the most important aspects of modern financial management. Before embarking on any investment, a person should understand both the expected returns and the likely riskiness of those returns.

Following are the measures of total risk,

- Standard deviation
- Variance.

Risk is generally referred to as “chance of loss” and the risk has numerous subsets. Total risk refers to overall variability of the returns of the financial asset. The total risk has two principal components, namely,

- Un-diversifiable risk and
- Diversifiable risk.

Un-diversifiable risk is the risk that must be borne by virtue of being in the market. The risk arises from systematic factors that affect all securities of a particular type. Diversifiable risk can be removed by proper portfolio diversification. The risk arises due to company-specific events or factors.

The investor shall aim to reduce the risk to the possible extent.

c) Availing tax shield

Investors try to take advantage of certain privileges from the Income Tax Act 58 of 1962 so that they engage in tax planning. In this process, they choose the investment channels that provide them cushion of paying lesser taxes. Investments such as insurance, retirement annuities and medical aid contributions etc. provide tax shield.

1.10 Investment vs Speculation

It is very important to distinguish investment from speculation. Investment differs from Speculation in many facets. Investors and speculators have different views and thus different actions. An investment operation is usually one which, upon thorough analysis, promises safety of principal and an adequate return.

Hence, investment has three components, namely,

- Thorough analysis
- Safety of principal
- Adequate return.

If any operation does not include all these three components, it is speculative.

The following further differences can be seen between investment and speculation,

- Investors have long term view, whereas speculators have relatively shorter duration
- Investors behave like the business owners, whereas speculators behave like creditors
- Risk inherent in investment is relatively lower as compared to speculation, where the risk is quite high
- The investors expect a moderate and a normal rate of return, as against speculator, who expects relatively higher rate of return

- An investor shall more often concentrates on fundamental analysis, while the speculator would depend on technical analysis, sentiments and psychology
- The investor more often is quite cautious and conservative, whereas the speculator is more aggressive and careless
- Returns of an investor is more stable and reasonable, wherein, the returns of a speculator is uncertain and erratic.

1.11 Portfolio Management

Portfolio is the grouping of various financial assets that consists of equity, debt, mutual funds, exchange traded funds, and real assets like gold, silver, other precious metals, real estate, etc. Portfolio Management refers to the art and science of making decision with respect to investment mix or asset allocation, so that the underlying objectives are achieved.

Portfolio management basically is choice of debt v/s equity, domestic v/s international, growth v/s safety and many other trade-offs encountered in the attempt to maximize the returns, at the given appetite for risk.

Portfolio management or investment management is the professional management of various assets, both financial and real assets, in order to meet the specified investment goals for the benefit of the investors.



1. Describe each of the main asset classes



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

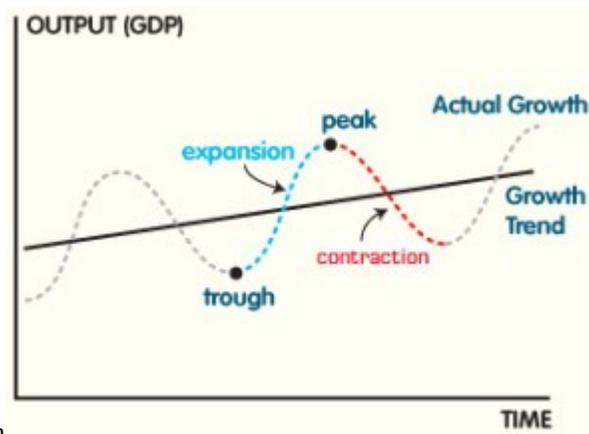
- Discuss the impact of business cycles on investments
- Describe and explain how inflation and interest rates impact on the returns of the different asset classes
- Explain the effects of taxation on investment returns

INTRODUCTION

The returns of the different asset classes are impacted by market conditions. As a result, a successful asset allocation strategy is one which anticipates and interprets current and future market conditions and allocates funds to assets that will outperform others. Market conditions are a function of several economic variables such as the business cycle, inflation, monetary and fiscal policies as well as interest rates and exchange rates. We look at the impact of these economic variables on asset returns below.

2.1 The Business cycle and investment returns

The fluctuations around the long-term growth trend of the GDP of a country is known as the business cycle. The business cycle is broken down into the following phases:



Source: lumenlearning.com

The trough is the bottom phase of the business cycle where GDP growth is at its lowest. The expansionary phase is characterized by rising GDP until the peak which is the point when GDP growth reaches its highest point and tapers off. The contractionary phase is when GDP growth falls. This trend continues until the lowest point of the business cycle (the trough) is reached and a new business cycle is born. A business cycle approach to asset allocation entails overweighting assets that will outperform in the business cycle phase that the economy is. The economic conditions in the different phases of the business cycle are typically as follows:

- The **early recovery stage** is the first stage of economic expansion. It is characterized by a rebound in economic activity, unemployment falls and incomes rise leading to growing consumer demand. Fiscal policy is stimulative (expansionary) and monetary policy is accommodative resulting in credit beginning to grow due to the low interest rates prevailing. Corporate profits grow as a result of increasing sales and inventories are lower. Stocks are the most sensitive to the early stage of economic recovery due to

rebound in corporate profits and prospects. Bonds and cash typically exhibit underperformance. In the early recovery stage of the business cycle, an overweight position in shares and lesser allocation to bonds and money market would pay off in a business cycle approach to asset allocation.

- In the **mid – cycle stage** of the expansionary phase, economic growth is strong but moderate compared to the rapid growth in the early expansion phase. Credit growth is strong and corporate profitability is high. Inventories and sales grow to equilibrium levels. Monetary policy is typically neutral at this stage and so is the fiscal policy. At this stage, shares still perform better compared to bonds and cash but the outperformance moderates in response to the moderating corporate profits. It still pays off to be overweight in shares and underweight in bonds and cash at this stage.
- During the **late – cycle stage** of the expansion phase, economic growth reaches peak stage, meaning that the rate of positive economic growth is slowing down. Companies have reached full capacity and because of this, supply is constrained and is outweighed by high demand. Inflationary pressures build up. Corporate profits taper off due to capacity constraints. In response to this, the monetary policy is tightened (higher interest rates) to contain credit growth and demand. The fiscal policy is typically contractionary at this stage. As corporate profit margins drop, investors shift their attention from economically sensitive stocks. The performance of the stock market is more or less in line with that of bonds and cash although some sectors of the stock market could perform better. Given the higher risk of stocks, investors' appetite for less volatile bonds and cash increases. Money market tends to outperform bonds at this stage. It makes sense to have a balanced portfolio of shares, bonds and money market investments at this stage.
- A **contraction** follows the peak of the expansionary phase. Two consecutive quarters of negative GDP growth is a **recession**. Economic growth contracts and the growth rate is negative. Corporate profits decline and credit creation is scarce. In order to stimulate the economy, monetary policy is eased to encourage borrowing and stimulate demand (low interest rates). Fiscal policy focuses on stimulating the economy and is expansionary at this stage. These conditions set up the economy for an economic recovery. At this stage, stocks which are economic sensitive, fall out of favour and investors prefer defensive assets. Bonds are typically the most buoyant asset class at this stage driven by the rising interest rates followed by cash which is preferred as a safe asset in bearish market conditions. In a nutshell, it may be worthwhile to be overweight in bonds and cash and underweight in shares in recessionary phases of the business cycle.

- For equities in particular, shares in economically sensitive sectors tend to perform well in the early and mid – stages of the expansion phase. Defensive stocks, for example those of companies that produce commodities, have historically performed better in the late cycle of the expansionary phase and recessionary periods. This is because these companies produce essential commodities whose demand does not fluctuate as the economic conditions change.
- Credit sensitive high yield corporate bonds are more sensitive to business cycles and tend to do better in the early phase of the expansion. This is because the ability of companies to repay debt in an economy that is growing rapidly, is higher than when the GDP growth slows down. On the other hand, interest rate sensitive bonds such as government bonds and high quality investment grade bonds, often outperform credit sensitive bonds in economic slowdowns.

2.2 Inflation and investment returns

Inflation is the general and sustained increase of price levels in the economy. The most common measure of inflation is the consumer price index (CPI). CPI measures the change in price of a basket of goods which is representative of collective consumer spending in the economy. Inflation erodes the purchasing power of money. A rational investor seeks to outperform inflation to preserve the purchasing power of their wealth. In other words, investors require real returns, that is, returns after adjustment for inflation. What then is the relationship between inflation and asset returns?

1. Equities:

- Theoretically, a rise in inflation should trigger a rise in the value of listed companies. The reasoning is that companies would be able to pass on the high cost of production to consumers by increasing their prices. However, the ability of a company to pass on the cost by increasing prices depends on the sector that the company is in. This is because investors react negatively to new inflationary expectations. This makes them risky for investors with a short-term investment horizon.
- However, some equities sectors such as materials, energy and commodities provide an inflation hedge, as companies in these sectors can pass on higher input costs to consumers. This is because they provide goods that consumers cannot do without regardless of economic conditions or prices. Equity investors could fare better by allocating more funds to companies in these sectors in inflationary times.

- Equities provide real returns for long term investment horizons. Investors with a long-term investment horizon should be overweight in equities for long term inflation beating capital growth.

2. Money market and cash equivalents

- The SARB responds to inflationary expectations by raising the repo rate and/or through open market transactions to mop up liquidity on the market. However, the SARB's response may lag inflation, resulting in lower real returns for money market investors. Although the primary mandate of the SARB is to keep inflation within the target range, there are times when interest rates may be kept low in order to stimulate the economy. A good example is the unprecedented interest rate cutting cycle following the Corona virus pandemic in 2020.
- Money market instruments are of a short nature and are unlikely to outperform inflation in the long term as long-term inflationary expectations are not reflected in short term interest rates. This makes the money market unsuitable for a long-term investor seeking a real return.

3. Bonds

- The price of a bond is derived as present value of its cash flows discounted by an interest rate that takes into account future inflation. Therefore, a rise in inflation expectations would cause a rise in the discount rate leading to a lower bond price (as it is being discounted by a higher discount rate). Longer term bond prices are more sensitive to changes in the discount rate (interest rate which changes according to inflation expectations). Bonds of shorter duration are less sensitive to changes in the discount rates as a result of inflation. In inflationary times, shorter duration bonds should be considered. Bond returns tend to rally during periods of low inflation in particular Treasury bonds.
- A good hedge against are inflation linked Treasury bonds whose par value and coupon payments are adjusted for inflation.

4. Alternative Asset classes

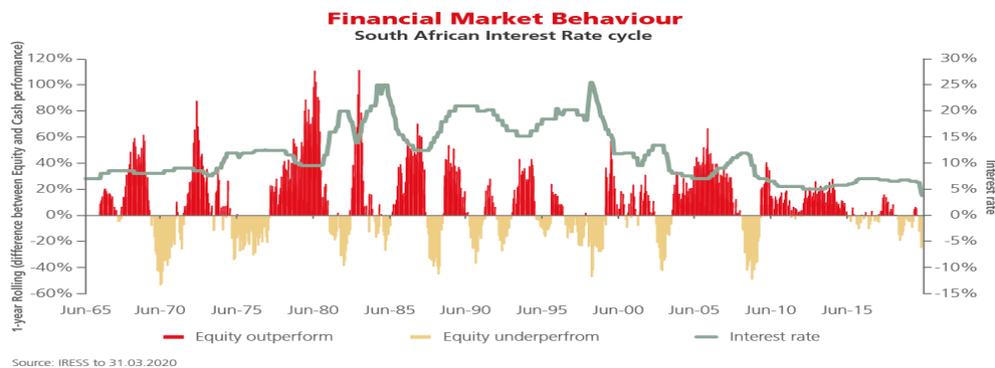
Alternative assets fall outside the definition of traditional asset classes. Examples of alternative assets are commodities such as gold and timber, derivatives, real estate and private equity. The returns of alternative assets are largely uncorrelated with traditional asset returns. Let us look at the effects of inflation on some alternative assets:

- **Gold** has for a long time been regarded as a safe haven in times of economic crisis. Gold prices tend to rise in times of inflation. In periods of rising inflation, real yields on interest bearing instruments are negative. This lowers the opportunity cost of holding gold. Gold has historically provided a hedge against inflation in the main.
- **Commodities and commodity futures:** Grain such as wheat, beef, oil and natural gas are examples of commodities. Commodities are included in the CPI basket and are inputs in the production process of goods which we consume. As a result, inflation is priced into their value. Because of this, commodities provide a good inflation hedge in the short term. Oil and oil futures (derivative products whose value is derived from the price of oil) is a good inflation hedge as it is an input in transportation (the cost of transport is included in the CPI calculation).
- **Property:** The value of property is calculated by discounting forecasted cashflows by the capitalization rate. When inflation rises, the capitalization rate increases to take into account the future inflation expectations. This leads to a decline in property prices.

2.3 Interest rates and asset classes

- In a loose monetary policy, interest rates are low and borrowing by corporates and individuals is high. This translates into higher corporate earnings due to the lower cost of production (lower borrowing costs) and the higher consumer disposable income (consumers borrow more at reduced interest rates). This often results in buoyant stock markets. On the other hand, a tight monetary policy is punctuated by high interest rates resulting in lesser borrowing and reduced corporate productivity. Further, bank deposits and money market instruments would be yielding higher interest making the equity unattractive due to perceived higher risk. This explains the low correlation between shares and money market returns over time.





The above graph depicts the relationship between interest rates and equity returns between 1965 and 2020. The grey line depicts the interest rate whilst the red line shows equity outperformance compared to cash investments. The gold lines show equity underperformance compared to cash. We can clearly see that when interest rates rise such as in the 90s and in the 2008 global crisis, equity underperforms cash.

- High interest rates affect bond yields. When interest rates fall, bond prices rise and this causes bond yields to decline. This makes bonds unattractive as investors look to dividends from equities as a more attractive return. In general, equity and bond yields and money market exhibit a negative **correlation**. In other words, equity and bond prices move in tandem. Low bond yields (higher bond prices) result in higher equity prices as investors “search for yield”.
- The level of Interest rates is directly related to the quantity of mortgages advanced by Banks and this has an impact on property prices. High interest rates discourage prospective property buyers from applying for mortgage financing in light of the high mortgage repayments involved. We have already established that high interest rates discourage borrowing by business and households and dampens earnings expectations. As a result, stock market and property prices are positively correlated. They generally move in the same direction in response to interest rate changes.
- The stock market is more sensitive to unexpected economic performance as it is more difficult to forecast returns as compared to money market and bond market securities. A higher than anticipated economic performance is typically met with a rise in share prices as investors re-evaluate the future earnings of the shares of the companies that they are invested in. This often results in capital moving from the money market to the stock market.

2.4 Taxation of investment returns from the different asset classes

(a) Capital gains:

Capital gains are subject to Capital gains tax (CGT). A capital gain is recorded when the price of a financial instrument is higher than the price at which it was bought. It is important for the investor to know that Capital Gains are realized when the asset is disposed of. In other words, an investor needs not pay capital gains tax until the date of disposal, which means that capital gains tax can be deferred until the date of disposal.



Any capital gain made in a tax-free savings account or retirement vehicle is exempt from capital gains tax.



The below table shows the inclusion rate and effective tax rate for capital gains for individuals and different legal entities as well as exemptions for the tax year 2019/2020. This applies to discretionary investments.

Type of Entity	Inclusion rate	Maximum Tax rate	Effective	Exemptions
Individuals	40%	18%		R40 000 (and R300 000 at death)
Special Trusts	40%	18%		R0
Companies	80%	22.4%		R0
Other Trusts	80%	36%		R0

The inclusion rate is the percentage of capital gains that is taxable. The maximum effective tax rate is calculated by multiplying the inclusion rate with the maximum tax rate for the type of entity under consideration. The exemption is the tax-free amount for that particular entity



For example if Jack (whose marginal tax rate is 45%, that is, he is in the highest tax bracket) made a capital gain of R300 000 on the disposal of his unit trust investment, the Capital gain taxable is calculated as $(R300\ 000 - R40\ 000 \text{ (annual exemption)}) \times 40\% \text{ (inclusion rate)} \times 45\% \text{ (his marginal tax rate)} = R46\ 800$.



The current CGT rate for an endowment for the 2019/2020 tax year is 12%. This makes an endowment an attractive investment vehicle for individuals with a higher marginal tax rate.

(b) Tax on interest and rental income

Unlike CGT, interest and rental income are taxed when accrued and not when the investor receives the actual income. This is a very important consideration when one is considering investing in an income producing investment.

Rent and interest are taxed at an individual's marginal tax rate with the first R23 800 for under 65 and R34 500 for over 65 being exempt from tax. This is as per the 2019/2020 tax tables and is subject to change in future. In an endowment structure, income is taxed at 30%, making it attractive for individuals in higher tax brackets.



Income earned or accrued in a tax-free savings account or retirement product are exempt from tax.

(c) Tax on Dividends

Dividends withholding tax is currently 20%. It is the responsibility of the company declaring the dividend to withhold the dividend tax and pay it over to SARS unless the dividend is being remitted to a regulated intermediary.



Dividends for shares held in tax free savings accounts and retirement vehicles are exempt from dividends withholding tax.

2.5 Taxation of returns in different investment vehicles

As we have already discussed, a key investment principle is for the investor to understand the implications of tax on investment returns. This knowledge can be used to maximize tax efficiency and to maximize returns. Investments can be grouped into the following categories:

- Discretionary investments (these include unit trusts, money in the bank, investments in listed shares).
- Tax free savings accounts.
- Long term insurance investments, that is, endowments.
- All forms of retirement investment vehicles.

An investor in any of these vehicles may realize a return in the following forms:

- Dividends payments: These are a portion of the company's profits that are paid to the shareholders.
- Capital Gains: This is the gain from the capital appreciation of the asset invested in.
- Rent: This is a return from investment in a rental producing asset for example property.
- Interest: This is a payment that an investor receives periodically as a reward for having invested in an interest-bearing asset.

A matrix of the application of tax for different forms of gains as at 2019/2020 budget speech is given below:

	Discretionary investments	Tax free savings accounts	Endowments	Retirement vehicles
Dividends	20% Dividend withholding tax	Full Exemption	20% Dividend withholding tax	Full exemption
Capital Gains	<ul style="list-style-type: none"> • Exemption on first R40 000(R300 000 at Death • Thereafter taxed at marginal tax rate of taxpayer (subject to inclusion rate of 80%) 	Full Exemption	12% with no exemption	Full exemption
Rent	<ul style="list-style-type: none"> • Exemption on first R23 800 for 	Full Exemption	30% with no exemption	Full Exemption

	<p>taxpayers under 65</p> <ul style="list-style-type: none"> • Exemption on first R34 500 for taxpayers over 65 • Thereafter taxed at marginal tax rate 			
Interest	<ul style="list-style-type: none"> • Exemption on first R23 800 for taxpayers under 65 • Exemption on first R34 500 for taxpayers over 65 • Thereafter taxed at marginal tax rate 	Full Exemption	30% with no Exemption	Full Exemption



1. Describe in your own words how inflation impacts on equities, bonds and money market investments

CHAPTER 3: TRADITIONAL ASSET CLASSES



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Discuss the general characteristics, terms and features of traditional asset classes
- Discuss the ways in which an investor can invest in traditional asset classes
- Discuss the fees, charges and other costs associated with investing in traditional asset classes
- Discuss the investment and risk principles pertaining traditional asset classes
- Evaluate the suitability of traditional asset classes to an investor
- Describe the different role players in traditional asset financial markets
- Discuss the correlation of asset classes in different economic circumstances
- Discuss portfolio management strategies on the management of investments in the different asset classes

INTRODUCTION

An investor can be described as one who purchases an asset with the expectation of an income, or capital gain if the asset is sold for a profit in the future. This brings us to a very important question. What is an asset class? An asset class is a group of investments that exhibit the same features, characteristics and risk and return profile. The main asset classes, also referred to as traditional or conventional asset classes, are equities, fixed income (bonds) and money market or cash equivalent investments. The other asset classes, which are collectively known as alternative assets, include real estate (property), commodities and derivative instruments. We cover the traditional asset classes in this section and alternative assets in the next section.

3.1 SHARES

3.1.1 The General Characteristics, terms and features of shares

A share is a fraction of ownership of a company.



Billy and Bob started a company where they injected total capital of R100 000 into a business. Billy contributed R75 000 and Bob R25 000. Each share is valued at R100 and each share has a voting right. How many shares does each shareholder have and what is the percentage shareholding of each shareholder?

Solution

The total number of shares for the whole company = $(R100\ 000/R100) = 1\ 000$ shares

Bob has $(R75\ 000/R100) = 750$ shares

Billy has $(R25\ 000/R100) = 250$ shares

Bob's percentage shareholding = $750(\text{the number of shares he holds})/1000(\text{The total issued shares of the company}) = 75\%$

Billy's percentage shareholding = $250(\text{the number of shares he holds})/1000(\text{The total issued shares of the company}) = 25\%$

Bob has the **controlling stake** in the company, that is, he has more voting rights in the company given the fact that he has more shares in the company. Billy is said to have a **minority stake** given his ownership in relation to Bob. A shareholder with a controlling stake has the capability to shape the strategic and operational direction of the company, veto or change the management of board of directors as well as the influence to increase current shareholding in the event of mergers or acquisitions. In the above example, the mere fact that Bob has more than 50% of shareholding gives him the controlling stake. However, a controlling stake can be achieved at a shareholding of less than 50% as long as the majority shareholder has a higher stake relative to the individual shareholding of the other investors.

According to the Companies Act which was promulgated in 2009, an investor could be a shareholder in any of the following companies:

- Public company whose name ends in "Ltd".
- Private company whose name ends in "Pty Ltd".
- Partnership.
- Business Trust.
- Sole proprietorship.
- External company.

The most common company structures are the public and private companies and it is these two entities that we will focus on this section.

Public versus Private companies

The fundamental differences between a private and a public company are as follows:

- The transferability of shares of a private company is limited whilst the shares of a public company are freely transferable. Many public companies are listed on a registered stock exchange, enabling shareholding and ownership to change hands at the market price of the shares.
- A public company has an obligation to lodge its financial statements to the CIPC whereas a private company is not obliged to meet this requirement. Further, a listed public company has to meet the reporting requirements of the registered stock exchange, such as the publication of financial statements and dissemination of important information that can affect the value of the company.

- Voting rights of shareholders in a private company are regulated by the **Memorandum of Association** of the company whilst the voting rights in a public company are proportional to the number of shares held.
- A public shareholder can appoint more than one proxy to act in the shareholder's interest whereas proxies for a private company shareholder are limited to one.
- The quorum for a private company is two as opposed to three for a public company.
- The auditor of a private company can serve as the secretary or bookkeeper of the company which is not the case with a public company. The auditor of a public company has to be independent and should not play any other role in the running of the company.

The process of a private company going public

There are some motivating factors for a company to remain privately held. The restriction of share ownership from members of the public provides the existing shareholders with a greater deal of control of the company. Additionally, the cost associated with an initial public offering, where shares of the company are offered to the public for the first time, may appear too prohibitive for the privately held company. In addition to this, the additional layers of costs that are related to compliance as a public company can also be a deterrent from offering the shares of the company to the public. Despite all this, the advantages of going public may far outweigh the disadvantages, culminating in the decision to go public. Some of the reasons a private company converts to a public company are as follows:

- Becoming a public company opens up a new avenue for financing company growth through the capital injection from new shareholders. The funds can be used to reduce company debt, to fund research and development (R&D) or to fund capital projects resulting in long term competitiveness of the company.
- Going public provides a way for existing private shareholders to exit the company. This is a way in which most venture capitalist shareholders exit successful companies that they may have built.
- An IPO can unlock value as the process involves marketing the products of the company to new customers.
- Although the additional regulatory requirements to comply as a listed public company can be onerous, they can improve the competitiveness of the company through improved governance.

1.1.1 The different forms of share ownership

The rights and obligations and the extent of control over the affairs of the company depends on the class and type of shares that the investor holds. An investor needs to understand the

implications of investing in the different types of shares in order to make an appropriate choice given the investor's objectives. We discuss the different classes of shares below.

a) Ordinary shares

An ordinary shareholder is entitled to a share of the company's profits (paid by way of dividend declarations). However, the dividends are not guaranteed as they rank secondary to (paid after) creditors, any other debt holders and preference shareholders. In certain cases, even after debt obligations have been settled, the company's Directors may decide to retain profits for future expansion plans, thus exacerbating the uncertainty element of the dividends. Ordinary shares carry the risk of capital loss in the event of bankruptcy, insolvency or if the market price plunges in the case of listed shares.

Given the above risks, why then would an investor opt for ordinary shares? Well, the shareholder is entitled to the profits of the company. In prosperous times, these profits can be substantial. In addition, because the shareholders are entitled to the profits, they have a say or control over the operations of the company through voting at company annual general meetings, choosing a board of directors that will shape the strategic direction of the company and other strategic decisions such as deciding on the level of executive remuneration.

In a nutshell, ordinary shares have a high return potential but carry the risk of total capital loss. They are ideal for investors looking for high returns but who, at the same time, have capacity, willingness and tolerance for short term volatility of their investment.

b) Preference shares

An ordinary preference share gives the investor a title to a pre-determined fixed dividend before ordinary shareholders have been paid BUT after the payment of short term and long-term creditors of the company. The distinguishing feature of an ordinary preference share is that the investor knows what percentage of profits will be declared after creditors have been paid. This provides a degree of certainty on dividend receipt. However, this dividend is fixed to the pre-determined percentage which provides a ceiling on the level of participation in the profits of the company by ordinary preference shareholders. A critical feature one has to consider, is that except in the case of non-cumulative participating dividends, the preference shareholder does not have voting rights and cannot shape the strategic direction of the company that they are invested in. There are a number of variations to the ordinary preference share as follows:

- **Cumulative preference shares** which give the shareholder a right to a fixed dividend percentage in profitable years with the added feature that the dividend can be deferred and cumulate in the following year, that is, in the following year any dividends not paid out need to be paid out before ordinary shareholders are paid.

- **Non-cumulative participating preference shares:** In this case, the holder is entitled to a fixed dividend when declared by the company and also has voting rights. However, the dividends are not cumulative in the event that the company is not in a position to declare one in a given year.
- **Profit sharing preference shares:** In addition to the fixed preference share dividend, the shareholders also receive a portion of the distributable reserves of a company.
- **Non-redeemable preference shares:** A holder of this class of shares is entitled to a dividend that is linked to a benchmark interest rate, for example a percentage of the prime interest rate. The major advantage of this class of shares is the tax treatment as dividends as opposed to income, which removes the tax burden from the taxpayer's hands.
- **Redeemable preference shares:** This class can either be participating (with voting rights) or non-participating (without voting rights), where the company can (at a pre-determined date) redeem (buy back) the shares at a discount (below market value), at par (at market value) or at a premium (above market price).
- **Irredeemable preference shares:** As the name implies, the shares exist in perpetuity, that is, the only time that the shares cease to exist is if the company is bankrupt or insolvent. The holder is entitled to a fixed dividend and these can be cumulative or non-cumulative.
- **Convertible preference shares:** This class of preference shares gives the holder the option, but not the obligation, to convert the shares to ordinary shares at a pre-determined option date. They can either be cumulative or non-cumulative.
- **Deferred shares:** This class is often structured as remuneration packages for the company founders. They share similar features with ordinary shares but the dividend is deferred until a particular time has passed or until ordinary shareholders have been paid.

3.1.2 The process of acquiring private company shares

An investor can acquire the shares of a private or a public company. Private company shares can be acquired by specific external parties or existing shareholders. Although the process will vary on a case by case basis, the following are the standard features of a private company asset sale:

- The sale is guided by the company's constitution (the Memorandum and articles of association). In most cases, the company constitution will require a board resolution authorizing the company to enter into a transaction where the shares of the company are sold. In addition, the company's constitution can have clauses that protect the interests of current shareholders such as the right of first refusal (that is the shares are offered to

existing shareholders first) and if they do not buy the shares, a requirement that they pass a special/unanimous resolution agreeing to the transfer of shares to a third party.

- The parties (that is the buyer and the seller) need to agree on the valuation of the company, the number of shares to be bought or sold and the purchase price. In certain cases, the parties need to agree on whether the buyer will pay for the acquisition in instalments over time or if the consideration will be a once off transaction.
- The date and completion of the acquisition
- Whether or not the business will change its name and the fate of the current employees are agreed upon, that is, whether or not they will be made redundant and the benefits to be paid out to them.
- The parties need to agree on how any tax consequences of the sale are to be addressed.

After the completion of the sale, the existing shareholder's certificates are cancelled and new certificates are issued. The changes in shareholding needs to be submitted to the Companies and Intellectual Property Commission (CIPC).

1.2 The process of acquiring public company shares

Publicly traded shares are available in the primary and secondary markets on the **Johannesburg Stock Exchange** and on international bourses such as the **New York Stock Exchange**. The investor can trade shares using the following methods:

1.2.1.1 Direct investment through a stockbroker

An investor can only trade on the JSE through a registered stockbroker. This applies to both individual and institutional investors. An **execution only stockbroker** is a broker who executes trades on behalf of the client without recommending which shares to buy or sell. An investor choosing this option is essentially engaging in DIY (do it yourself) investing as the broker is not involved in the research and investment decision making process. Alternatively, the investor could enter into an agreement where the stockbroker has **an advisory mandate**, that is, the broker suggests and recommends trades to the investor. Another option is to give the broker full discretion where the broker would be authorized to trade on the investor's behalf without having to consult the investor for authority to trade.

One of the major advantages of investing through a stockbroker is the wealth of experience and research capabilities of the broker that the investor taps into. However, critics of this investment method argue that the minimum amount required by some brokers is beyond the reach of many small time investors. Although some brokers have reduced the minimum amounts required to

open a brokerage account in order to accommodate previously excluded investors, the cost may erode the modest gains for a small time investor.

The cost of buying and selling shares through a stockbroker

Most brokerages now offer online trading platforms. The investor needs to be aware of the costs associated with trading shares through a stockbroker. The costs that are involved are discussed below:

(a) Brokerage fees

Only a registered stockbroker can buy and sell shares on the JSE. For providing this service, stockbrokers charge a brokerage fee whose structure varies from firm to firm. The fee is made up of a fixed percentage of the value of the shares traded and may be structured such that there is a minimum brokerage fee per trade as well as a fixed monthly fee (some brokers do not have a monthly fee). The below table shows the breakdown of brokerage fees for some of South Africa's most recognised brokerages as at Feb 2020:

Platform	Minimum investment	Monthly fees	Brokerage fees	Minimum brokerage fee
 ABSA Stockbrokers and Portfolio Management	R 0	R 75	0.40%	R 120
 Easy Equities	R 0	R 0	0.25%	R 0.01
 FNB Securities First National Bank	R 0	R 70	0.50%	R 100
 NEDBANK Nedgroup Private Wealth Stockbrokers	R 0	R 120*	0.70%	R 81
 PSG PSG Securities	R 0	R 43.48	0.90%	R 98
 Sanlam Sanlam iTrade Standard	R 5,000	R 50	0.50% + R75	R 75
 Sanlam Sanlam iTrade Pro	R 5,000	R 130	0.50% + R75	R 75

 <p>Standard Bank</p> <p>Standard Bank</p>	R 0	R 99	0.50%	R 99
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Source: <https://zonotho.co.za/south-african-online-share-trading-platforms-compared/>



Let us suppose that an investor traded shares worth R10 000 in the month of Feb 2020 through the ABSA stockbrokers online trading platform. The brokerage fees for that particular month would be:

1 Monthly fee = R75

2 Brokerage fee = $(0.40\% \times R10\ 000) = R40$. Because the minimum brokerage per trade is R120, the brokerage fee would be R120

3 The Total brokerage fee for the month would be $R75 + R120 = R195$ per month

(b) Strate Settlement costs

The technology that is used to trade on the JSE is provided by a company called Strate and a fee named after the company name is payable per transaction. As at 2020, this fee was 0.005787% with a minimum of R10.19 per trade and a maximum of R73.49. In order to cushion investors from paying high costs, some providers do not pass through the full Strate cost to the investor whilst some charge a flat fee which makes it cheaper on smaller trades.

(c) FSCA investor protection levy

This is a fee that is payable to cover the cost of continuously regulating the JSE and role players. It is currently pegged at 0.0002% as at 2020.

(d) VAT (Value Added Tax)

This a tax that is payable as a percentage of the stockbroker's fees. The VAT as at 2020 is 15%.

(e) Securities transfer Tax

This is a tax that is applicable to buying shares only and is not levied when selling shares. It was implemented in July 2008 and is currently 0.25% for the 2021 tax year.

(f) Custody fees

Levied on a monthly basis, this fee is charged for the deposit of uncertificated securities for safe custody in the Securities Ownership Register (SOR) at **the Central Securities Depository (CSD)**. The current custody fee is 0.10% including VAT with a minimum of R50.00 and maximum of R200.00 per month for JSE listed shares. The custody fee for international shares is USD/EUR/GBP 5.00 per month.

1.2.2.2 Investing in shares through Collective Investment Schemes

A collective investment scheme is an investment setup where, in exchange for a participatory interest, several investors contribute money in order to share the risk and rewards from the underlying assets in which their funds are invested. The proportion of the participatory interest is in proportion to how much the investor has invested in relation to other investors in the collective investment scheme. Collective investment schemes fall under the ambit of the Collective Investment Schemes Control Act of 2002 which regulates the administration, management and sale of collective investment schemes which replaced the Unit Trust Control Act of 1945. The definition of a collective investment scheme covers participatory interests in various types of collective investment schemes including hedge funds, open ended investment schemes, exchange traded funds and others. In this section, we discuss how an investor can invest in shares in a collective investment scheme that invests in shares as the underlying investment. This is commonly referred to as a unit trust investment as a result of the legislation which was the predecessor to the current regulatory structure.

1.2.2.2.1 The Advantages of investing in shares through a Unit Trust

(a) Professional management

For an investor with limited financial literacy or an investor who does not have the time to research the investment universe, a CIS offers the advantage of professional investment management by investment professionals whose mandate is to achieve the investment mandate of the fund that they manage.

(b) Cost effective diversification

A unit or participatory interest that an investor owns represents ownership of a number of securities that are held by the fund. This results in investors' diversification which reduces risk at a much lower cost.

(c) Liquidity

Collective investment schemes have an obligation to provide liquidity to holders of participatory interests. This means that investors can buy and sell their units at any given time.

(d) Transparency and regulation

Collective investment schemes are well regulated. This enables an investor to make informed investment decisions. The Collective Investment Schemes Control Act sets minimum reporting requirements which must be furnished to investors on a regular basis in order to keep them informed.

(e) Capital Gains Tax Advantage

An investor in a CIS benefits from the exemption of capital gains tax within the portfolio. This means that capital gains tax is not triggered when the fund buys and sells shares in the portfolio. Capital gains becomes payable when the investor eventually sells the units or switches from one collective investment scheme to the other. The deferral of capital gains tax is a huge attraction for investors.

1.2.2.2 The Disadvantages of investing in shares through a Collective Investment Scheme (CIS)

(a) Cost

CIS have an added layer of fees that are payable for fund management, administration and platform fees where applicable. These fees are higher on actively managed funds compared to passively managed funds such as ETFs.

(b) Complexity of choice

There are around 1 500 CIS to choose from in South Africa. Although having many choices is good on one hand, it presents an investor with a challenge of sifting through such a large investment universe and choosing the right investment option. This is more pronounced for an investor who has limited financial know how.

1.2.2.3 Investing in shares through Exchange Traded Funds

Exchange traded funds are collective investment schemes that are listed and traded on the JSE. This is the major difference between **Exchange Traded Funds (ETFs)** and the other form of **Collective Investment Schemes** also known as Unit Trusts.

One of the limiting factors in accessing the stock market directly through a stockbroker is the high minimum amount required



Naspers is a JSE listed global internet group and one of the largest technology investors in the world. Its market capitalization is quite significant and is a key constituent of the **JSE Top 40 index**. Its share price as at 14 July 2020 was R3 158.79.

What this means is that an investor with R5 000 to invest cannot buy two shares of this company.

A way to go around this obstacle is for an investor to buy an exchange traded fund (ETF). An ETF is a basket of securities that a service provider purchases and in turn sells participating interests to investors. Investors who buy the ETF get a return that tracks the performance of the Top 40 index in this example. In this case, an investor would not need to buy the shares of all the 40 companies in the Top 40 index but would get a return that tracks the Top 40 by virtue of buying an ETF. ETFs are listed and traded on the JSE.



The Satrix Top 40 ETF is a fund that tracks the performance of the FTSE/JSE Top 40 index which is comprised of the largest 40 shares listed on the JSE by **market capitalisation**. In this case, Satrix is the fund provider that buys the shares of all the Top 40 companies listed on the JSE in relation to their market capitalisation. By buying a Satrix 40 ETF, the investor will get a return equivalent to Top 40 Index return before fees charged by the provider. On 14 July 2020, the Unit price of the Satrix Top 40 was R51.52. The minimum investment amount per month was R500 or R10 000 once off. An investor with R500 would have purchased 9.7 Units of the ETF. The top 10 holdings out of the 40 shares held by the ETF were as follows:

Securities	% of Portfolio
Naspers -N-	21.41
BHP GROUP PLC	12.78
Compagnie Fin Richemont	9.26
Anglos	8.06
BTI Group	3.49
Prosus NV	3.45
AngloGold	3.13
FirstRand / RMBH	2.97
Mondi	2.82

Source: <https://satrix.co.za/media/42263?inline=true>

1.2.2.3.1 The Advantages and Disadvantages of investing in shares through ETFs

ETFs benefit the investor in a number of ways discussed below:

- An investor buys a basket of shares through an ETF. An ETF gives market access to investors with lower amounts to invest.
- ETFs provide diversification benefits and, in the process, reduce the risk of capital loss. In our Satrix example, the investor would be exposed to the performance of 40 different shares with different correlations. This eliminates the risk of capital loss that is inherent when only a handful of shares comprise a portfolio.
- An investment in an ETF reduces the cost of investment by eliminating or reducing some costs related to direct share investment such as broker commissions. Although a broker may charge a broker fee for trading an ETF on behalf of the investor, a single trade in an ETF is equivalent to trading a basket of stocks unlike trading in the shares of the companies that make up the basket of shares.

On the other hand, there are a few drawbacks of ETFs that an investor should be aware of:

- There are ETFs that are actively managed. The cost of active management is higher than passive ETF strategies and this may eliminate the cost effectiveness of ETFs.
- Although ETFs achieve diversification, there are some ETFs that focus on certain industry sectors. This narrowing of the investment universe may reduce the benefit of diversification benefits of ETFs particularly when the targeted industry's profitability prospects are dim due to industry specific factors.
- ETFs can be illiquid in certain cases. In order to cater for this some, ETFs may borrow up to 10% of the market value of the portfolio in order to bridge illiquidity.

1.2.2.4 The Costs associated with investing through Collective Investment Schemes

The costs of investing in an ETF include the following:

(a) Advice Fees

This fee is payable if the investor uses the service of a financial adviser for guidance in the investment decision making process. The adviser may charge an upfront adviser fee (currently a maximum of 3%+VAT) and/or an annual adviser fee (currently 1%+VAT). The ongoing adviser fee is payable through repurchase of units (selling of units) every month.

(b) Total Expense Ratio (TER)

These are charges incurred by the portfolio for the payment of services rendered in the administration of the ETF. The TER is expressed as a percentage of the daily net asset value (NAV) of the ETF and calculated over a period of 1 year. A TER does not necessarily imply a poor return. An analysis of the fund's objective and returns should be done in order to determine whether the TER incurred is justified. The average TER for ETFs in South Africa is less than 1% per annum.

(c) Manager Annual Fee

This is a fee payable to the service provider for managing the fund. The fund manager is responsible for making sure that the fund's weighting is in line with the underlying index which it tracks on an ongoing basis. This will entail rebalancing the portfolio on an ongoing basis. The fund management fee for a passive ETF will be lower than one that is actively managed.

(d) Transaction Costs (TC)

The TC is the cost incurred by the portfolio in the buying and selling of the underlying assets. Transaction costs include brokerage where applicable, securities transfer tax [STT], STRATE and investor protection levy plus VAT thereon.

3.1. 3 Role players in the Stock Market

Regulators, institutional and individual investors and brokers are the major players on the Stock Market. We discuss their role below:

1.3.1 The Johannesburg Stock Exchange(JSE)

The JSE provides a primary and secondary market where investors can buy and sell shares of listed entities. **The primary market** is where companies sell shares to the public for the first time through what is known as **initial public offering (IPO)**. The **secondary market** is a market where existing shares are traded. The JSE plays an important economic role of channelling the savings of investors to economically viable projects and thus fostering economic growth. It provides a platform for investors seeking good returns to invest in profitable projects by buying the shares of the companies that show the highest economic gain. The JSE lays down the rules and regulations for all market participants in order to ensure equitable treatment of all market players. In point form, the role of the JSE can be summarized as follows:

- **Regulation and market information:** Although the JSE is self-regulated, its activities are overseen by the **Financial Services Conduct Authority (FSCA)**. It monitors the behaviour and transparency of market players and ensures that democratic information is disseminated timeously to all relevant parties. It ensures that the market is well informed of all relevant information pertaining to listed companies through

continuous provision of data on the price, trading volumes of listed shares as well as information on the movement of indices. Company announcements and price sensitive information are disseminated through **Stock Exchange Services (SNS)** in order to ensure that all market participants trade based on publicly available information. In addition, the JSE provides daily market activity reports to give investors a summary of the trading for the day. On a macro scale, the JSE also provides continuous data on index changes. An index measures the changes in the market value of a group of listed shares that share a common characteristic, for example the financial index reflects the market value of all shares in the financial services sector.

- **Clearing:** The JSE ensures that the seller delivers the shares that has been sold and the buyer pays for the shares that have been bought timeously. This function minimizes counter party risk where one party to a transaction fails to deliver on their promise. The JSE achieves this through risk management, transaction monitoring and netting multiple transactions between buyers and sellers.

1.3.2 Institutional and individual investors

Institutional investors such as pension funds, medical aid societies and other financial institutions, are the biggest participants on the JSE. Individual investors also play a significant role on the Stock Market. A large number of investors on the JSE are looking for long term, inflation beating capital growth. On the other hand, some participants are looking for short term speculative gains. The latter includes investors who use **leverage** (borrowing) in their investment strategy, for example **short sellers** who sell a share that they do not own in advance with the expectation that the share price will fall.

1.3.3 Brokers

As already discussed, any trade on the JSE can only be done through a registered stockbroker. In return for a brokerage and other fees if applicable, a stock broker executes trades on behalf of an investor.

3.1.4 The forms of returns from investing in shares

Capital gains and **dividends** are the returns that a shareholder can get. A capital gain measures the appreciation of a share price over time whilst dividends are profits that are paid to shareholders after all debt obligations and preference shareholders have been paid. Another way of putting it is that capital gains represents capital growth as reflected by the share price appreciation whilst dividends represent the income component of returns as shareholders receive a payment when an ordinary dividend is declared. Although a larger proportion of returns is in the form of capital gains, the level of capital appreciation and dividend payment by

a listed company is dynamic and depends on which level in the product life cycle the company finds itself in. These stages are categorized below:

a) Growth companies

A company is in the growth stage when it is expanding rapidly. Because of the need to fund the growth and new projects, the company hardly pays a dividend. Rather, the future growth prospects drive the share price up as investors bid up the share price in order to be part of the growing company. Generally, investors invest in growth shares for capital appreciation as there is little or no income in the form of dividends. This makes investment in growth shares suitable for investors looking for long term capital growth with no need for income in the form of dividends.

b) Dividend growing companies

Over time the level of growth of a company slows down. As a result, there is less need for reinvestment into newer or expansion projects. The company at this stage may begin rewarding shareholders by paying them a portion of the profits through dividends. Price appreciation is not as rapid as in the growth stage as the share price reflects the lesser growth prospects of the company. An investor of a company at this stage will receive a combination of capital gains and dividends.

c) Dividend paying companies

Companies in mature industries have reached a stage where there is little growth prospects. With fewer new and expansion projects to fund, mature companies who have strong cash flows, typically share these profits in the form of dividends. The capital gains of mature companies is less. Typically, mature dividend paying companies are ideal for investors looking for income and capital preservation from their investment.

d) Value Companies

Value shares are shares whose prices are relatively low given their fundamentals such as the company's earnings, dividends, turnover and profitability. They typically have low price to earnings (P/E) ratios. A number of factors may have contributed to the share price trading at a discount to **intrinsic value**, for example the company might have fallen out of favour for a particular reason, or the company may be priced at a discount to peer companies in the same industry. Whatever the reason for the discount, investors in value stocks look for capital appreciation when the market finally corrects the mispricing.

3.1.5 Suitability of shares as investment

Shares provide long term capital growth but are volatile in the short to medium term. As such, this asset class is for investors who:

- Seek exposure to listed equities to provide long-term capital growth.
- Are comfortable with stock market fluctuation, i.e., short- to medium-term volatility.
- Are prepared to accept the risk of capital loss.
- Typically have an investment horizon of more than five years.
- Wish to use the shares as a 'building block' in a diversified multi-asset class portfolio (that is a fund with different asset classes).

1.4 Measuring the return from investing in shares

The total return of an ordinary shareholder, that is, capital gains and dividends, is known as the **holding period return**. The holding period return is given by the following formula:

$$\text{HPR} = \frac{\text{Share price at the end} - \text{Initial share price} + \text{Dividends}}{\text{Initial share price}}$$



An investor bought shares of a JSE listed company two years ago at R40 per share. The shares are currently R50 per share. During the two-year period, a total of R7 dividends per share were declared. What is the holding period return for the investor?

$$\text{HPR} = \frac{\text{Share price at the end} - \text{Initial share price} + \text{Dividends}}{\text{Initial share price}}$$

$$\frac{50 - 40 + 7}{40} = 42.50\%$$

Typically, an investor wants to know what the return on investment has been annually. The holding period return calculated above can be converted into an annual return, known as the **holding period yield**, by using the below formula:

Holding Period Yield = $[1 + \text{HPR}]^{(1/n)} - 1$, where n adjusts the HPR to an annual figure. In a case where the HPR is more than a year, we divide 1 by the number of years. Where the HPR is less than a year say for example a quarter we raise the HPR by the relevant factor to get to 1 year.



What is the HPY when the 2-year HPR is 42.50%?

$$\text{Holding Period Yield} = [1 + 0.4250]^{(1/2)} - 1$$

$$\text{Holding Period Yield} = 1.1937 - 1$$

$$\text{Holding period Yield} = 19.37\%$$

If the return had been 42.50% over a 6-month period, the holding period yield would be:

$$[1 + \text{HPR}]^{(n)} - 1$$

$$\text{Holding period yield} = [1 + 0.4250]^{(2)} - 1$$

$$\text{Holding period yield} = 103\%$$

3.1.6 Valuation of shares

Shares provide a return in the form of capital gains and dividends. Capital gains provide capital growth over the long term whilst dividends are a form of income as this is cash that is paid back to investors. In order to determine which shares, provide the best prospects for return, investors need to analyze the investment. An investor can make this analysis using **fundamental** and **technical analysis**.

1. Fundamental analysis

Fundamental analysis ascertains the **intrinsic value** of a company by analyzing the economy, industry and company specific factors. In top-down approach, the analysis looks at macro-economic factors before analyzing the industry prospects and finally factors specific to the company. The opposite approach is known as a bottom-up approach, and this entails analyzing company specific factors first and foremost before looking at the industry and finally the broader economy.

The analyst's goal is to determine whether the company's forecasted earnings are reflected in the current share price. In a case where the share price is higher than the perceived intrinsic value, the company is said to be overvalued by the market and this may present a case for offloading the share. Market undervaluation of the share occurs when the share price is below the value that has been determined by the fundamental analysis. This would motivate the investor to own the shares of the company. Fundamental analysis will employ some of the following techniques or methods in the determination of intrinsic value.

i) Discount valuation models

The premise of a discount valuation model is that the value of the company can be determined by discounting forecasted future earnings to the present using the investor's **required rate of return**. The most common discount model is the Gordon dividend discount model. It states that the value of a company can be derived by discounting forecasted future dividends at the required rate of return. The required rate of return is the return that the investor requires given the risk of investing in the security.

A company that pays a fixed dividend every year is valued according to the following Gordon dividend discount formula:

$$\text{Intrinsic Value} = D1 / (k - g)$$

Where, D1 = the next year's dividend

k = the investor's required rate of return

g = the expected growth rate of the dividend



Company A is a listed company on the JSE and its share price is currently R35 per share. The investor's required rate of return of 9%. The company's expected dividend next year is R1.50 per share and this dividend is expected to grow at 2% every year in the foreseeable future. Calculate the intrinsic value of the company and advise if this share is overvalued or undervalued.

Solution

$$\begin{aligned}\text{Intrinsic Value} &= D1 / (k - g) \\ &= 1.5 / (0.09 - 0.02) \\ &= R21.42\end{aligned}$$

According to the valuation model, the share price is supposed to be R21.42 given its forecasted future dividends. The company is currently overvalued and the investor should consider disposing of the shareholding before the market realises the mispricing which would cause the share price to revert to its intrinsic value

In a case where the dividend is not expected to grow but remain constant in perpetuity, the formula would simply be

Intrinsic Value = $D / (k)$, where D is the fixed dividend and k is the required rate of return



Company B is expected to pay a fixed dividend of R5 is perpetuity. The investor's required rate of return is 10%. What is the intrinsic value of the company using the Gordon dividend valuation model? The company's share price is currently R45.

Solution

$$\begin{aligned} \text{Intrinsic Value} &= D / (k), \\ &= 5/0.1 \\ &= R50 \end{aligned}$$

The company share price is undervalued based on the valuation model, as the intrinsic value has been determined to be R50. The investor should consider buying the shares of the company.

Although the Gordon dividend valuation model is widely in use, its major limitation is that forecasting dividends with certainty is a tall order. Further, fast growing companies that are not paying dividends, in order to finance new and expansion projects, would prove to be a challenge in forecasting dividends. Despite these limitations, the model plays an important role in the valuation of shares.

ii) Valuation of shares using Relative valuation models

Relative valuation models compare different financial metrics between peer companies in order to determine whether a company's current share price is overvalued or undervalued. The most common relative valuation models are discussed below:

(a) Price to Earnings ratio

The P/E ratio is derived by dividing the price of a share by its headline earnings per share. In other words, it is the price of a share relative to its historical earnings. This is known as the historical P/E. A forward P/E ratio is calculated by dividing the current share price by forecasted earnings of the company. A very high P/E ratio relative to the company's peers may indicate that the share is overpriced, whilst a low P/E relative to peers could reflect a share price that is trading at a discount.



Company A is a company listed on the JSE. The average P/E for the industry that the company operates in is currently 9. Currently, the share price is R15 and its last reported headline earnings were R6 per share. Using the P/E measure, is it viable for the investor to buy the shares of Company A?

Current P/E = $15/6 = 2.5$.

The company's historical P/E of 2.5 is significantly lower than the industry average of 9. It looks like the company's share price has not yet reflected the growth prospects of the industry. Based solely on the P/E measure, the investor should consider buying the shares of Company A.

(b) Earnings Yield

In contrast to the P/E, earnings yield is the inverse of P/E and is calculated as headline earnings per share/price of a share. All things being equal, a higher earnings yield is desirable. It indicates that the company's earnings are high relative to the cost of owning the company as reflected by the share price.

(c) Earnings per share

One of the most important figures that an analyst looks at is the earnings per share. It is calculated as the net profit after tax divided by the total number of ordinary shares. A higher earnings per share of a company relative to peers in the industry reflects a higher return given the price that the investor pays for shares (the share price).



A high earnings per share in itself is not a conclusive measure of a company's profitability. This figure can be distorted or manipulated through accounting principles. The investor needs to look out for this by meticulously combing through the financial statements. Additional tools such as the analysis of cash flows should be carried out in order to have a clearer picture of the company's profitability.

2. Technical analysis

This analysis looks at historical price movements in predicting future price movements. It is based on the notion that markets are efficient and that it is a waste of time to conduct fundamental analysis as the intrinsic value of shares is reflected in the share price already. In short, its major premise is that markets are efficient. Further, its premise is that history will always repeat itself and that the investor simply needs to identify a price pattern, and this is used to predict future price movements. The most common technical analysis techniques are the following:

(a) Trend indicators: These indicators are an analysis of which direction the market is taking over time, that is, whether it is going up, down or sideways.

(b) Mean reversion indicators: The premise of this indicator is that the share price will always revert to the mean. They are used to predict how far the share price will stretch from the mean before reverting to its mean.

(c) Relative strength indicators: The analysis here is the movement between the strength of buyers and sellers in order to determine the supply and demand dynamics and in so doing predict where the market is headed.

(d) Momentum indicators: This technique measures the speed at which the share price changes over time.

(e) Volume indicators: This entails analyzing the trade volumes to determine whether the market is a bull or bear market.



The premise upon which fundamental and technical analysis are based, are different. However, the two are not used in isolation. Analysts use the methods in conjunction with each other in order to make investment decisions.

3.1.7 The concept of Risk in relation to shares

Investing in shares can reward an investor over the long term but the investor needs to be wary of the risk that the investment carries. There are two forms of risk that can cause an unexpected outcome in returns. **Systematic risk** is the risk that an investment in stock can deviate from the expected outcome as a result of macro factors that affect the equity market as a whole, that is, this risk is not specific to the company that has been invested in. Examples of these factors are

economic growth, recessions, and changes in the interest rate cycle, inflation and the exchange rate. The other facet of risk is termed **unsystematic risk** and this stems from company specific factors that cause a deviation from expected returns. Company specific factors include changes in forecasted earnings, unexpected changes in the leadership of the organization, changes in the company's competitive advantage in its specific industry and innovations that introduce competition to the company that an investor is invested in. Systematic and unsystematic risk result in volatility of stock market returns and this is more pronounced over the short term. Fluctuations in the stock market returns caused by these two forms of risk can result in capital losses when the share prices drops to levels below the price that the investor bought the shares for. Additionally, it can affect the dividend component of the return when a company forgoes paying a dividend in order to respond to unexpected changes in profitability.



A clear example of how systematic risk impacts markets is how the Corona virus pandemic caused extreme volatility on the JSE and worldwide markets at the beginning of 2020. In March 2020, the JSE's all share index lost 12% at one point during the day, breaking a record that had been set in 1987. Overall, it lost 15% of its value in the same week. These extreme market movements had been unexpected prior to the Corona pandemic.

3.1.8 The concepts of return and risk in shares

Investors have an expected return when buying shares. The expected return of an asset is the return that an investor anticipates given a range of economic outcomes that can pan out. It is the probability weighted sum of expected outcomes. It is derived by the following formula:

Expected Return = SUM (Return x Probability)



An investor has looked at the historical data of Company A which is a company listed on the JSE. He has determined that an investment into the company has the probability of giving the following returns:

State of the Economy	Probability	Return
Normal	20%	10%
Boom	60%	20%
Recession	20%	-5%

What is the expected return of the investment?

Solution

Expected Return = SUM (Return x Probability)

Expected Return = 0.2(10%) + 0.6(20%) + 0.2(-5%)

$$= 2\% + 12\% - 1\%$$

$$= 13\%$$

It is not always the case that the expected return will be realized. The probability of actual returns deviating from expected return is the **risk** of investing in shares. The question that we need to answer is how we quantify the risk of investing in shares. This brings us to our next section.

3.1.9 Measuring the risk of investing in shares

(a) Standard deviation

In investment decision based on the expected outcome only is not complete. In addition, the investor needs to know how historical returns have deviated from the mean (expected return). A useful measure of the dispersion of historical returns is the **standard deviation**.

Standard deviation is the average deviation of an asset's returns from the average return (expected return) over a time period. An asset with historical huge fluctuations around the mean will have a higher standard deviation compared to one whose returns rotate closer to the expected return. All things being equal, investors prefer assets with a lower standard deviation given a return. Standard deviation is calculated as the square root of the investment's variance.

We do not cover the calculation of standard deviation in this module as it is beyond the scope, but what is important, is the ability to determine which security has higher risk given returns and standard deviation.



Let us suppose that an investor has been presented with a choice between the shares of Company A and Company B. The expected returns of the shares and the standard deviations of the assets are given below.

Company	Expected return	Standard Deviation
A	20	4
B	20	10

Would a rational investor pick the shares of A or B given the expected return and risk (as measured by the standard deviation)? The standard deviation measures how spread-out historical returns have been from the mean (expected return). A higher standard deviation denotes higher volatility as the deviation from the mean is greater. In the above case, the expected return is the same for both companies, but Company A has lower deviation from the expected return compared to Company B. In other words, there is a greater degree of certainty for Company A's returns compared to Company B.

Standard deviation is a useful tool when comparing the risk between two securities with the same expected return. However, it is an absolute measure and is inconclusive when faced with securities with different returns. Further, it measures all forms of volatility as undesirable, that is, even positive deviations from the mean are captured when these should in fact be desirable to the investor. In order to overcome this challenge, the techniques discussed below are employed to measure risk.

(b) Sharpe ratio

The Sharpe ratio measures an asset's excess risk adjusted return per unit of risk. It is calculated by measuring the asset's excess return and then dividing it by the standard deviation of the portfolio.

Formula for the Sharpe ratio = $\frac{\text{Return of portfolio} - \text{Risk free rate of return}}{\text{Standard deviation of portfolio}}$



Let us continue with our example of Company A and B. Let us suppose they have the following statistics:

Portfolio Name	Portfolio Return	Portfolio standard deviation
Portfolio A	15%	10%
Portfolio B	10%	3%

The **risk-free rate of return** is 5%. The risk-free rate of return is the return on government issued Treasury Bills. Government securities are considered risk free as the government is not expected to default on debt obligations. The risk-free rate of return is therefore a good proxy for a rate of return that is risk free.

Given the above which option would maximize return for an investor at minimal risk?

Solution

Sharpe ratio for Portfolio A = $\frac{\text{Return of portfolio} - \text{Risk free rate of return}}{\text{Standard deviation of portfolio}}$

$$= \frac{15-5}{10}$$

$$= 1\%$$

Sharpe ratio for Portfolio B = $\frac{\text{Return of portfolio} - \text{Risk free rate of return}}{\text{Standard deviation of portfolio}}$

$$= \frac{10-5}{3}$$

$$= 1.67\%$$

Portfolio B is a more efficient portfolio. It has a higher excess risk adjusted return to portfolio A.

(c) Coefficient of variation (CV)

The CV is the inverse of the Sharpe ratio. It measures risk per unit of return. Using this logic, it follows that a rational investor would seek a lower CV. The formula for the CV is given below:

Coefficient of variation = $\frac{\text{Standard deviation}}{\text{Expected return}}$



Using our two-company example, let us suppose that the expected returns and the standard deviation are as per below:

Company Name	Expected Return	Standard deviation
A	15%	20
B	15%	16

$$\text{CV for Company A} = \frac{20}{15} = 1.33$$

$$\text{CV for Company B} = \frac{16}{15} = 1.07$$

Company B has lower risk. This is because it has lower risk per unit of return than Company A.

(d) Beta coefficient

The **Beta coefficient** is a measure of the volatility of an asset in relation to the volatility of all the shares in the market as a whole. Put differently, Beta measures the magnitude of a share's response to movement in the market as a whole. A Beta of 1 means that the shares' returns fluctuate at exactly the same rate as movements of the market. A Beta greater than 1 reflects means that the shares of the company in question are more volatile than the market. Finally, a Beta less than 1 reflects an asset with a lower risk compared to the entire market.

(e) Treynor Ratio

This is a measure of excess risk adjusted return per unit of market risk measured by Beta. The Sharpe ratio considers total risk, that is, systematic and unsystematic risk as measured by standard deviation. According to the Treynor, unsystematic risk can be diversified away such that the only risk that remains and that matters is systematic risk. This explains the use of Beta instead of standard deviation in the formula.

$$\text{The Treynor ratio} = \frac{\text{Return of portfolio} - \text{Risk free rate of return}}{\text{Portfolio Beta}}$$

3.1.10 How to reduce the risk of investing in shares

(a) Diversification

In order to reduce the risk of capital loss that could result if the company invested in does not perform well, investors should diversify their risk by investing in the shares of different companies within the same industry, across different industries and sectors and where possible across geographical locations. Diversification is effective when the assets invested in have a low **correlation**.

(b) Long term outlook

Investment in shares has the potential to give an investor inflation beating capital growth over the long term. Volatility of returns in the short term is higher. Investors can reduce risk by having a long-term view of the investment, that is, investing over the long term typically for investment periods not shorter than 7 years. The investor should avoid the temptation of switching in and out of the market to try and time the market. This often results in the investor buying shares at “highs” and selling “low.”

(c) Avoid making emotional investment decisions

It is important for an investor to choose an investment strategy and stick to it regardless of market changes. In other words, a successful investment strategy is one where an investor ignores “market noise” and sticks to a long-term investment objective. This is easier said than done. The large sell off of risky assets in early 2020 in response to the Corona virus effect on world economies is a good example of emotions getting the better of investors.

(d) Understand the company before investing in it

An investor who buys a share of a company becomes a part owner of that company. It is vitally important that the investor understands the business model of the company that they are investing in as well as the company's strengths and weaknesses. In order to do this, the investor must thoroughly analyse the company based on all the historical and forward-looking information available. Where the investor does not have the time or expertise to do so, it is recommended that the investor engages a professional equity analyst for recommendations or invest through investment vehicles that offer professional investment analysis before investment, such as Collective Investment Schemes (CIS).

3.2 BONDS

3.2.1 The general characteristics, terms and features of Bonds

A bond is a fixed income asset that entails a series of fixed payments to the investor on specified dates and repayment of the principal at maturity date. Maturities range from 2 to 20 years and they are traded in the **Capital market**. The issuers of bonds (borrowers) range from governments and municipalities seeking capital to fund government programmes, state owned enterprises (SOEs) and unlisted and listed entities on the JSE. The **Primary bond market** is where new securities are issued and existing issues are traded in the **Secondary bond market**. Bonds are a conservative investment and ideal for investors seek an inflation beating return that is higher than money market returns. The risk of capital loss in a bond investment is less than investing in more volatile assets like listed shares but higher than a money market investment. Bonds are a liquid investment providing an income in the form of regular income payments.

They are therefore suitable for investors looking for inflation beating returns and an income at a lesser risk than investing in the stock market.

3.2.2 The Different types of Bonds

(a) Coupon Bonds

Coupon bonds pay periodic **coupons** (interest payments) at pre-determined dates. The most common coupon payment is every 6 months. The principal (initial amount invested) is paid on maturity date. Another name for a coupon bond that has no additional feature is a **Vanilla** or **Straight** bond.

(b) Convertible Bonds

A convertible bond gives the holder (investor) the right to convert the bond into ordinary shares of the issuing company.

(c) Bonds with Put options and Callable Bonds

A **Put option bond** gives the bondholder (the investor) the option to sell the bond to the issuer at a special put price. In a rising interest rate environment, the bondholder can profit from selling the bond to the issuer and reinvest the proceeds in a bond that pays a higher coupon. There is a price that the investor pays for this option (the option price).

On the other hand, a **Callable bond** gives the issuer (the borrower) the right to buy the bond from the bondholder (the investor). In a declining interest rate environment, the issuer can buy back the bond at the prevailing market price and then borrow again at lower interest rates. This would reduce the issuer's debt obligations.

(d) Zero Coupon Bonds

A zero-coupon bond does not pay a regular coupon. Instead, it is issued at a discount, that is, the investor pays the issuer a price that is equal to the par value less the discount. Upon maturity, the issuer pays the par value (maturity) to the investor.

(e) Inflation linked Bonds

An inflation linked bond's par value and repayments is adjusted for inflation, unlike all the other bonds discussed thus far. This makes it an ideal investment for investors looking to hedge against inflation



An Investor invests R1 000 000 in a treasury inflation linked bond at 8% per annum. The coupon is paid annually. The Coupon at the year-end would be calculated as 8% of R1 000 000 = R80 000. If the inflation rate is 3% in the second year, the calculation of the coupon in the second year would be as follows:

The initial amount invested adjusted for inflation = $R1\ 000\ 000 \times 1.03 = R1\ 030\ 000$.

The coupon in year 2 is calculated as 8% of R1 030 000 = R82 400. At maturity, the principal, adjusted for inflation during the period, is repaid to the investor.

(f) Debentures

A number of bonds that we have discussed are secured by specific assets of the issuing company. These bonds are referred to as secured debt or senior debt. This means that the bondholders can attach specific assets as recourse in the event of default.

Debentures are a type of debt instrument, similar to a bond, that companies issue in order to raise capital. Details of debentures are documented in an indenture, which is a written agreement between the issuer and the holder. Companies pay investors interest for the term of the debenture. At the end of the lending period, issuing companies usually offer the choice of converting the debentures into shares. Debentures are not secured by physical assets or collateral of the issuing company. The investor in the bond, thus cannot attach anything if the borrower (the debenture issuer) fails to meet the debt obligation. As a result, a debenture is only backed by the creditworthiness and the full faith of the issuer. This makes it riskier than secured bonds in the event of the issuer's insolvency, as the debenture holders only have a claim against general assets of the company after secured bond holders have claimed assets that were secured against their loans.

Companies looking to finance operations through debt can offer debentures for several reasons:

- A company that has strong cash flows and a healthy balance sheet that has high creditworthiness may not require to incentivise investors by issuing secured debt (debt that is secured by specific assets in the event of default). Because investors have confidence and faith in the ability of the issuer to repay debt obligations, it may not be necessary to encumber itself by pledging its assets to entice investors in its debt. A company in this position can issue debentures at a low interest rate, as its creditworthiness is anchored by its ability to pay, and not the security of pledged assets.
- On the other hand, a company might have pledged a significant portion of its assets to existing debt such that it no longer has latitude to pledge additional assets. A company in this position would be riskier to invest in and it would have to raise the interest that it

pays in order to attract investors. Investing in debentures of a company in this position is risky given the fact that the debentures would fall in ranking below secured debt.

- In certain cases, a company might want to leave its assets unencumbered by issuing secured debt for now, in order to have the assets available to secure future debt obligations.
- Companies that do not have the flexibility to issue regular debentures, sometimes issue a special form of debentures known as **subordinated debenture bonds**. These rank low in order of priority of repayments in the event of default after senior debt, regular debentures and sometimes after general creditors have been paid. In compensation for the high risk, the interest rates are often higher than regular debentures and senior debt.

Key features of debentures

- Typically provide higher rates of financial return than government bonds or bank interest rates.
- At the end of the lending period, issuing companies usually offer the choice of converting the debentures into shares. These are called Convertible Debentures and usually pay a lower interest rate to the lender (the investor).
- Interest is paid to investors whether or not the issuing company makes a profit.
- Are transferable (from investor to investor).
- The debt-equity ratio: The investor should consider the ratio in which debt is used to finance projects and capital compared to that used for equity. If more debt is used to finance the company, the risk of default should be taken into account.
- Debentures are unsecured and only backed by the issuing company's creditworthiness and reputation. The investor is lending money to a business and a debenture carries all the risks that this involves.

Some debentures have built in features and clauses to provide some protection for investors:

- Clauses that prevent the company from issuing additional debt can be included in order to avoid overleveraging the company and diluting the power of existing bondholders.
- A **negative pledge clause** is a condition that prohibits the issuer from issuing additional debt if this will result in the deterioration of the issuer's ability to repay debt.
- Covenants that require the issuer to limit the probability of default such as certain financial limits, are sometimes built into the terms of the debentures, for example the company may be required not to exceed a certain level of debt/equity ratio,

- Additionally, a condition that requires repayments to bondholders first before payments to preference shareholders can be included in order to protect the interests of debenture holders.

3.2.3 Bonds and Risk

An investor in bonds is exposed to the following forms of risk:

(a) Inflation Risk

The risk that inflation rise and erode the value of fixed coupon payments for bonds. This risk is not borne by investors in inflation linked bonds, as these are adjusted for inflation

(b) Credit Risk

This is a risk posed by the deterioration of the creditworthiness of an issuer. If this happens, investors require a higher interest rate for investing in that bond as compensation for the credit risk. The higher required rate of return results in the decline in the price of the bond. In other words, credit risk results in capital losses.

(c) Reinvestment Risk

This is the risk that interest rates may be lower at the time that the bond is called by its issuer or at the time that a coupon is reinvested. If prevailing interest rates are lower, the proceeds from the callable bond are reinvested at a lower interest rate.

(d) Sovereign Risk

Government issued bonds are considered risk free. However, mounting public debt of a country can cause debt strain, resulting in a government facing difficulties in honouring its debt obligations. This risk is known as sovereign risk. Investors require a higher return where sovereign risk is high, to compensate for the higher default risk.

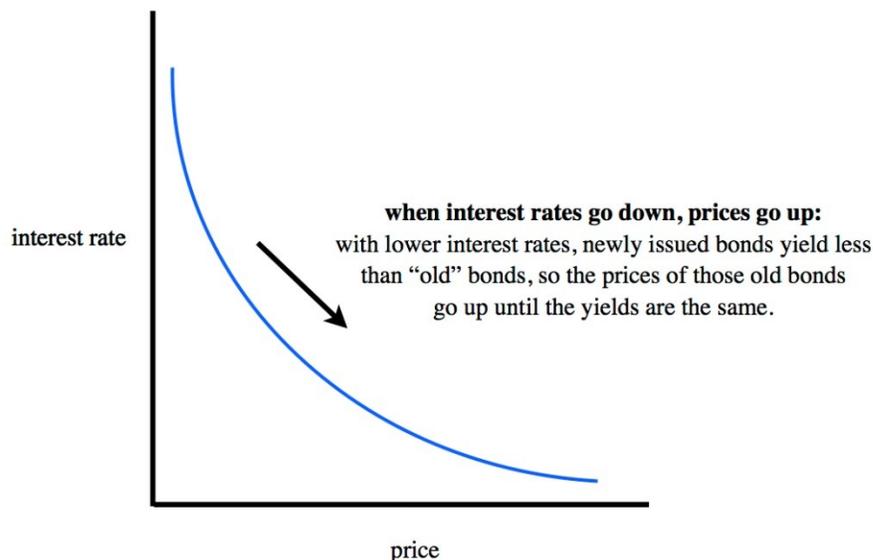
(e) Liquidity Risk

Liquidity risk is closely linked to credit risk. Bonds with high credit risk are not in high demand and this can result in an investor facing difficulty in selling the bonds at prevailing market prices. This results in capital losses for the investor.

(f) Interest Rate Risk

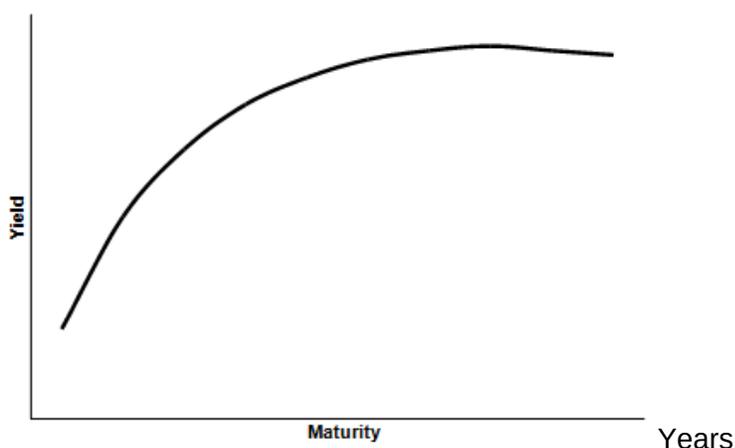
The price of a bond is determined by discounting future cash flows and the maturity value at the required rate of return. The investor's required rate of return is the prevailing interest rates on the market. When interest rates rise, the price of bonds falls as cash flows are discounted at a higher required rate of return. Another way to look at it is that existing bonds are paying coupons calculated at lower interest rates and hence have a lower demand resulting in the fall in prices. Conversely, when interest rates fall, the existing bonds are paying a higher coupon

and more attractive. This results in the prices of bonds going up. Below is a depiction of the relationship between interest rates and bond prices:



(g) Yield curve risk

The interest rate that makes all future cash flows of the bond (the coupon and the par value) equal to the present value of the bond is known as the yield. Bonds of different maturities have different yields, that is, 2-year bonds will have different yields to 20-year bonds. A yield curve measures the yield on bonds with different maturity profiles. Typically, when depicted graphically, a **normal yield curve** is upward sloping. This means that bonds of longer maturity have a higher yield than bonds of shorter maturity. The duration of a bond is a measure of how far a bond is from maturity. In a normal scenario, long dated bonds will have higher yields compared to shorter dated bonds to compensate the investor for time value of money and perceived risk of investing in longer term bonds. This is depicted below:



A change in the yield for bonds with a specific duration, for example 5-year bonds only, is known as yield curve risk. An unequal change in the yields of bonds of different maturities is termed yield curve risk.

(f) Call Risk

Applicable to bonds that have call options. This risk is more pronounced in a declining interest rate environment where the issuer may be tempted to call in the bond and refinance through issuing bonds at a lower interest rate.

3.2.4 Values of bonds

a) Par value

The par value of a bond, also called the face amount or face value, is the value written on the front of the bond. This is the amount of money that bond issuers promise to repay bondholders at a future date. For instance, a company might issue R5 000, 15-year bonds to the public. The par value of these bonds is R5 000. In other words, the company promises to pay the public back R5 000 in 15 years from the bond issuance.

b) Market value

A bond's market value is the price at which the investor could sell the bond to another investor prior to the bond coming due. The time in the future that the bond is due is also known as expiration or maturity. The market value price is mainly determined by current interest rates and, in a normally functioning market, your bond will be worth a little bit less or a little bit more than par value prior to maturity.

The market value of a bond has two parts: The value of the amount of the bond itself, or its face value, and the value of the interest you would receive if you held on to the bond until it matures. The total of these two amounts is a bond's market value.

c) Intrinsic value

The intrinsic value of an asset (the perceived value by an individual investor) is determined by discounting all of the future cash flows back to the present at the investor's required rate of return. It represents an investor's perception of the inherent value of a bond. Knowing an investment's intrinsic value is useful for value investors who have a goal of buying bonds and other investments at a discount to this amount.

3.2.5 Valuation of Bonds

The price of a bond is the value of all future cash flows (coupon payments and the maturity value) discounted by the prevailing interest rate (also known as the required rate of return). The price of a bond rises and falls in response to changes in the market interest rates. Recall that

the cash flows from a bond are coupons that are calculated based on the interest rate when the bond was issued as well as the repayment of par value (that is initial amount invested). When prevailing interest rates are above the interest rate that was used to calculate the coupon for existing bonds, the price of bonds falls. This is because existing bonds are not as attractive, as they are paying an interest rate below what the market is currently offering. The reverse is true when interest rates fall. In a declining interest rate environment, existing issues are paying an interest rate that is higher than the prevailing market interest rates. As a result, the prices of existing bonds rise when interest rates fall. Let us look at worked examples to test this principle.



Example 1: Prevailing interest rates = Coupon rates

An investor purchases a 10-year bond issued by company A. The interest rate is 10% and it pays the coupon bi annually. The investor will receive the R1 000 000 initially invested when the bond was issued (the par value). What is the price that the investor should pay for this bond if the prevailing interest rate is also 10%? Using Time Value of Money principles, the price of the bond is calculated as follows:

The cash flows occur at the end of every 6 months; hence the calculators should be in END mode:

P/YR	2 (The coupon is paid twice a year)
N	10 (This is the investment period)
I/YR	10 (Interest rate)
FV	R1 000 000(Par value)
PMT	R50 000 (Coupon every 6 months)
PV	R1 000 000 (This is the current market price)

In this example, the interest rate that is used to calculate the coupon (coupon rate) that the bond is paying, is equal to the prevailing market interest rates. The price of the bond is equal to the par value because the prevailing interest rate is equal to the coupon rate. The investor would get the same return whether he/she bought the bond or subscribed to a new issue (invested in a new bond).

We have therefore established that: **When Prevailing interest rates are equal to the coupon rate, the bond price = par value**

Example 2: Prevailing interest rates > Coupon rates

An investor purchases a 10-year bond issued by company A. The coupon rate (the interest at bond issue) is 8% and pays the coupon bi annually. The investor will receive the R1 000 000 initially invested when the bond was issued (the par value). What is the price that the investor should pay for this bond if the prevailing interest rate is 10%?

The cash flows occur at the end of every 6 months hence the calculators should be in END mode:

P/YR	2(The coupon is paid twice a year)
N	10(This is the investment period)
I/YR	10(Interest rate)
FV	R1 000 000(Par value)
PMT	R40 000(Coupon every 6 months)
PV	R964 540 (This is the current market price)

The purchase price of R964 540 is less than par value which R1 000 000. This is a discount bond that is it is trading at a discount to par value. The logic behind this is simple. The bond is paying an interest rate (coupon rate) that is less than prevailing interest rates. Its price is therefore less than the par value is not attractive to investors.

We have further established that: **When Prevailing interest rates are higher than the coupon rate, the bond price < par value**

Example 3: Prevailing interest rates < Coupon rates

An investor purchases a 10-year bond issued by company A. The coupon rate (the interest at bond issue) is 12% and pays the coupon bi annually. The investor will receive the R1 000 000 initially invested when the bond was issued (the par value). What is the price that the investor should pay for this bond if the prevailing interest rate is 10%?

The cash flows occur at the end of every 6 months hence the calculators should be in END mode:

P/YR	2(The coupon is paid twice a year)
N	10(This is the investment period)
I/YR	10(Interest rate)
FV	R1 000 000(Par value)
PMT	R60 000(Coupon every 6 months)
PV	R1 124 622(This is the current market price)

This bond is trading at a higher price of R1 124 622 compared to the par value of R1 000 000. Think of it this way: Existing bondholders are getting a coupon rate that is higher than what is available on the market. This makes the bonds more attractive and hence their price is high.

When Prevailing interest rates are lower than the coupon rate, the bond price > par value

3.2.4.1 The Concept of Yield in relation to bonds

One of the most important indicators in the bond market is the yield of a bond. It is made up of all future cash flows from the bond which are the periodic coupons during the life of the bond, income from reinvested coupons and the capital gains/loss as the market price of the bond changes. There are different forms of measuring the yield as given below:

(a) The nominal yield: is the coupon rate of the bond. In other words, it is coupon rate in relation to the par value.

(b) Current yield: The current yield is the coupon rate in relation to the current market price. Current yields will rise when the bond price falls and fall when bond prices rise.



What is the current yield if a 10-year bond with a par value of R1 000 000 has a coupon rate of 10% and the market price of the bond is R1 050 000. The coupon is payable annually.

The coupon = 10% of R1 000 000 = R100 000

The current yield = Coupon/Current market price

$$= \text{R}100\,000/\text{R}1\,050\,000$$

$$= 9.5\%$$

The current yield is less than the nominal yield (coupon rate) due to the fact that bond has risen in value in relation to the par value.

(c) Yield to Maturity: Assuming that an investor holds a bond to maturity, the yield to maturity is the interest rate that will equate all future cash flows to the current market price. The future cash flows comprise of the coupon, any income from reinvested coupons and the par value to be received at maturity as well as any capital gains/losses emanating from fluctuations in the price of the bond. Given the par value, the current bond price, the term of the bond and the coupon, an investor can calculate the yield to maturity of a bond.



A 10-year old bond has a par value of R1 000 000 and its current market value is R1 050 000. Its coupon rate is 10%. The coupon is paid bi-annually. Calculate its yield to maturity.

The cash flows occur at the end of every 6 months hence the calculators should be in END mode:

P/YR	2(The coupon is paid twice a year)
N	10(This is the investment period)
FV	R1 000 000(Par value)
PMT	R50 000(Coupon every 6 months)
PV	R1 050 000(This is the current market price)
I/YR	9.22 %(Yield to maturity)

3.2.4.2 Bond duration and convexity

We have established that the duration of a bond is its term to maturity. Bond prices are sensitive to interest rate movements. The longer the term of the bond, the greater the chance that its price will be affected by changes in the interest rates. In other words, the longer the duration of a bond, the more sensitive is its price to interest rate movements. As a result, under normal circumstances, investors will require a higher interest for investing in longer term bonds compared to shorter dated paper. Duration measure reflects a change in the bond prices given changes in interest rates. However, it does not measure the magnitude of the change in prices given different interest rate shocks.

When interest rates change, bond prices of different maturities may change at different magnitudes. The **convexity** of a bond measures the percentage change in the price of a bond given a change in interest rates.

The formula for calculating the convexity of bond is as follows:

Convexity = Percentage change in price/ Percentage change in interest rates



The price of a 10-year bond issued by Company A changes from R1 000 000 to R1 050 000 given an interest rate change from 10% to 8%. What is the convexity of the bond?

First calculate the percentage change in the Bond price: $(R1\ 050\ 000/R1\ 000\ 000) - 1 = 5\%$

$$\begin{aligned}\text{Convexity} &= \text{Percentage change in price} / \text{Percentage change in interest rates} \\ &= 5/2 \\ &= 2.5\end{aligned}$$

This means that the bond's price changes by a magnitude of 2.5 given a change in the interest rate. This bond would be riskier than a bond which for example has convexity of 2.

3.2.6 Ways of investing in bonds

The JSE provides a primary and secondary market after acquiring the bond exchange of South Africa in 2009. Investors seeking exposure to listed bonds have the following avenues:

- For government bonds specifically, an investor with a minimum of R10m can invest directly with the SARB. Private investors can invest in government bonds through **RSA retail bonds** for a minimum of R1 000 for terms ranging from 2 to 5 years. The investor should consider that RSA retail savings bonds are illiquid and the capital can only be redeemed at maturity. The bonds pay coupons at pre-determined dates. The RSA retail savings bond is also available online at <https://secure.rsaretailbonds.gov.za/>
- Collective investment schemes that invest in both government and corporate bonds are another option for the investor. The return on the investment in the collective investment scheme depends on the return of the underlying bonds held by the CIS. This option is attractive due to the liquid nature of CIS. In addition, the risk profile is lower than a direct invest in RSA retail savings bonds due to the fact that the CIS is well diversified with holdings of both corporate and government bonds. Bond CIS typically target a return of inflation plus 1 - 3%.
- Income CIS are unit trusts that have an objective of providing an income to investors through interest payments from bonds and money market instruments. They typically target a return of inflation plus 1% and have a lower risk profile compared to bond CIS due to the addition of the cash/money market component which diversifies risk.
- An investor can also access bonds through a registered dealer on the JSE.

3.6.7 The costs of investing in bonds

The cost of investing in bonds is split between explicit costs and implicit costs:

Explicit costs

These are made up of the following:

- Brokerage commission

- Mark-up, which is the difference between the price you pay for the bond the suggested selling price.
- Strate bonds depository and settlement fees (custody fees).

Implicit costs

These are costs that vary per broker for the services provided. They will include a combination of any of the following:

- **Account transfer fees:** These are costs for moving assets in or out of an existing account.
- **Account maintenance fees:** These are fees for maintaining your account.
- **Inactivity fees:** These are fees for not having any account activity over a certain period of time.
- **Minimum balance fees:** These fees are charged when you fail to maintain the required minimum balance in your account.
- **Interest on margin loans:** This is interest charged on money you borrow to buy securities.

3.3 MONEY MARKET

3.3.1 The general characteristics, terms and features of the money market

The money market is a broad definition of liquid interest-bearing investments with maturities that are less than 12 months. This includes cash (your checking account at the bank), call and notice deposits, bankers' acceptances (BAs), promissory notes and negotiable certificates of deposits (commonly known as NCDs). A characteristic that is worth noting is that money market instruments are low risk investments with a return that is usually less than longer term securities. The primary market of the money market is where the initial money market instruments are issued and the secondary market is where existing money market instruments are traded. Issuers of money market securities include the **SARB**, Public Investment Corporation, Industrial Development Corporation and listed and unlisted corporates.

3.3.2 Ways of investing in money market instruments

- An investor can access money market investments through money market linked deposits at their bank.
- Investors can access newly issued money market instruments in the primary money market and purchase existing securities in the secondary money market through market dealers.

- An alternative is for an investor to invest in a money market CIS, an income CIS that has a money market component or a multi asset CIS where money market securities are included as a building block.

3.3.3 Suitability of money market instruments

Money market investments are short term with maturities less than a year. The short-term nature of the investment reduces the risk of default. Further, they are highly liquid and actively traded on a secondary market making it less likely for an investor to carry liquidity risk.

However, there is still a probability of default, and for this reason, securities issued by non-governmental institutions have higher yields compared to government money market instruments in order to compensate the investor for the risk of default. Amongst all the asset classes available in the investment universe, money market carries the lowest risk of capital loss. However, the lower investment returns on money market instruments could expose the investor to inflation risk as the returns can be lower than the inflation rate, particularly in inflationary periods. In summary, money market instruments are ideal under the following circumstances:

- Investor requires monthly income distributions.
- The investor is highly risk-averse but seeks returns higher than bank deposits.
- An investor needs a short-term investment.

3.3.4 Types of money market instruments

(a) Treasury Bills,

Treasury bills are government issued in order to raise money for government programmes or as a way of implementing monetary policy.

91-day treasury bills have a maturity of 91 days, that is, the government through the SARB issue these to market participants and they mature in 91 days. The SARB also issues 182-day treasury bills.

Treasury bills are considered risk free as governments are not considered to carry default risk.



A government that has a huge public sector debt relative to its GDP may face increasing pressure to reduce its debt as it may become unsustainable to repay debt without resorting to extreme measures such as the printing of more money to repay its obligations. The notion of a

risk-free government debt is theoretical. A case in point in recent history is Greece which got to a point of not being able to service its own debt.

The treasury bill interest rate is the benchmark used for calculation of the return of other money market instruments and other securities, for example the risk-free rate is the benchmark for the capital asset pricing model in calculating the return on equities. The reason for this is that investors cannot expect a return on any other asset class that is less than the risk-free rate. In other words, they would need additional compensation for investing in more risky assets than the risk-free treasury bill.

Treasury bills are discount instruments, that is, they are issued at a discount and pay the full value (par value) on maturity.

i) Calculating the Purchase Price and the yield of a Treasury bill



A 91 day treasury bill with a nominal value of R1 000 000 at a discount rate of 5% would have its purchase price calculated as follows:

Step 1:

Calculate the amount discounted first

$$= \frac{\text{Face value} \times \text{term to maturity} \times \text{discount rate}}{365 \text{ Days}}$$

$$= \frac{R1\,000\,000 \times 91 \times 0.05}{365}$$

$$= R12\,467$$

Step 2:

Calculate the purchase price.

$$\text{Purchase Price} = \text{Face value} - \text{Amount Discounted}$$

$$= R1\,000\,000 - R12\,467$$

$$= R987\,533$$

The buyer of the treasury bill would pay R987 533 upfront to receive R1 000 000 in 91 days' time.

The yield (actual return received) on buying and holding this treasury bill is calculated as follows:

$$\begin{aligned} \text{Yield} &= \frac{\text{Discount amount}}{\text{Purchase amount}} \times \frac{365}{\text{Days to maturity}} \\ &= \frac{12\,467}{987\,533} \times \frac{365}{91} \\ &= 0.51 = 5.1\% \end{aligned}$$

Treasury bills are popular with investors due to their high liquidity (they can be traded with ease) and less risk of default.

(b) Bankers' Acceptances (BAs)

A bankers' acceptance is a bill of exchange that entitles the holder of the instrument to a payment of the face value at maturity day by a bank. The maturity period varies between 30 to 180 days.

BAs are sold at a discount similar to treasury bills. A holder of a BA can sell it on the secondary market at a discount, that is, receive a purchase price that is less than the face value. The buyer of the BA will receive the face value at maturity from the bank that guaranteed payment of the BA.



Prior to 2013, the SARB could issue and trade in BAs. This was however discontinued on 13 September 2013. BAs however still remain highly marketable and are used by corporates for short term financing needs.

(c) Call and notice deposits

Call deposits are interest bearing accounts with banks that can be called at any time by the depositor. The interest rate earned is a function of the amount invested and is paid monthly but calculated on a daily basis.

With a notice deposit, the investor needs to give notice of withdrawal in advance. The deposited funds earn interest based on the amount invested.

(d) Promissory Notes

- A promissory note is a written promise by the issuer to pay another party a specified sum of money at an agreed date or on demand.
- The promissory note will contain the principal amount, interest rate, maturity date, date, place of issuance and the issuer's signature.
- The promissory note is also a discount instrument and the holder at maturity is paid the face value.
- Promissory notes are an alternative way for companies to get financing from non-banking institutions.

(e) Negotiable certificates of deposits

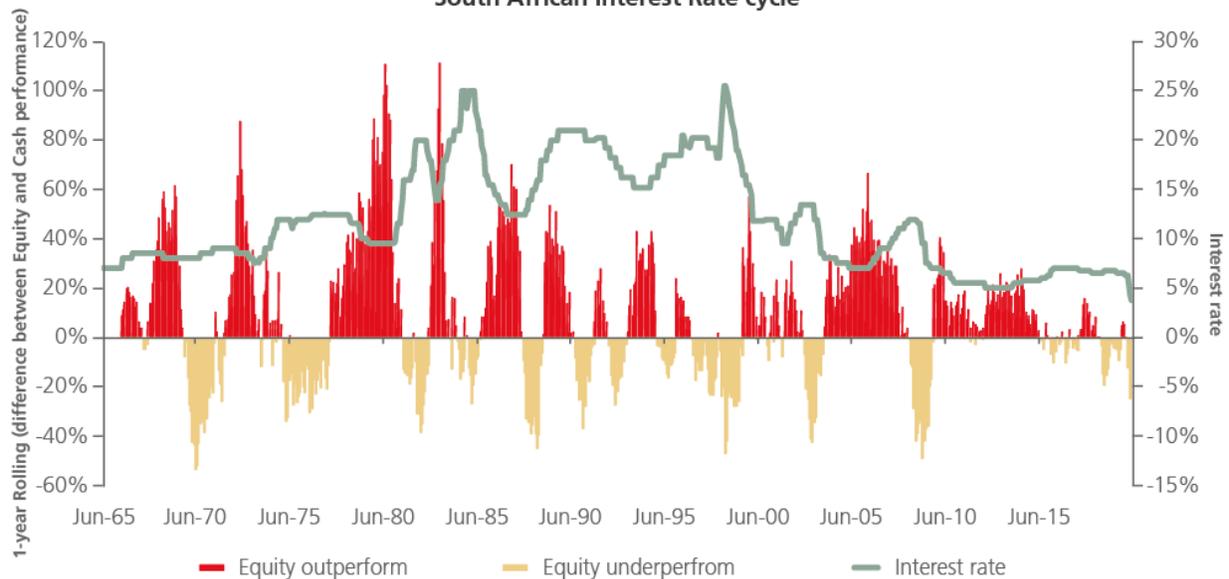
- An NCD is a receipt issued by a bank as acknowledgement that an investor has deposited funds with the bank. It offers a market related rate of return.
- Instead of holding the NCD to maturity, the holder or bearer of the NCD can sell the NCD in the secondary market.
- NCDs are highly liquid and negotiable and are a good alternative for an investor who is looking for higher yields as they offer market related returns.

3.4 Correlation of the asset classes

In a loose monetary policy, interest rates are low and borrowing by corporates and individuals is high. This translates into higher corporate earnings due to the lower cost of production (lower borrowing costs) and the higher consumer disposable income (consumers borrow more at reduced interest rates). This often results in buoyant stock markets. On the other hand, a tight monetary policy is punctuated by high interest rates resulting in lesser borrowing and reduced corporate productivity. Further, bank deposits and money market instruments would be yielding higher interest, making the equity unattractive due to perceived higher risk. This explains the low correlation between shares and money market returns over time.



Financial Market Behaviour South African Interest Rate cycle



Source: IRESS to 31.03.2020

The above graph depicts the relationship between interest rates and equity returns between 1965 and 2020. The grey line depicts the interest rate whilst the red line shows equity outperformance compared to cash investments. The gold lines show equity underperformance compared to cash. We can clearly see that when interest rates rise, such as in the 90s and in the 2008 global crisis, equity underperformed cash.

- High interest rates affect bond yields. When interest rates fall, bond prices rise and this causes bond yields to decline. This makes bonds unattractive as investors look to dividends from equities as a more attractive return. In general, equity and bond yields and money market exhibit a negative **correlation**. In other words, equity and bond prices move in tandem. Low bond yields (higher bond prices) result in higher equity prices as investors “search for yield”.
- The level of Interest rates is directly related to the quantity of mortgages advanced by banks and this has an impact on property prices. High interest rates discourage prospective property buyers from applying for mortgage financing in light of the high mortgage repayments involved. We have already established that high interest rates discourage borrowing by business and households and dampens earnings expectations. As a result, stock market and property prices are positively correlated. They generally move in the same direction in response to interest rate changes.
- The stock market is more sensitive to unexpected economic performance as it is more difficult to forecast returns as compared to money market and bond market securities. A

higher than anticipated economic performance is typically met with a rise in share prices as investors re-evaluate the future earnings of the shares of the companies that they are invested in. This often results in capital moving from the money market to the stock market.

3.5 PORTFOLIO MANAGEMENT

Portfolio management is the process of selecting, overseeing and managing a group of investments in order to fulfil a client's investment mandate. It entails the identification of opportunities in the asset classes as guided by the investment mandate, in order to maximize return at minimum risk. Before we look at portfolio management in detail, we discuss the concept of investment mandate which is the foundation upon which a portfolio management strategy is built.

3.5.1 Portfolio mandate

The portfolio mandate is the mission that the portfolio manager is instructed by the client to achieve. It clearly spells out what the objective of the portfolio is as well the strategy that must be used in order to achieve the objective. The mandate will draw parameters regarding the risk the portfolio may take and the asset classes that can be invested in. Any strategy that falls outside the investment mandate is in violation of the objective of the portfolio. The following are examples of investment mandates and illustrate the impact that these have on the assets that can be included in a portfolio.

a) Long term growth investment mandate

In this case, the client's long-term goal is capital growth with little regard for income needs. The investment manager must give priority to long term growth. A portfolio with this mandate will focus on shares in its asset allocation as this is where long term growth will be achieved. The portfolio would have short term volatility but this would not be a concern as the investment period is long enough to recover from short term negative fluctuations. Any income from dividends is automatically reinvested.

b) An income investment mandate

The primary investment goal in this case is income for the client. This is a mandate that a pensioner would typically have as the income from the investment would be used to fund living expenses. The emphasis is on income as opposed to capital growth. Assets that may form part of the portfolio will include money market instruments, shares of mature companies that have a high dividend yield, preference shares and REIT shares as these have an obligation to distribute a portion of their profits.

c) A Balanced investment mandate

This mandate entails a manager balancing capital growth with capital preservation. The aim is to generate an income but at the same time grow the capital to mitigate erosion of purchasing power by inflation. Typically, the portfolio will invest across asset classes, that is, in shares, bonds, money market and property. Regulation 28 compliant funds used for retirement planning fall within this investment mandate.

d) Flexible/speculative investment mandate

The portfolio manager is given the freedom to seek arbitrage opportunities in any asset class in order to maximize short term returns. The primary objective is not risk minimization but exploitation of mispricing of assets to make quick gains. This strategy is synonymous with high net worth individuals who can afford to take on unlimited risk as any financial loss does not have a huge bearing on net wealth.

e) Other investment mandates

Some investment mandates may limit the manager to specific factors such as:

- Geography: Some investors may want exposure to certain asset classes, for example listed shares in developed markets or emerging markets.
- Market capitalization: Mandates can limit portfolio to assets of particular sized issuers, for example small to mid-cap portfolios.
- Asset orientation stocks: An example of this is investment mandates that pursue value strategies compared to growth strategies.

3.5.2 Elements of portfolio management

In pursuing the objective of portfolio management, portfolio managers piece together the following facets:

a) Asset Allocation

This is the decision on which assets to allocate funds to. Assets move or respond to market and other factors differently. Portfolio managers make a decision on which assets to allocate funds to base on research and forecast about future factors such as macroeconomic, industry specific and company specific factors. This results in the fund being overweight in assets that are forecasted to contribute more to portfolio returns with minimal risk and underweight in those that are likely to underperform. According to William Sharpe, asset allocation is the most important driver of investment performance by mutual funds in the US whilst specific share selection accounts for only 10% of the performance. Asset allocation is broken down into three components:

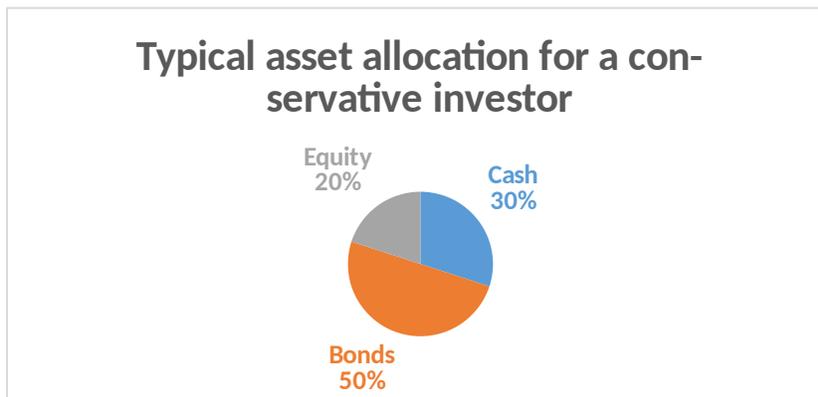
- Strategic asset allocation: This is the asset allocation decision for the long term. The portfolio manager determines the long-term mix of assets that will achieve the highest return at minimal risk taking into account the objectives of the investor.
- Dynamic asset allocation: As circumstances and macroeconomic and asset specific factors change, the portfolio manager may change the asset mix in response to the changing market conditions. This is known as dynamic asset allocation.
- Tactical asset allocation: This refers to active portfolio management strategies that seek to maximize portfolio performance after the evaluation of return possibilities across asset classes.

b) Diversification

It is a mammoth task to correctly predict the asset that will consistently outperform others within a certain asset class. As a result, diversifying the investment by investing in many assets within the same asset class will capture the returns of that specific asset class, at the same time minimizing risk. Further real diversification is achieved by investing in different asset classes. This is effective when assets that do not have a perfect positive correlation are combined in a portfolio.

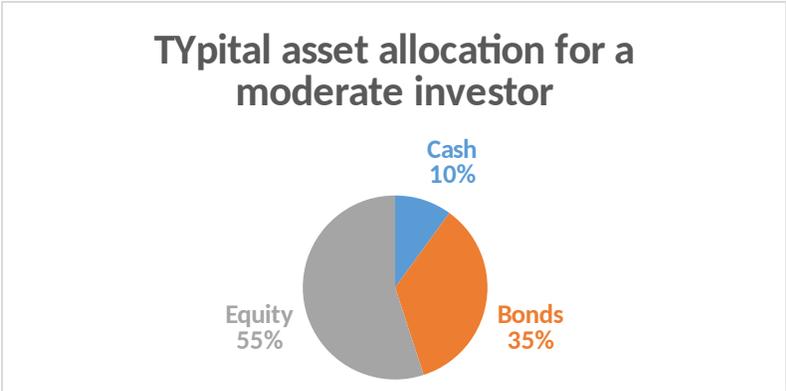
i) A typical portfolio for a conservative investor

Diversification can be used to mitigate risk in a portfolio for a conservative investor. A conservative investor's primary investment goal is capital preservation with lower emphasis on growth. As a result, the portfolio is overweight bonds and cash and underweight equity. A typical portfolio for a conservative investor would strategically allocate assets as follows:



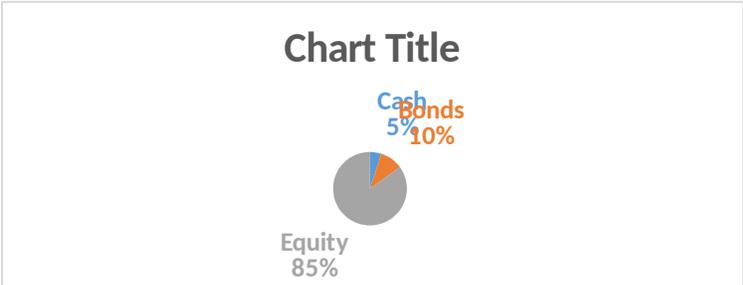
ii) A typical portfolio for a moderate investor

A moderate investment mandate entails a delicate balance between income and growth. The growth element would be catered for by the interest component of bonds and cash and dividends whilst the growth aspect would be catered for by equities and the price sensitivity of bonds. The asset allocation may look something like this:



iii) A typical portfolio for an aggressive investor

The aggressive investor is looking for growth over the long term with little regard to short term volatility. As a result, a significant portion, if not all the funds, are allocated to growth producing equities. This is reflected in the below asset allocation:



3.5.3 Rebalancing

This is the process of restoring the asset mix to the weights originally established by the strategic asset allocation decision. Over time the performance of an asset class in the portfolio can result in a portfolio being overweight than originally intended. Rebalancing entails selling the assets that have caused the misalignment (and thus realising gains) and buying assets which are undervalued until the strategic asset allocation weights are achieved.

3.5.4 Investment styles

A decision an investment manager must make is what investment style it has to use in order to generate maximum return at a given risk for investors. The following are the investment styles that asset managers pursue:

a) Active Asset management

Active fund managers are of the conviction that detailed research of the market can unearth opportunities that can be exploited to generate greater returns for their clients. In other words, they believe that the market is inefficient and available information can be used to identify undervalued assets. Due to the rigorous research employed in an active strategy, the asset manager employs a team of investment professionals who have to be remunerated for their expertise. In addition, exploiting pricing opportunities means high trading activity. The combination of these two factors makes an active management style more costly compared to a passive strategy. Active asset managers employ fundamental and technical analysis to identify investment opportunities.

b) Fundamental analysis

An analyst looks at the company's fundamentals in order to determine the intrinsic value, which is the value that the company should be priced at in light of the fundamentals. If the current price is less than the intrinsic value, this is a buying opportunity as the belief is that the share price will move to its intrinsic value in the long term. A share price that is above the intrinsic value is overpriced and should be disposed of to lock in gains. In a bottom up fundamental analysis, the analyst looks at the company's fundamentals first, which are earnings, assets and liabilities among others in order to determine the profitability prospects and intrinsic value. Bottom up analysis is based on the premise that it is the company fundamentals that matter most and not the broad economy or industry that the firm operates in. In top down approach, the analysis focuses on macroeconomic fundamentals first before narrowing the analysis to industry and firm specific factors.

c) Technical analysis

At the core of technical analysis is that all macroeconomic and firm specific factors have been priced and are reflected in the share price. What matters is an analysis of the trading price and volumes. Technical analysis entails the analysis of trading charts in order to identify opportunities when there are deviations from historical price movements. Common technical analysis strategies are simple moving averages techniques, support and resistance levels, trend lines and momentum based indicators.

The jury is still out as to whether an active strategy is worth the extra cost, as empirical evidence points out that only a few managers manage to outperform a passive investment strategy.

d) Passive Management

Proponents of the passive management strategy argue that the extra cost incurred for active asset management is not worth it, as an investor can maximize return by holding an index that tracks the performance of a basket of assets. Passive asset management does not require extensive research and as such the cost of investing is low. Investors in passive management strategies invest in index tracking funds whose performance will mirror the returns of the index being tracked. Research points out that passive management has given long term returns that are higher than active management due to the reduced cost of investment and also due to the fact that it is only a few active managers that have managed to consistently beat passive management strategies.

e) Growth investment

Growth investing focuses on investing in rapidly growing companies that are usually innovators in their field of operation. Due to the stage that they are in the product life cycle, these companies are poised for rapidly growing profits. Growth companies will typically have high earnings growth rate, high return on equity, high profit margins and low dividend yields. Growth strategies are ideal for investors with a long-term growth investment mandate.

f) Value investing

In contrast to growth strategy, a value investment style focuses on investing in mature and steady companies with a higher dividend pay-out. An additional characteristic of these companies is that the share price is at a discount to fair market value as reflected in low price to earnings ratio (P/E) and low sales to earnings ratio.

g) Small market capitalization investment strategy

Here the asset manager focuses and invests in companies with a small market capitalization (as measured by market price multiplied by the number of shares). The belief here is that small market capitalization shares are not the darling of the market and not researched extensively. As a result of this, there is less trading activity which results in mispricing. Further, there is an opportunity for small cap firms to grow over time, thus offering opportunity for greater return. However, the risk with small caps is higher as they are less resourced and there is potential for corporate governance lapses as they do not attract the best talent to lead them.

h) Large capitalization strategy

Risk averse equity market investors may take comfort in an investment style that focusses on mature blue-chip companies which have large market capitalizations. These businesses have grown over time, are tried and tested and have high dividend yields as a result of operating in mature markets. They have little risk of insolvency and will offer returns at reduced risk compared to a small market cap strategy.



INDIVIDUAL ACTIVITY

1. A shareholder with a controlling stake always needs to own more than 50% of the ordinary shares of a company. Is this statement correct? Give reasons for your answer. (2)
2. Ordinary shareholders get a share of the company profits through dividend declarations. However, this dividend is not guaranteed. What are some of the reasons why the company can fail to pay a dividend?(4)
3. An investor bought the shares of Company A at R20 two years ago. During the two-year period, the company declared dividends worth R5 in total. The share price two years later is R25. Calculate the holding period return (HPR) and the holding period yield for the investor. (4)

CHAPTER 4: ALTERNATIVE ASSET CLASSES



OUTCOMES

Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Discuss the general characteristics, terms and features of

INTRODUCTION

An alternative asset is an asset that does not fall into the conventional asset category. Real estate, derivatives and other like instruments, private equity and distressed securities,

commodities and collectibles are classified as alternative assets. Alternative assets bear the following characteristics:

- Due to the low correlation with traditional asset classes, it is believed that they add to a portfolio's risk adjusted return by providing capital growth, income generation and diversification. In other words, they enhance returns in a portfolio of traditional asset classes.
- Some alternative assets provide a hedge against inflation as their value is not eroded in inflationary times, for example commodities such as gold and real assets such as timber.
- Alternative assets serve as safe havens in times of economic crisis, for example gold. This offers capital protection for investors.
- Alternative assets are typically more complex in structure. This makes them riskier investments, particularly for novice investors.
- Caution should be applied when investing in alternative assets as they are more volatile than traditional asset classes.
- Some alternative assets are not listed, for example private equity, and as a result are less transparent, which makes them risky. Unlisted assets also carry liquidity risk which makes them risky particularly for a short-term investor.

We discuss some of these alternative investments in this section.

4.1 DERIVATIVES

A derivative is an asset whose value is derived from the value of an underlying asset. The underlying asset is most often shares or indexes of shares, bonds or bond indexes, interest rates, currencies or commodities. Derivatives are traded over the counter (OTC) or on public exchanges. The latter are more regulated than over the counter derivatives.

Derivatives are used to mitigate risk by hedging positions in an underlying asset, to make speculative gains or to provide gearing (leverage) to a portfolio. The following are the common forms of derivatives:

4.1.1 Futures

Futures are standardized contracts between two parties where one agrees to purchase and the other to sell an asset at a predetermined price at a future date. Futures are traded on exchanges and the underlying asset can range from commodities to stocks and fixed income instruments. They are primarily used to hedge price uncertainty or for speculative reasons by investors.



Let us suppose that Company XYZ uses crude oil in its production process and is worried that the price of oil may rise in a year's time. Let us suppose as well that the price of the oil is currently US\$30 per barrel. The company could hedge the risk of escalating oil prices by buying (going long) a futures contract where it will buy oil in a year's time for say US\$35. The party that shorts the contract will be under obligation to deliver the oil at the agreed price. If in a year's time the oil price goes up to US\$40 per barrel, XYZ Company would have made a profitable hedge. However, if the oil price drops to say US\$25, XYZ is still under obligation to buy the oil at US\$35 and the hedge would not have been profitable.

4.1.2 Forward contracts

Forward contracts are similar to futures contracts, with the major difference being that they are not standardized and not traded on exchanges like futures. As a result of lack oversight by exchange regulators, they carry counterparty risk where one party to the contract might fail to honour the contract.

4.1.3 Swaps

A swap is a derivative where one cash flow is exchanged for another. It is often used to hedge risk that a party to the swap is exposed to. Most common swaps are based on currency cash flows and interest-bearing instruments.



Let us suppose that Company XYZ has borrowed R1 000 000 at a floating/variable interest rate from the bank (this means that the interest rate will change as interest rates change). Suppose as well that the current variable interest rate on the loan is 5%. XYZ is concerned that interest rates may go up which would increase its interest expense. In order to hedge this risk, it enters into a swap contract with Company ABC to pay to ABC a fixed interest of 5% of R1 000 000 which is R50 000 for the term of the loan. In return, ABC would pay a variable rate based on R1 000 000.

If the interest rate goes up to 6%, XYZ would pay R50 000 to ABC and receive R60 000 from ABC to pay its debt obligation of R60 000. In this case, XYZ has effectively converted its variable interest debt to fixed interest.

4.1.4 Options

An option is an agreement between two parties which gives the buyer of the option the option to buy or sell an underlying asset on or before a predetermined future date at an agreed price (called the strike price). The buyer has the option, but is under no obligation, to meet his/her side of the contract. Because of this, the buyer pays the seller a price called the option cost.

A **put** option gives the buyer of the option the right to sell an underlying asset to the option seller at a predetermined strike price on or before a pre-determined date. The buyer of the option pays an option price to the seller at the date that the option is sold.



Let us suppose that investor A owns 1 000 shares of Company ABC. Investor A believes that the market may decline and that the shares of ABC could be below R60 at the time that he wants to sell in a year's time. He buys a put option from an option seller that gives him the option to sell the shares for R60 in a year's time at an option price of R1 000.

If the shares of ABC are valued at R50, investor A will exercise his option and sell them for R60 and make R10 per share. His gain would be R10 000 but after taking into account the option price, he would have made a net gain of R9 000.

If the shares of ABC are valued at R70 on or before the exercise date, it would not make sense to sell at the exercise price of R60. The put option holder would not exercise and the loss would be limited to R1 000 exercise price paid to the option seller.

A **call** option gives the buyer of the option the right to buy an underlying asset from the option seller at a predetermined strike price on or before a predetermined date. The buyer of the option pays an option price to the seller at the date that the option is sold. This is called a **long call option** strategy and its payoff profile is depicted below:

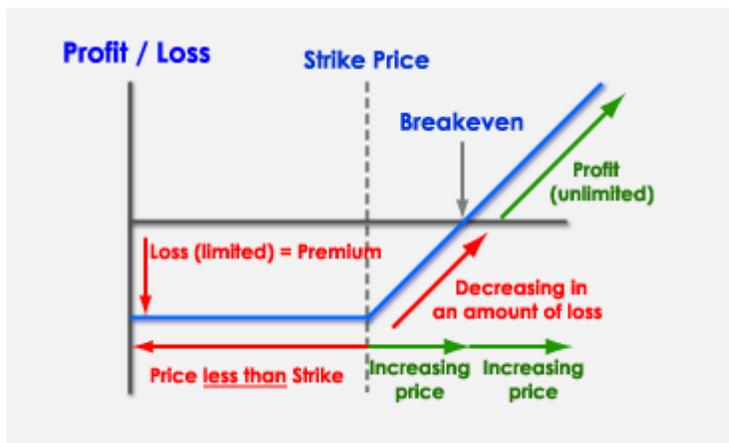


Let us suppose that investor A forecasts a bull market. He decides to buy a call option for 1 000 shares of Company ABC at an exercise price of R60 in a year's time. The option price is R1 000

If the shares of ABC are valued at R70 before expiration, investor A will exercise his option and buy them for R60 and make R10 per share. His gain would be R10 000 but after taking into account the option price, he would have made a net gain of R9 000.

If the shares of ABC are valued at R50 on or before the exercise date, it would not make sense to buy the shares at the strike price of R60. The put option would not be exercised and the loss would be limited to R1 000 exercise price paid to the option seller.

The payoff of the position is depicted in the below diagram:



The price of the asset is on the horizontal axis whilst the profit/loss is on the vertical axis. For an investor who is long on the call option (the buyer), any price that is less than the strike price will result in a loss equivalent to the option price. This is because the buyer would not exercise the option and would not recover the price paid for the option. However, as the price rises beyond the strike price, the amount of loss decreases. The investor breaks even when the price of the asset = strike price plus the option price and in the above case, R61 000(R60 000+ R1 000).

4.1.5 Warrants

A warrant is a derivative instrument that gives the buyer (holder) of the warranty the right to buy the shares of a particular company at a specific date and price. This makes it similar in nature to an option, but the main differences are as follows:

- A warrant is issued by the company that the holder of the warranty acquires the right to buy. This is not the case with options as an option is a contract between two investors.
- Warrants are typically long-term investments and can last up to 15 years whilst options are short term in nature typically structured for a term of a few months. As a result, warrants may be more ideal for long term investors given their long-term nature compared to options which are mostly used for short term speculative gains.
- Companies issue warrants in order to raise future capital whilst options are created for short term speculative gains. With options, the trade is between investors and there are

no funds that flow to the company as a result of the investors' activity. However, the company actually receives additional capital when an investor exercises their right to purchase the shares of the company.

4.1.6 Certificates

Investment securities are securitized derivatives, that is, they can be traded like listed shares. The returns on the certificate is derived from the performance of an underlying asset, for example a listed share or the performance of an index. They are issued by financial institutions that have the obligation to pay cash flows as stipulated in the investment certificate. A good example of a certificate is the bonus certificate

A typical investment certificate can include any of the following clauses:

- Directionality of the underlying asset (exposition to positive and negative movements).
- Cash flows during the life of the instrument (coupons).
- Early redemption with premium for the investor.
- Full, partial, or conditioned capital protection of the initial amount invested.
- Redemption premium at maturity.

An example of an investment certificate is the bonus certificate which has two components: the underlying asset and the second which is a barrier option with a strike price set higher than the initial level.



Let us suppose that an investor buys a bonus certificate whose underlying assets are the shares of Company A whose share price is R30. The certificate sets the bonus level at 120% of today's price (R36) and a barrier at 80 % (R24). The certificate matures in a year's time. The payoffs are as follows: If at maturity the share price is not below 80% of today's value, the investor receives a bonus of at least 130% (R36 per share). If, however, the share price is more than 80% below today's value, the investor is fully exposed to the share price movement below the barrier.

4.2 REAL ESTATE

4.2.1 The general characteristics, terms and features of property

An investment in property offers a two-fold return proposition. The property can generate **rental income** and also **capital gains** when the value of the property gains in market value. On the flip

side, the property market is sensitive to the economy and more specifically to interest rate patterns, which may see property values falling and selling of property taking longer, a scenario which would pose a **liquidity risk** to the investor. The investor has a choice of investing in residential or commercial property, either directly or through indirect investment through property collective investment schemes, buying the shares of listed property companies or **Real Investment Trusts**.

4.2.2 Ways of investing in property

(a) Direct investment in a full title property

- The investor who employs this method, gets rental income by letting out the property and capital gain over time as the value of the property appreciates. In a declining property market, there is a risk of capital loss. The factors affecting the return from property investment include its relative pricing to similar properties in the same area, the location of the property, any nearby developments in the area the property is located and availability of social amenities in the area, for example its proximity to a school or shopping mall. How secure the area is in terms of crime rate contributes to the value of the property.
- Because a property investment requires significant capital outlay, investors usually opt for mortgage financing. The advantage of mortgage finance is that interest payments may be tax deductible. The disadvantage is that the interest payments may be too high such that the rental income does not cover the cost of financing. This often is the case for floating rate mortgages in a high interest rate environment.
- The costs of investing in property directly include transfer duty, VAT, conveyancing fees, bond expenses, bank fee for assessing the property, registration fees and bond initiation fee.
- Direct property investment can be in the form of full title ownership or sectional title as well time-share ownership. The investor owns the entire property in a full title property investment. In a sectional title set up, the investor is a part owner of the property which is controlled by a body corporate. The body manages and administers the property and the investor pays a fee for this service. The time-share investment is popular among holiday makers. The ownership of the holiday accommodation is divided into 52 units (which are the number of weeks) in a year. The investor is then responsible for 1/52 of the costs of the unit. Time shares are popular as they serve as a saving on future holiday expenses.

(b) Share block schemes

In a share block investment, the investor buys the shares of a company which owns the property in which they have a right of occupying. The investor shares in the returns of the company that owns the property. As the investment is through a company, share block schemes are often financed through personal loans which attract higher rates of interest.

(c) Property syndication

In this type of property investment, investors pool funds together to purchase commercial or industrial property from the syndication management company. Units are usually priced at R10 000 and the unit has a component of a share and a loan. Typically, no investor can own more than 25% of the syndication. Net rental is paid quarterly in proportion to shareholding. Demand and supply of property syndications determines whether the investor will make a capital gain or loss when the units are sold. A major advantage of property syndications is that if properly structured, returns can be good. On the other hand, investors should be wary of the illiquid nature of property syndications. There has been notable cases of investors losing capital due to poorly structured syndications or as a result of misleading marketing by financial advisers. It should be noted that the FSCA closely monitors the advice and marketing of property syndications in order to protect investors.

(d) Lease – backs

In order to convert fixed assets to cash so as to finance operations, a company in a lease-back transaction sells its property to an investor and then leases it back (that is, pays rental based on a lease) to the investor. The company also benefits from deducting rental payments for tax purposes.

On the other hand, the investor benefits from rental income and a long-term lease that secures the income for a period among other benefits.

(e) Participation mortgage bonds

Financial institutions form a management company that pools together money from investors in order to make it available for borrowing in order to finance the purchase of property. The property bought by the borrower secures the loan. The participating bond is in turn registered as a nominee company. A set of rules accepted by the Registrar of Collective Investment Schemes (CIS) govern the running of the nominee company. Among the measures to protect investors, the CIS Act limits investment to a minimum of R1 000 and for 5 years minimum investment period and a maximum of 75% of the value of the property may be loaned.

(f) Investing through Listed property

- Listed property shares are similar to ordinary shares of any company in any sector with the major difference being that property companies invest solely in income producing property. An investor in listed property expects a return in the form of capital gains when the share price rises, as dividends. Property companies invest in diverse sectors, for example residential, industrial, office and commercial properties. There is a widely held perception that property is the most secure form of investment, but evidence on the ground points out to the risks embedded in property investment. Some Investors also point out that the Real Estate Invest Trust (REIT) legislation, which compels property companies to distribute at least 75% of profits to shareholders, reduces the risk of investing in property.
- The most obvious risk of a listed property investment is the risk of capital loss when the share price falls. Any factor that contributes to falling profit prospects, such as low occupancy rates, increasing rental defaults, slow economic growth, high interest rate environment and falling consumer disposable incomes, may cause a decline in the share price of the listed property company.

4.2.3 Valuation of property

A key component in calculating the value of a building is its capitalisation rate. It is calculated as first year operating income divided by the purchase price. The capitalization rate is used to discount future cash flows from the building to determine the present value of a property.



A residential building in Morningside is expected to generate a rental income, after costs, of R12 000 per month. Its capitalisation rate is 12% what is the property's capitalized value?
The capitalized value = $144\ 000/0.12 = R1\ 200\ 000$.

4.2.4 Suitability of listed property investment

Property investment would be desirable for investors with the following profile:

- Investors with medium to high risk tolerance.
- Investors looking for long term capital and income growth through efficient and cost-effective exposure to the listed property sector in South Africa.
- Investors with an investment horizon of at least 5 years.

- As a building block for in a multi asset portfolio.

4.3 PRIVATE EQUITY

Private equity investment funds invest in private companies that are not listed on public company stock exchanges or buy listed companies and subsequently delist them. Simply put, businesses are bought, held for a reasonably long time (typically five to seven years) and then sold again.

The funds for investment are pooled from both institutional and retail investors. Limited partners in a private equity set up own the bulk of the shares but have limited liability, whilst general partners own an insignificant portion but are tasked with the day to day running of the fund. Private equity funds typically target distressed companies that have a potential to be turned around and are typically long-term investments. The benefits of private equity are as follows:

- For investee companies, private equity may provide a more cost-effective funding model compared to bank loans or through listing.
- Private equity provides a funding opportunity to startup companies with brilliant ideas who traditionally would find it hard to access financing due to no track record.
- The returns to investors can be typically high but it also carries significant risk.

The drawbacks of private equity can make private equity a risky investment as discussed below:

- There is no ready market to buy the shares of private companies. As such it carries significant liquidity risk.
- The pricing of private equity transactions does not have the same transparency as publicly listed entities. This increases the uncertainty and risk of the investment.

4.3.1 Private Equity strategies

Private equity fund managers employ different strategies to acquire firms with potential profitability. The most common strategies are as follows:

4.3.2 Leveraged buyout (LBO)

This is one of the most popular strategy for acquiring private equity stakes. The strategy here involves the private equity firm raising funds to acquire the target through a combination of equity contributions by the private equity partners and the raising of debt by a financial sponsor. Typically, the private equity company approaches a financial sponsor to finance the acquisition of the target company and has to demonstrate that the company to be acquired can be profitable, to meet its debt obligations. The debt to equity ratio in an LBO ranges from 60% - 90%. The limited partners benefit from a non-recourse loan (no personal liability) to finance the acquisition, whilst the financial sponsor benefits if the acquired firm is profitable, as it would

have contributed the bulk of the acquisition funds. As soon as the target has been acquired, the private equity firm embarks on strategic reorganization of the acquired firm and this may include changes in the management structure, reduction of workforce and/or the sale of assets. At some point in time, the private equity firm will exit the investment when the value of the acquired company exceeds its value at acquisition. The financial sponsor would be paid off from the proceeds of the sale, with the private equity firm pocketing capital gains after all costs have been settled. An LBO can be profitable if structured properly and things go according to plan but can be risky if the turnaround strategy does not work where the leverage magnifies the losses.

4.3.3 Mezzanine financing

Small companies may not have the track record and muscle to access finance at attractive interest rates from financial institutions. One way that a company in this scenario can raise capital is through the use of mezzanine capital from a private equity firm. This term refers to a form of financing through subordinated debt or preference shares. This debt is junior to other forms of senior debt in the company's capital structure and only rank higher to ordinary shares. In return for the lower ranking of the debt, mezzanine capital debt holders will require a higher return on the debt compared to senior debt holders.

4.3.4 Growth financing

Mature companies which have a profit-making track record, may sometimes find themselves with a short-term liquidity crunch where they are not able to fund new expansions and acquisitions. Due to lack of capacity at that point in time, such companies may find it a challenge to raise debt in a cost-effective manner. A way to around this is to rope in a minority equity partner that will provide equity finance for minority shareholding in the company, as mature companies often prefer not to relinquish control of the company. The benefit to the current shareholders is a reduction in the debt to equity ratio as well as the spreading of the risk of the new venture to additional shareholders.

4.3.5 Venture capital

This is the financing of new innovative ideas by startup companies that need significant financing in order to bring their ideas to life. The financing can take place at different stages of the start up's life cycle, ranging from the launch to late stage. A start up faces the unenviable task of raising capital without a proven track record to back it up and this makes access to debt markets virtually impossible. Faced with these obstacles, the startup may rope in a venture capitalist whose required rate of return will be high, given the risk involved in investing in a start up with no proven track record. In the past few years, venture capital transactions have focused on the fast-growing industries of technology, healthcare and biotechnology.

Commodities are real assets i.e. assets that have intrinsic value. Real assets include land, property, equipment, raw materials, infrastructure, and intellectual property. The equivalent in finance to a real asset is a financial asset such as shares, bonds, futures and options. Commodities are used as an input in the production of other goods and services and basically bears the same characteristics regardless of the producer of the commodity. Examples of commodities are grain products like maize and wheat, gold, oil and natural gas. Traditional commodities are traded through derivative products such as futures and forwards and these derivatives are mainly used by producers and sellers of commodities as a hedge against uncertainty in the future prices. Speculators who have no intention at all to deliver or take delivery of the commodity are active participants in the commodity market as they seek to make speculative gains from uncertain future prices of commodities.

Commodities differ from financial assets in that:

- Commodities are investable assets but not capital assets.
- Commodities do not generate dividends, interest payments or other income.
- Commodities are valued because they can be consumed or changed into something else. Their value is determined by supply and demand.

There are a number of ways an investor can gain exposure to i.e. invest in commodities:

1. Direct physical investment

Investors can obtain exposure to commodities through a direct physical investment.

Unless the investment comprises commodities such as Krugerrand gold coins, investors would require warehouses to store the commodities, which is generally considered impractical and uneconomic. In addition, physical investment is limiting for investors seeking a broad exposure to commodities.

2. Shares of commodity producers

Investors can invest in the shares of commodity producers. However, this will expose them not only to commodities but to the financial structure, governance and management skills and practices of the company. In addition, management of the company may validly hedge its commodity production and as a result, investors will not get the full benefit of changes in commodity prices.

3. Commodity futures

Investors can purchase commodity futures contracts to simulate ownership of commodities. By periodically rolling over the futures contracts prior to their expiry date and reinvesting in new

futures contracts, investors obtain investment returns equal to the return from a single commodity or index of several commodities.

4. Commodity index funds

Commodity index funds enable investors to buy a balanced and diversified basket of commodities in a single investment.

Index funds do not have physical ownership of the underlying commodities. Instead index funds use futures contracts to buy a forward position, then sell this as it approaches expiry and use the proceeds from this sale to again buy forward by one or two months.

An investment in commodities, can provide value to the investor in the following ways:

- In inflationary periods, commodities are seen as a hedge against inflation. This is because a rise in prices generally across the economy means the rise of commodities which are used as input in the production process. Additionally, the prices of commodity producing companies usually rise in periods of inflation.
- Commodity prices typically have a negative correlation with traditional asset classes. This makes them a good tool in diversification of portfolio risk.

However, the risks of investing in commodities are very high given the fact that they are mainly traded through derivatives which introduces gearing into the investment which can result in huge losses if the anticipated market movements do not occur.



1. Match a feature of a derivative to the name of a derivative in the below table:(6)

Description	Name of derivative product
The buyer has the option but not the obligation, to sell a security on or before a specified date at a specified strike price	
The buyer has the option but not the obligation, to buy a security on or before a specified date at a specified strike price	
One cash flow is exchanged for another in order to hedge the risk that a counterparty is exposed to	

2. Which are the forms of return that an investor in a commercial property can expect? (2)
3. Mezzanine capital debt holders require a higher return on debt compared to senior debt holders. Why is this the case? (2)

CHAPTER 5: COLLECTIVE INVESTMENT SCHEMES AND OTHER INVESTMENT VEHICLES



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Distinguish between an investment vehicle and an asset class
- Discuss the investment vehicles that are at the investor disposal
- Describe the structure of different investment vehicles
- Identify the most appropriate investment vehicle for an investor given an investor's circumstances
- Highlight the benefits and disadvantages of choosing different investment vehicles

INTRODUCTION

An asset class is a range of investment securities which exhibit the same risk/return characteristics. An investor should decide which asset class or a combination of asset classes will achieve their investment objectives. This is known as **asset allocation**. Once this decision has been made, the investor has to make a decision on which vehicle to utilize in order to invest in this asset class. An **investment vehicle** is the mechanism through which an investor accesses an asset class. Another way of looking at it is that it is the container which carries the assets selected. A good asset allocation decision can be derailed by a poor choice of an investment vehicle. We look at the investment vehicles in this section.

5.1 COLLECTIVE INVESTMENT SCHEMES

A collective investment scheme is an investment that entails the pooling of funds from different investors with the same risk/return objective and investing the funds in any of the following asset classes: shares, bonds, money market, property or a combination of the different assets. Each investor is allocated units (also known as participatory interest) based on the value of the investor's investment. Each unit represents the value of the assets of the fund. In other words, the price of each unit reflects the value of the assets in the fund invested in. Collective investment schemes distribute income to investors at pre-determined dates. The income is derived from interest income and dividend declarations from securities that are in the fund. Capital gains occur when the assets in the underlying fund appreciate in value resulting in the unit prices/value increasing. Collective investment schemes are regulated by the Collective Investment Schemes Control Act of 1945(CISCA) and this act regulates collective investment schemes in securities, schemes that invest in foreign securities, participating bonds schemes and collective investment schemes in property.

5.1.1 How are Collective investment schemes classified?

In order to allow for simplicity in choosing funds, and to allow for comparison of risk/return profiles of funds and asset classes as well as generating awareness of the investment universe by the general public, one of the leading professional bodies in South Africa, ASISA, has developed a classification guideline which all its member must use. The first classification is based on where the assets that are invested in are domiciled. This is as follows:

Classification	<i>Minimum/maximum investable in South Africa</i>	<i>Minimum/Maximum investable Globally</i>	<i>Minimum/Maximum investable in Africa</i>
South African Funds	<i>Minimum 70%</i>	Maximum 25%	Maximum 5%
Worldwide Funds	No restriction	No restriction	No restriction
Global Funds	Maximum 15%	<i>Minimum 85%</i>	0%
Regional funds	Maximum 20%	<i>Minimum 80% in a specific Country</i>	<i>Minimum 80% in a specific Country</i>

The Second and third classification focuses on what the fund invests in. This is as follows:

Classification	Subcategories	Investable universe	Minimum/Maximum
Equity	General portfolios	No restrictions	No restrictions
	Large cap portfolios	Any JSE listed share with market	Minimum 80% of Net Asset Value in

		capitalization greater or equal to the smallest constituent of the JSE Top 40 index or foreign index	investable universe. 100% of share repurchases must be in investable universe.
	Mid and small cap portfolios	All shares with a market capitalization less than the smallest constituent of the JSE Top 40 or foreign index	Minimum 80% of Net Asset Value in investable universe. 100% of share repurchases must be in investable universe.
	Resource portfolios	All shares in Oil, Gas and Basic materials sectors of the JSE or similar sector of an international stock exchange (excluding gold and other precious materials)	Minimum 80% of Net Asset Value in investable universe. Maximum 10% of shares not in the investment universe.
	Financial portfolios	All shares in the Financial Sector of the JSE or similar sector of an international stock exchange	Minimum 80% of Net Asset Value in investable universe. Maximum 10% of shares not in the investment universe
	Industrial portfolios	All shares in the Industrial Sector of the JSE or similar sector of an international stock exchange	Minimum 80% of Net Asset Value in investable universe.

			Maximum 10% of shares not in the investment universe
	Unclassified portfolios	To be used where no classification of a sector can be made for example gold or technology sector	No restrictions
Multi Asset	Low equity	Shares and other asset classes	Minimum 0%/maximum 40% equity
	Medium equity	Shares and other asset classes	Minimum 0%/maximum 60% equity
	High equity	Shares and other asset classes	Minimum 0%/maximum 75% equity
	Flexible	All Asset Classes	No restrictions
	Income	All Asset classes	Minimum 0%/Maximum 10% equity
Interest Bearing	Variable term	Money market, government and corporate bonds	Unlimited modified duration
	Short term	Money market, government and corporate bonds	Maximum weighted duration of 2 years
	Money market	Money market instruments as defined in CISCA	Money market instruments only
Real Estate	General	All shares falling in the Real Sector of the JSE or similar sector of an	Minimum 80% of Net Asset Value in investable

		international exchange	stock	universe. Maximum 10% of shares not in the investment universe
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5.1.2 Collective investment schemes terminology

- Portfolio manager:** This is the investment specialist who is charged with making investment allocation decisions, security selection and portfolio trading activities to achieve the investment objectives of the fund. The fund manager is bound by the investment mandate of the fund and implements the strategy in order to fulfill the mandate.
- Portfolio Benchmark:** This is the minimum level/acceptable level of performance that the fund is required to meet. The Benchmark chosen usually has a similar risk profile to the fund. As an example, most South African interest-bearing money market funds will use the Short-Term Fixed Interest (STeFI) Benchmark. This benchmark is the Alexander Forbes Short Term Fixed Interest (STeFI) which measures the performance of money market instruments in the money market. If for example, the annual return of the money market as measured by STeFI was 7%, a performance by the fund of 7% would mean that the fund has matched its benchmark. A performance above the benchmark means outperformance and an underperformance is when the fund's return is below the benchmark.
- Units:** As already discussed, the portfolio invested in is divided into equal parts and these parts are known as Units. Each Unit reflects the value of all the underlying assets of the fund. A rise in the value of the underlying assets will result in higher Unit prices and vice versa.
- Net Asset Value (NAV):** The Net Asset Value of a fund is used to calculate the value of a Unit on a daily basis. This is done by using the day's closing values of the assets held by the fund to calculate the price of the unit. For example, the opening unit price on a Wednesday morning is calculated by calculating the value of the assets held by the fund at close of trade on Tuesday and then adjusting the Unit price to reflect this valuation.
- Management Company:** The management company is the company that launches the scheme and coordinates its functions, that is, the administration, appointment of the portfolio manager/s and trustees and marketing the fund. Examples of Management companies in the South African Industry are Allan Gray and Coronation fund managers.

- **Income Distributions:** Unit Trusts that invest in interest bearing instruments and equity receive interest and dividend payouts. The management company distributes these on pre-determined dates either annually, biannually or monthly (as in the case of money market funds). Investors have an option of having these distributions paid to them or reinvested. The Unit price before the next distribution (cum div) will be higher than after the income distribution date (ex div).
- **Fund Classes:** In addition to the classification of funds that we have already looked at, the fund names will reflect the fee structure for different forms of investors. Examples are as follows:

Fund Class	Description
R Class	Applies to funds in existence before June 1998 and no longer available to new investors
A Class	Created after April 2000 and available to new investors
B Class	For institutional and wholesale investors

- **Fees:** The following fees are incurred by investors:
 - 1 Initial fees:** This fee varies per management company. Some management companies do not charge an initial fee. Those that do charge, cover marketing and administration costs from the initial fee and this can range from 0 - 0.5% of the amount invested.
 - 2 Ongoing fund fees:** This fee is charged for the service provided by the management company and is charged against the interest and dividends received by the fund from the underlying assets. It is calculated daily, levied monthly and expressed as an annual percentage.
 - 3 Financial adviser fee:** For investors who choose to invest using the services of a financial adviser, a fee that is negotiable between the adviser and the client is payable. The adviser can charge an initial fee (up to a maximum of 3% of the initial amount invested) and/or an annual adviser fee (up to a maximum of 1% of the asset value expressed as an annual percentage but levied monthly).
 - 4 Annual Management Fee:** This fee is structured so as to incentivize the portfolio manager and the management company for meeting investment objectives. An example of an annual management fee structure can be as follows:

The annual management fee is 1% subject to the following:

For any percentage point outperformance of the benchmark, the management company adds an additional 0.2% to the annual management fee. There is no limit to the fee for outperformance.

For any percentage point underperformance of the benchmark, the management company subtracts 0.2% from the annual management fee with a minimum of 0% fee charged per any given month (that is any negative fees are carried over to the following month).



Let us use the above example of management fees on a practical scenario. Suppose that the benchmark of a general equity fund is the JSE all share (ALSI). Suppose that the monthly return in January 2020 of the general equity index was 3% and the benchmark return was also 3%. Using the management fee structure above, the annual management fee would be 1% as the fund matched the benchmark return.

If the fund gave a return of 4% and the benchmark 3%, this would mean out performance of 1%. The annual management fee would then be 1 % (for matching the benchmark) plus 20% of each percentage outperformance. In this case, the fund outperformed the index by 1% and therefore there would be an additional 0.2% added to annual management fee (20% of 1). Therefore, the annual management fee would be 1.2%.

On the other hand, if the fund gave a 2% performance figure compared to the 3% benchmark return, 20% is deducted for each percentage underperformance. The annual management fee would be 1% - 0.2% which 0.8% is.

5 Total Expense Ratio (TER): This is the annualized percentage of the fund's assets that has been used to pay the fund's expenses. The TER is already reflected in the Unit prices, that is, unit prices are published net of fees that are included in the TER. These fees are as follows:

Annual management fees

Administration costs

Custody fees

Trustee fees

Audit fees

Taxes

6 Transaction costs: These are costs related to transactions that the fund executes in its day to day operations. Included in the transaction costs are:

Brokerage fees payable to stockbrokers

Securities Transfer Tax (STT)

STRATE

Investor protection levy

VAT



TER and transaction costs combined give what is known as the Total investment charge (TIC). The TIC has already been deducted from published unit prices and returns.

Fund Objective and Benchmark: This a description of what the fund seeks to achieve in terms of returns and the risk that the fund takes on in order to meet this objective. This is capped by the description of the benchmark used to measure the fund's progress in achieving the objective.

5.1.3 The Advantages of a collective investment scheme

(a) Diversification: Collective investment schemes achieve diversification within the same asset class, across asset classes, different sectors of the economy and geographically.

Diversification reduces the risk of capital loss as the investor is exposed to assets that have different specific (unsystematic risk). Provided that the assets in the portfolio have limited positive correlation, the investor will be shielded from enduring capital losses as some assets may gain to counteract the losses that may have been incurred by some of the assets in a portfolio. In other words, investing through a collective investment scheme reduces risk that would be incurred if an investor exposed capital to a specific asset. As already discussed, the portfolio that collective investment scheme investors are invested in is split into units that represent the total value of the assets in the portfolio.



Diversification reduces risk but does not eliminate risk totally. It is the asset specific risk (unsystematic risk) that is reduced in a collective investment scheme. Systematic or market risk cannot be eliminated by diversification only as it will affect all assets that are in the market.

(b) The benefit of expert management of funds

It is a fact that not all investors are well versed with financial markets and how they operate. This information asymmetry makes it difficult for most investors to study market trends and use available information to make correct investment calls. The collective investment scheme addresses this challenge by appointing seasoned professionals who study the markets and make investment decisions on behalf of the investors subject to the fund's investment objective. This also reduces the extra transaction costs that an investor would bear in researching the market and assets.

(c) Accommodation of investors with small amounts

Most often the hindrance to an investor participating in the financial markets is the inability to raise the minimum amounts required to trade. This requirement often crowds out investors with lower amounts to invest. Collective investment schemes enable such investors to invest at lower amounts by pooling together funds from many investors. In other words, it provides access to markets for investors who do not have the financial muscle to access the financial markets directly.

(d) The benefit of sound governance

Collective investment schemes have solid governance structures that benefit investors. Trustees of the fund ensure that the fund is run with transparency and the assets of the fund kept in safe custody. The funds are also subject to audit to ensure compliance and the protection of members' interest. This added layer of governance provides investors with comfort that their funds are managed in a transparent and lawful manner.

(e) Liquidity

One of the major advantages of a collective investment scheme is the ability of the investor to buy and sell units at any time at no significant additional costs. This eliminates liquidity risk where an investor invested in one or a few assets finds it difficult to sell the assets due to the deterioration in the marketability of the assets.

5.1.4 The Disadvantages of investing in collective investment schemes

(a) Restrictions on investable universe

Collective investment schemes are limited to listed assets, that is, shares, bonds, money market, listed property shares and derivatives. An investor looking to invest in other assets such

as commodities like platinum would not be able to do so through a collective investment scheme.

(b) Higher transaction costs

Because a collective investment scheme can invest in many diverse assets, investors may incur more transaction costs due to the high turnover assets than would be possible if the investor invested directly into the market.

(c) Legislation limits

Due to legislation and classification of collective investment schemes, the fund manager or the investor may be hampered from investing in profitable investments. For example, a regulation 28 compliant fund would not be able to invest more than 30% offshore regardless of the attractiveness of the offshore market.

(d) Transparency regarding cost structures

Although there has been much improvement in the reporting of fees that investors pay, the collective investment schemes industry has been rapped for the lack of transparency of fee structures. This has led to investors incurring costs that they would not have been aware of. The move by the industry to adopt a “clean pricing” model in fee structures and the adoption of effective annual cost (EAC) is a move to address this long-standing problem in the industry.

5.1.5 The structure (elements) of a collective investment scheme

There are several main role players in a collective investment scheme set up namely the fund, the trustees, the administration company and the asset/portfolio manager. Their roles are as follows:

(a) Fund: The fund is made up of contributions by the investors and these contributions are invested in any or a combination of the different asset classes according to the fund’s objective.

(b) Trustees: The trustees are the custodian of the assets held by the fund. The trustees are independent from the fund and their role is to ensure that the investors’ funds are allocated in accordance with the trust deed which is drawn up at the inception of the fund. The fund’s assets are always held in the name of the trustees. The trustees ensure compliance by the fund to the trust deed of incorporation that spells out the objective of the fund, the measurement of performance as well as the charges that investors pay for administration and attainment of performance targets. The valuation of the assets of the fund and the manner in which the unit prices are determined are also defined in the trust deed of incorporation.

(c) Administration company/Asset Manager: This is the company that directs the day to day operations of the trust, that is, accepting new investments and executing trades in line with the mandate of the collective investment scheme. In most cases the administration company employs the investment specialists to analyze the market and assets and develop asset allocation strategies. In some cases, the management of the assets is outsourced to investments specialists that are not employed by the administration company. Third party portfolios/funds are funds where the management company has outsourced the investment expertise to an investment management company. The rationale for outsourcing is that the investment mandate of the fund may require a specialist investment manager whose unique skills fall outside the competencies of the administration company.



Let us suppose that ABC Asset Management Company is a firm that has traditionally offered collective investment scheme funds to investors seeking exposure to listed equities on the JSE. To date, all the administration and investment management has been handled by ABC's administration and investment experts. Recently the firm has identified an opportunity where it could offer investors exposure to internationally listed equities. ABC is not convinced that they have the in-house expertise to manage international equities. They therefore look for an investment firm that will make the investment decisions such as allocation strategies and asset selection. ABC would therefore launch a new collective investment scheme, targeting investors with appetite for international equities, and manage the administration of the scheme. The asset management would be done by the outsourced firm. This would be referred to as a third-party portfolio.

5.1.6 Legislation pertaining to Collective investment schemes

a) The role of the FSCA in the industry

The governing act regulating the CIS industry is the Collective Investment Schemes Control Act, 2002(Act 45 of 2002) (CISCA). The act regulates the establishment and ongoing management of collective schemes in order to safeguard investor's funds.

The FSCA is the body that regulates and ensures compliance with the act. Firstly, and foremost, any person carrying on the business of asset management (which includes collective investment schemes) must register with the FSCA as per the FAIS Act. In addition, the FSCA oversees the functions of the CIS industry in the following ways:

- Liaison with other regulatory and industry bodies such as the Association of Savings and Investment South Africa on regulatory and supervisory matters in the industry.
- Conducting inspections through the inspectorate department on CIS where irregularities are suspected to have occurred and taking remedial action.
- Imposition of penalties and legal action for breach of the CISC Act and /or FAIS Act
- Raising awareness amongst the public on the regulation of CIS.
- Registration, licensing and deregistration of collective investment schemes.
- The regulation of advice given to investors in relation to collective investment schemes.

b) The role of Industry Bodies in the Industry: The Association of Investment and Savings South Africa (ASISA)

ASISA is the main Industry body in the CIS Industry. It was borne in 2008 with the merging of four previously independent bodies in order to speak with one voice. The entities that merged to form ASISA are the Association of Collective Investments (ACI), Investment Management Association of South Africa (IMASA), the Linked Service Providers Association (LISPA) and the Life Offices Association (LOA). ASISA is a voluntary body comprising the majority of players in the CIS industry and its goal is to speak with one voice on matters pertaining to the industry in order to remain relevant and viable in the future in the interest of all stakeholders. ASISA also promotes financial literacy through its foundation in order to achieve greater financial capability and financial participation by the poor. All members of ASISA are required to abide by ASISA's Ethics and standards for the mutual benefit of the industry and clients.

5.1.7 Legislation and regulation of collective investment schemes

a) Legal Requirements that collective investment schemes should meet

For the purposes of licensing and operating, collective investment schemes need to meet requirements that have been put in place to protect the interests of the investors. The FSCA oversees and regulates compliance with the following legal requirements:

- No unit trust management company may operate without registration by the FSCA. The management company should be a public company with at least R2 000 000 in non-distributable reserves and issued share capital and in addition the management of the unit trust management company should hold at least 10% of the units of the fund. This is to protect investors from insolvency of the unit trust management company and to align the interests of management and investors.
- A maximum of 20% can be invested in a single JSE Listed share with a limit of 35% for specialist funds. This is to ensure that the unit trust fulfills one of its important objectives which is diversification.

- All net interest and dividends should be distributed in full to investors.
- The management company has an obligation to purchase units offered to it by investors for cash and in Rand currency. This is meant to guarantee liquidity for investors.
- A trust deed must be drawn up that sets up the terms of the investment as well as an FSCA appointed trustee. An additional requirement is for the trustee a capital adequacy level of at least a R1 000 000.
- The manner in which the unit trust advertises and discloses information is also spelt out. This is discussed in more detail below.

3.1.7.2 Advertisement, marketing and information disclosure requirements for collective investment schemes

Board Notice 92 of 2014 deals with the manner in which advertising, marketing and information disclosure must be lodged with the registrar and ultimately how it should be communicated to current and prospective clients. The aim of the notice is to achieve the following:

- Provide a legal framework within which managers of collective investment schemes may advertise and market their products in a manner which ensures that investors base their investment decisions on full, accurate and comprehensive information.
- Protect investors from deceptive, misleading, unfair or fraudulent conduct by managers through advertising and marketing material.
- Promote the fair treatment of investors.
- Encourage fair competition amongst managers.
- Promote the use of plain and understandable language by managers in respect of any information provided or displayed to investors.
- Ensure alignment with relevant international information disclosure standards and practices.
- Encourage investor understanding of the key features of a collective investment scheme through the manager's use of suitable disclosures for the intended target market.
- Determine the manner in which managers must lodge advertising and marketing material.

The advertising, marketing and disclosure of information requirements are split into the following parts:

- Definitions, objectives and application.
- General rules for marketing and advertising.
- Mandatory disclosure.
- Performance disclosure.
- Information disclosure.
- General provisions.

In this section, we deal with the mandatory disclosure requirements. The learner is encouraged to read further on the various sections that the Board Notice deals with.

3.1.7.3 Mandatory Disclosure requirements for collective investment schemes

(1) A manager must include the following disclosures in all marketing material:

- (a) Collective investment schemes are generally medium to long-term investments.
- (b) The value of participatory interests or the investment may go down as well as up.
- (c) Past performance is not necessarily a guide to future performance.
- (d) Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending.
- (e) A schedule of fees and charges and maximum commissions is available on request from the manager.
- (f) A detailed description of how performance fees are calculated and applied.
- (g) A statement that the manager does not provide any guarantee either with respect to the capital or the return of a portfolio.

(2) In addition to the general disclosures in sub-paragraph (1), a manager must disclose, in respect of:

(a) An exchange traded fund registered as a collective investment scheme:

- (i) That the exchange traded fund is listed on an exchange and may therefore incur additional costs.
- (ii) The difference between an exchange traded fund and other collective investment scheme portfolios.
- (iii) The index that the exchange traded fund tracks and how it will track the index.
- (iv) Where an investor can view the index and its performance as tracked by the exchange traded fund.
- (v) The tracking error of the exchange traded fund.
- (vi) Where the index tracking portfolio engages in securities lending activities, information on such securities lending activities, the percentage of securities lent out, the names of all the counterparties related to these activities as well as the risks associated with counterparty exposure.

(b) A money market portfolio:

- (i) That a money market portfolio is not a bank deposit account.
- (ii) Whether the price of a participatory interest is a marked-to-market value or targeted at a constant value.
- (iii) That the total return to the investor is made up of interest received and any gain or loss made on any particular instrument; and that in most cases the return will merely have the effect

of increasing or decreasing the daily yield, but that in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio.

(iv) How the yield is calculated.

(v) That excessive withdrawals from the portfolio may place the portfolio under liquidity pressures; and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed.

(c) A portfolio that derives its income primarily from interest-bearing instruments in accordance with section 100(2) of the Act, whether the yield is historic or current as well as the date of calculation of the yield.

(d) A fund of funds portfolio, that a fund of funds is a portfolio that invests in portfolios of collective investment schemes that levy their own charges, which could result in a higher fee structure for the fund of funds.

(e) A feeder fund, that a feeder fund is a portfolio that invests in a single portfolio of a collective investment scheme, which levies its own charges and which could result in a higher fee structure for the feeder fund.

(f) A third party-named portfolio, that the manager retains full legal responsibility for the third party-named portfolio.

(3) Where foreign securities are included in a portfolio, the manager must, before entering into a transaction to purchase foreign securities, disclose to potential investors any material risk, such as:

(a) Potential constraints on liquidity and the repatriation of funds.

(b) Macroeconomic risks.

(c) Political risks.

(d) Foreign exchange risks.

(e) Tax risks.

(f) Settlement risks.

(g) Potential limitations on the availability of market information.

5.1.8 Pricing of collective investment scheme portfolios

An important aspect of a CIS is the manner in which the units are valued. This determines the price at which units will be traded on any particular day. The first step in the pricing of a unit trust is the determination of its net asset value (NAV). The NAV of a unit trust is determined by subtracting certain charges from the assets of the fund. The charges to be subtracted from the Value of the assets are reflected in the Total investment charge (TIC). The NAV is then divided by the total number of units issued. The formula is summarized below:

Price of Unit Trust = (Values of Assets – Total investment charge)/No of Units in the fund.



Let us suppose that ABC Asset Management South African general equity CIS has assets worth R10 000 000, and the total investment charge is 1.25%. The total number of units issued is 500 000. What would be the price of the unit to a prospective investor?

The TIC can be calculated as 1.5% of R10 000 000 = R150 000

The Net Asset Value of the fund would be R10 000 000 – R150 000 = R9 850 000

The price of the Unit (NAV per unit) would then be (R9 850 000/500 000) = R19.70 The unit price will be quote in cents as 1970c per unit

The calculation of the NAV can either be done on a historic pricing or future pricing model. Under a historic pricing model, the net asset value of the fund is calculated using the closing market value of the assets of the previous trading day. This means that the prices at which the units trade on the following day are based on the closing market values of the previous day. In a future pricing model, the price at which transactions occurred during the day, is only determined at the end of the trading day. This means that the CIS calculates the closing value of assets on that particular day and applies these to transactions that occurred during the day.

5.1.9 Publishing of Collective investment schemes in financial media

Major financial newspapers publish information related to unit trusts as per closing prices of the previous day's trading. Newspapers publish unit prices per asset manager and not per category as per ASISA classification. An example of published unit trusts in the Citizen newspaper on Saturday 18 April 2020 is given below:

Full Name	Initial fee	NAV	CPU
ABSA Fund Managers (RF)Pty Ltd - Balanced R	2.3	409.08	8.7
Allan Gray Unit Trust Management (RF)Pty Ltd – Balanced A	-	9919.06	129.85

The above table can be interpreted as follows:

The first column is the full name of the collective investment scheme management company and the particular fund and fund class (gives an indication of the fee structure of the fund).

The second column is the initial fee if applicable. The initial fee is not part of the total investment charge (TIC).

The NAV column is the price of a unit in cents.

The CPU column shows the amount that has been distributed as income in the last 12 months

Money market funds will reflect an additional column reflecting the yield of the fund. This is the annualized effective yield for the fund.



Suppose an investor has R20 000 to invest in ABSA Balanced fund R that is in the above table, how many units would the investor receive?

Each unit is worth 409.08 cents which is R4.09. This would mean the investor would get $(R20\ 000/R4.09) = 4\ 889.98$ units.

If the investor invested the same amount in the Allan Gray Balanced Fund A, the number of units bought would be $(R20\ 000/R99.19)$ which would be 201.63 units.



It is important when comparing unit trusts to remember that the price of a unit does not necessarily mean that it has performed better than a unit trust with a lower price. The price of a unit trust is dependent on the number of units that the fund has been split into. For example, consider the following funds:

Fund Name	Fund Value	No of units	Unit price (NAV)
ABC Balanced fund	R20 000	10 000	R2
DEF Balanced Fund	R20 000	5 000	R4

The value of the underlying assets is the same but due to the different number of units, the NAV (prices) are different.

5.1.10 How to choose a Unit Trust as an investor

As at May 2018, there were 1261 unit trusts on offer in South Africa. Faced with such an overwhelming investment universe, how does an investor decipher which unit trust to invest in?

The ASISA classification of unit trusts is a good starting point to filter out options that will not suit the investor's profile. An understanding of the ASISA classification will give an investor an indication of the minimum and maximum percentages of an asset class that a certain category of unit trust can hold. For example, an investor who is in need of an income bearing portfolio and is risk averse, would need to limit the investment universe to the Multi Asset – Income category or the interest-bearing category. But let us suppose that the investor has determined the unit trust category that suits his/her profile, how does the investor determine the actual unit trust to invest in? Further, how does an existing investor determine if the portfolio has delivered on its mandate? The following techniques are at the investor's disposal:

(a) Comparison of the portfolio return to its benchmark

A benchmark is the measure against which the portfolio's return is measured. Most often the asset composition of the benchmark mirror the risk/return profile of the assets that the unit trust holds. As an example, most equity funds in the ASISA unit trust category: South African Equity – General, use the market value weighted average return of funds in South African Equity – General category. The fund's cumulative and annual returns over different periods versus the benchmark return will give an indication of whether the fund is delivering on its mandate. A fund can underperform its benchmark in the short-term but long-term underperformance of the benchmark requires an investigation into the causes of underperformance. Another simple measure is to compare the fund's return to inflation over different periods. An investment that perennially underperforms inflation should be a concern as the investor is losing purchasing power of the funds invested therein.

(b) An analysis of the fund's risk given its benchmark

An investor should analyze at what risk returns are being generated. It is not enough to just read into return numbers without looking at the risk underlying the investment. All things being equal, a rational investor requires the highest risk adjusted return, that is, the highest return with the lowest risk. A number of techniques can be used by the investor to gauge the risk of an investment. Most funds will publish the maximum drawdown figures, which are the highest and lowest percentage declines in the history of the fund. These give an indication of how severe the fund's returns can fluctuate. In addition, the investor can use risk adjustment techniques to measure the risk of the fund. An example is the Sharpe ratio which measures the excess risk adjusted returns of the fund. A higher Sharpe ratio is desirable, all things being equal.



Consider two funds in the South African – Equity – General category, ABC fund and XYZ fund. The following information has been collected from the fund fact sheet:

Fund Name	Annual Return since inception	Benchmark return since inception	Maximum Drawdown %	Sharpe ratio %	Standard Deviation (in percentage)	% Positive months	% Negative months
ABC	30	25	-55	5	15	30	70
XYZ	26	25	-20	10	10	60	40

An investor is looking to invest in a fund that has outperformed the benchmark but not at excessive risk. Given the profiles above, which the fund would be suitable for the investor? On the surface, fund ABC outperforms the benchmark and has delivered the highest return since inception. However, it looks like the fund takes on very significant risk compared to XYZ fund. It has realized the highest annualized decline of 55% compared to 20% for XYZ. Although past performance is not an indicator of future returns, this may be a source of worry for the investor. Further, fund ABC's history of negative monthly returns shows that the percentage of months in which returns were negative is 70% compared to 40% for XYZ. Fund XYZ deviates 15% from the average compared to 10% for XYZ (as measured by standard deviation) and the risk adjusted excess return (as measured by the Sharpe ratio) is lower at 5% compared to 10%. The investor would be able to beat the benchmark at a lower risk in fund XYZ and this fund would suit his/her objective of minimizing risk.

(c) Fee analysis

Although unit prices are reported net of fees, it is critical for the investor to interrogate the fees that are being charged as these have an impact on the return. Investors need to be wary of a TER or effective annual cost (the sum of investment management, advice, administration and other costs) that are uncharacteristically higher compared to peer funds (funds within the same category).

(d) Attribution analysis

An investor can further analyze a manager's strength by zooming in on the source or cause of a portfolio's outperformance or underperformance. An explanation of why the portfolio's performance is different from the benchmark return can be achieved by the following:

- Was the source of outperformance due to the decision to actively manage the portfolio compared to pursuing a passive investment approach? In other words, did the decision to actively manage the portfolio rather than tracking an index contribute to the performance of the portfolio?
- A second technique is to check if the performance was as a result of the manager's market anticipation, that is, correct prediction of future market movements.
- Thirdly, an analysis can be made on the manager's ability to select assets and make buy, sell, hold investment decisions as the right time. This is an analysis of the manager's asset selection. A look at the fund's top 10 holdings can provide a clue in this regard.
- The source of the portfolio's performance can also be attributed to a manager's asset selection. This analysis is very important, particularly multi asset portfolios where the manager has discretion to invest across multiple asset classes.

5.1.11 Rand cost averaging

A regular question the financial adviser will get is whether or not it is wiser to invest a lump sum, as opposed to investing a fixed regular amount or phasing in the investment over a period of time. The answer is that it all depends on the direction that markets will take. Some experts argue that it does not really matter how the money is invested in the long term. However, some argue that in periods of market declines (bear markets), a regular fixed investment results in an investor buying more units compared to a lump sum investment. This concept is known as rand cost averaging. Let us look at an example to see how this principle works.



Let us suppose that an investor has R50 000 to invest, either as a lump sum or as monthly contributions over 5 months of R10 000 each. At the date the decision is made, the unit price is R100. Let us suppose that there is a bear market (asset prices are declining, and the price of the units also decline) over the next 5 months. Let us look at the positions of two investors: Investor A invests a lump sum and Investor B invests a fixed amount of R10 000 over the next 5 months. The table below shows their position after 5 months

	Month 1 R100)	Month 2 Unit price = R95	Month 3 Unit price = R90	Month 4 Unit price= R85	Month 5 Unit price = R80	Total Units after 5 months	Total investment value at R80 per unit
Investor A (R50 000 lump sum)	500	0	0	0	0	500	R42 500.00
Investor B (R10 000 monthly)	100	105.26	111.11	117.65	125	559.02	R44 721.60

In a declining market, the fixed amount investor B benefits from averaging out the cost of the units, as the investment amount is higher than the investor who invested a lump sum.

What if there was a bull market? The scenario would be as below:

	Month 1 R100)	Month 2 Unit price = R105	Month 3 Unit price = R110	Month 4 Unit price= R115	Month 5 Unit price = R120	Total Units after 5 months	Total investment value at R120 unit price
Investor A (R50 000 lump sum)	500	0	0	0	0	500	R60 000
Investor B (R10 000 monthly)	100	95.23	90.91	86.96	83.33	456.43	R54 771.60

In a rising market, lump sum investments provide a higher return as the average cost of the units is rising over time.

In a nutshell, there is no right or wrong answer in the debate about rand cost averaging. It really depends on the forecast or prediction on the course the market is going to take.

A hedge fund is a pooled investment that shields the investors in a portfolio of assets from market volatility and at the same time generates returns in different market conditions. In South Africa, there two types of hedge funds namely the **Retail Investor Hedge Fund (RIHF)** which any investor can invest in and the **Qualified Investor Hedge Fund (QIHF)** which is designed for sophisticated investors, mainly institutional investors with considerable knowledge on financial market dynamics. The latter has less stringent regulations for investor protection as it is focused on professional investors with in depth market knowledge. Hedge funds exist to manage downside risk for portfolios and at the same time generate above average returns for investors. Additionally, the low correlation with traditional asset returns provides an opportunity to diversify risk.

5.2.1 Legislation of Hedge Funds

Because they are a pooled investment such as a collective investment scheme, hedge funds are regulated by the Collective Investment Schemes Control Act (CISCA). A hedge fund needs to register with the FSCA first before it can solicit for investments from the public. Hedge Funds, for the purposes of registration, are defined as a CIS whose strategy can lead to losses greater than its aggregate market value and these strategies encompass leverage or net short positions amongst others. The FSCA focusses regulation on hedge funds to minimize losses as there have a complex structure, carry credit counter party risk, are less transparent and less liquid in nature. As a result of this, they are a high-risk investment but have a potential of very high returns. The following are elements of hedge funds that the FSCA focusses on in terms of regulation:

- **Management of Liquidity risk:** Hedge funds have greater liquidity risk than a traditional CIS. The fund must at all times demonstrate its ability to repurchase units from investors who want to exit the investment. An RIHF is obliged to repurchase units at 30-day calendar notice and within 90 days for a QIHF.
- **Management of counterparty credit risk:** Due to the high risk of default risk, a hedge fund is restricted to 30% exposure of its market value to a counterparty for over the counter (OTC) derivatives, except if the counterparty is a bank, in which case it can have 100% exposure (this is informed by the strict capital adequacy requirements that banks have to meet).
- **Regulation on leverage:** Leveraging is defined as the use of derivatives, short positions and borrowing capital which increases exposure beyond the capital invested. QIHF have

more leeway in certain limits on the exposure they may have whilst RIHFs are limited to 200% of capital employed or 20% of value at risk where applicable (VaR).

- **Asset Class limitations:** The FSCA restricts the assets that an RIHF can invest into securities, participatory interests in other hedge funds and OTC derivatives, as long as these do not impact on the liquidity obligations of the fund. Further securities that require physical delivery of commodities, investments in physical property and private equity are not permitted. QIHFs do not have prescription on the assets that they can invest in (except that a fund of funds cannot invest in another fund of funds), but they must do so prudently with due regard to liquidity obligations.
- **Valuation of Hedge fund portfolios:** Both RIHFs and QIHFs must be valued in line with the manner in which the different assets in the portfolio are managed. The valuation must be validated by the trustee in the case of a RIHF and an independent administrator (in the absence of an appointed trustee) in the case of a QIHF.
- **Disclosure requirements:** In order to increase transparency, hedge funds are required to disclose their strategies, fees, TERs, level of leverage and asset allocation and other important information to current and potential investors to enable them to make informed decisions.

5.2.2 Hedge fund strategies

a) Long/Short directional strategy

The fund goes long(buys) the shares of a company that is predicted to outperform (Company A) and goes short on the shares of a company that is predicted to underperform (Company B) for the same value. To go short means the company enters into a contract to sell the shares of Company B at a predetermined price.



Hedge fund XYZ employs a long/short position to hedge against market uncertainty. It decides to take buy shares of Company A for R200 000 and short sells the shares of Company B for R200 000 in 3 months' time. In three months, the shares of A have gone up by 30% whilst Company B's price has gone up by 25%. Has the fund made a gain or loss in this scenario?

Solution:

The Below table summarizes the investor's position after 3 months:

Company	Position	Value at	Value after	Gain/Loss
---------	----------	----------	-------------	-----------

		inception	3 months	
A	Buys	R200 000	R260 000	R60 000
B	Short sells	R200 000	R250 000	(R50 000)
Net position				R10 000 Gain

The fund would have sold the shares of A and made R60 000 gain. It would have to sell the shares of B at R200 000 (contract price) for shares that are valued at R250 000, which would be a loss of R50 000. The net position of the fund would be a R10 000 gain.

What if there was a bear market and Company A lost 20% of its value and Company B lost 30%. Would the fund have made a loss or gain?

Below is the investor's position under in this scenario:

Company	Position	Value at inception	Value after 3 months	Gain/Loss
A	Buys	R200 000	R160 000	(R40 000)
B	Short sells	R200 000	R140 000	R60 000
Net position				R20 000 Gain



The above strategy is also called a market neutral long/short position, as the long position is fully hedged. The returns in this strategy will depend purely on the fund manager's asset selection capabilities.

In contrast, a net long position means the manager's long position is not fully hedged, that is the short position is not equivalent to the value of the long position.

b) Merger Arbitrage

This strategy entails the fund manager buying the shares of the target company and short selling the shares of the acquiring company at a ratio equivalent to the price that the acquiring company is paying to acquire the target. The shares of the target company will be trading at a different price to the post-merger price and this provides an arbitrage opportunity for the hedge fund.

c) Convertible Arbitrage

The hedge fund explores arbitrage opportunities by going long on convertible bonds that convert into ordinary shares and shorts shares of the same value. A delta neutral position is sought where the bond and stock price movements offset each other.

d) Event driven Arbitrage

An event driven strategy involves anticipating corporate events such as liquidation or insolvency of a firm and taking a position to benefit if the event occurs. A good example is for the fund to buy the senior debt of a distressed company before liquidation and hoping to get paid out in the event of liquidation.

e) Credit structure Arbitrage

In this scenario, hedge fund managers capitalize on the difference between the relative values of senior and junior debt to make arbitrage profits. Another strategy is to trade in the securities of equivalent credit quality from different issuers or different tranches of mortgage backed securities and collateralised debt obligations. Credit arbitrage pays off in narrow credit spread environments but can incur huge losses when credit spreads increase in different economic conditions.

f) Fixed income Arbitrage

Fixed income arbitrage strategies exploit price differences in the government bond yield curve. Where there is an expectation of a rise in long term interest rates (and a fall in the price of long dated bonds) for example, the hedge fund manager would short sell long term bonds and take a long position in shorter dated government bonds.

g) Short only Arbitrage

The premise of a short only strategy is that the market will always have overvalued securities and all it takes is to identify overvalued securities and short sell them and, in the process, make arbitrage profits.

5.3 LINKED PRODUCTS

Linked investment providers invest their clients' funds in CIS that they do not manage themselves. In other words, they are an intermediary between the CIS and the investor. They are categorized as follows:

5.3.1 LISP Collective investment schemes

A linked investment service provider (LISP) offers a wide range of CIS managed by other providers. The LISP is able to negotiate charges with CIS managers for the benefit of investors who use its platform. Investors are able to switch between different CIS managed by different

companies in a cost-effective manner. The LISP provides a single platform for an investor to select CIS of their choice in a cost-effective manner. However, the investor should be aware that the using a LISP adds an additional management fee that the LISP platform charges in addition to the management fee charged by the CIS. A typical LISP platform has the following fee structure:

- Initial administration fees of up to 2.84% reduced at a sliding scale as the investment amount increases. Note that some LISP platforms do not charge an initial fee.
- Initial service fees of up to 2.5% per annum.
- Annual administration fees of 0.5% per annum.
- Annual service fee of 0.5%.

In addition to **discretionary investments**, LISP platforms also offer investments in retirement linked products such as retirement annuities, living annuities, pension and provident preservation funds and living annuities.

LISPs have become popular investment vehicles due to the availability of a wide spectrum of assets to choose from, benefit of professional management of portfolio, liquidity which is guaranteed, a high degree of flexibility and transparency such as the full disclosure of costs. The major drawback is the additional layer of fees that the investor has to bear.

5.3.2 Investment trusts

Investment trusts are listed holding companies whose shares trade on the JSE. As a result, they are only available to the investor through a stockbroker. Investment trusts are regulated by the Companies Act and are closed ended funds unlike CIS which are open ended. This means that there is a limit to the number of shares that can be issued and traded. There is no guaranteed liquidity as in the case of CIS and as such there is liquidity risk for an investor as there has to be a willing buyer and seller for an investor to transact. The share price of an Investment trust does not mirror the value of underlying investments. The shares can trade at a discount or at premium in response to demand and supply dynamics. Investment trusts linked companies can raise capital through debt or by issuing additional shares. The value of the shares of the investment trust (NAV) is calculated as the value of all investments held by the trust divided by the number of shares issued.

5.3.3 Guaranteed products

A guaranteed product provides a guarantee against capital loss. The investments are for a fixed period of time ranging from three to ten years. They are ideal for investors who do not want uncertainty in relation to their returns. Guaranteed products are popular amongst investors looking for income. Typically, such an investor would be averse to market fluctuations. Most

guaranteed products are linked to an **endowment** or **sinking fund**. The investor sacrifices return as the guarantee has to be paid for. For example, some guaranteed funds, in return for the guarantee, require the investor to forgo any dividends paid during the investment period. This would impact the investor's total return, although the investor has peace of mind as the capital is guaranteed.

5.3.4 Multi – manager products

Asset managers use different styles and some are specialists in different categories, for example there are asset managers who are specialists in value investing, that is, investing in shares that are at a discount, given fundamentals, whilst some managers are specialists in specific asset classes. Different investment styles and assets perform differently under different economic scenarios. As a result, it is a challenge for an investor to pick an investment style or manager that consistently outperforms the market. The multi – manager approach overcomes this challenge by combining the managers perceived to be the best in their chosen strategy to maximize returns and reduce risk. The investor would participate in the returns of the best performers. The disadvantage is that the investor is also exposed to the performance of the poor investment style/asset class when the strategy of a chosen fund underperforms. The multi – manager (the manager who selects the different investment managers and combines them to offer the investment package to the investor) would typically follow this process:

- Analyze the market conditions and structure and establish the investment objectives of the fund.
- Identify the top performing asset managers that are forecasted to deliver superior performance given market fundamentals. In analyzing which managers to choose, the multi – manager looks at the asset manager's investment performance, investment style, and the characteristics of the asset manager's portfolio as well the investment manager's investment philosophy and investment team's cohesion.
- The multi – manager then shortlists the potential asset managers to be combined and conducts further due diligence on them, such as interviews to verify the competitive advantage and validation of performance.
- The next step is analyze which asset manager combinations would optimize performance and minimize risk under different scenarios. The multi – manager also formulates investment guidelines at this stage, and this will determine how much is allocated to each fund manager.
- The multi – manager offers the multi – manager portfolio to investors and continually monitors the performance of each individual manager and the portfolio as whole.

- The multi- manager provides ongoing reporting of the performance of the multi – managed portfolio to clients.

Proponents of a multi – manager approach to investment managers argue that combining different funds from various asset managers and offering them as a single multi – managed portfolio has the following benefits:

- It is argued that different asset managers have unique skills in different categories. If investors invested with a single asset manager, they would lose out on the skills of other asset managers who are skilled in other categories.
- It diversifies investment style risk. Market conditions change and this can negatively impact whose portfolio focusses on a particular investment style. A multi management approach would diversify the investment style risk.
- Multi – management is believed to reduce asset manager risk. Changes within an asset management company, such a key member leaving or the asset manager deviating from the investment mandate, could impact the returns of an investor. Combining the portfolios of different asset managers would minimize this risk.

Multi – management gives diversification benefits, but an added layer of fees, that are payable to the multi – manager in addition to the fees that are paid to the asset managers that manage the investments. This is the major drawback of multi – management.

The following are the different types of multi – manager products in the South African market:

(a) Multi – manager CIS

This is a collective investment scheme that invests directly in shares, bonds and cash and outsources the investment management to portfolio asset managers who are specialists in the categories that are set by the investment mandate. The investor purchases a participatory interest in the multi – manager collective investment scheme which in turn invests the funds in investment portfolios that are managed by portfolio asset managers. The scheme is regulated by the Cisca as it is a collective investment scheme.

(b) Fund of funds

A fund of funds is a collective investment scheme that invests in other collective investment schemes. It differs from the multi – manager collective investment scheme in that it invests in other collective investment schemes as opposed to the former, which invests directly in asset classes. It is regulated by Cisca and has to have a minimum of two underlying funds that it invests in.

(c) Wrap funds

A wrap fund is a collection of collective investment schemes that are bundled in a single product. The main difference with a fund of funds is that the wrap fund is not a collective investment scheme in itself and is therefore not a separate legal entity. The investors in a wrap fund own participatory interests in the collective investment schemes that the wrap fund invests in. Many wrap funds are converting to fund of funds and multi – manager collective investment schemes due to the administrative burden of tracking capital gains tax.

(d) Structured funds

This is a pooled investment where many investors own a portion of the assets that are held by the fund. It is not unitized as in the case of multi – manager collective investment schemes and fund of funds.



1. What is portfolio benchmark and what is it used for in the collective investment schemes industry? (2)
2. Diversification can eliminate unsystematic risk but cannot reduce systematic risk. True/False?
3. List 3 advantages and 3 disadvantages of collective investment schemes. (6)
4. State three uses if hedge funds in a portfolio. (3)

CHAPTER 6: RETAIL PENSION BENEFITS



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Define the different types of retail pension benefits
- Discuss the legislation regulating retail pension products
- Explain the rules regulating retail pension benefits
- Outline the tax implications at different life stages of the investor
- Discuss the rules applicable to different retail pension benefits
- Discuss the options available at different life stages for an investor in retail pension benefits

INTRODUCTION

Retirement planning is a critical component of a financial plan. A well-executed retirement plan can mean a comfortable retirement whilst a poorly executed one often results in a deterioration in the standard of living of an individual compared to pre-retirement stage. The investor can plan for retirement through **occupational retirement** funds that are set up through the employer. In other words, the investor is not investing for retirement directly but through their employer. Three types of occupational retirement funds can be set up by the employer, namely pension, provident and group retirement funds. An investor seeking to complement the occupational retirement funds by personally investing for their retirement can make use of individual funds or retail pension products, which are retirement annuities for members who desire to contribute for retirement directly, and pension and provident preservation funds for members that wish to preserve money from occupational retirement funds, for example upon resignation from employment. Our focus is on retail pension funds in this chapter.

6.1 RETIREMENT ANNUITY

Retirement annuities are regulated by the Pension Funds Act 1956 (Act 24 of 1956). A retirement annuity is defined by the income tax act as a fund that accepts contributions from members for the objective of providing an income to the member after retirement. The contributions made by the members can be in the form of direct contributions by members or transfers between other approved funds, for example the transfer of a member's fund credit from an approved pension fund to a retirement annuity or a transfer from pension preservation funds to a retirement annuity. Retirement funds have the following features:

- A retirement fund has a lock-in provision that states that a member cannot access the funds prior to reaching the age of 55, except when the fund value is below a limit determined by the Minister of Finance (currently R7 000).
- At retirement, the member can only access a maximum of 1/3 as a lump sum and the remaining 2/3 have to be invested in annuity policy that provides an income in retirement. This does not apply if the retirement benefit is below R247 500, that is, amounts below this limit can be commuted as cash. This is similar to rules of a pension fund.
- In addition, the restriction on cashing out the benefit does not apply to persons who are emigrating and who cease to be residents of South Africa, or to an expatriate who is leaving South Africa as a result of expiry of work visa.
- Prior to retirement, retirement fund benefits are regulated in their investment strategy by regulation 28 of the Pension Funds Act.
- Effective 1 March 2016, the maximum tax deduction for all retirement contributions, that is, retirement annuity, pension and provident funds contributions in a tax year, changed to 27.5% of taxable income but limited to a maximum of R350 000 in a tax year.
- Contributions made by employers will reflect as fringe benefits in the calculation of taxable income but are also tax deductible. In other words, both employee and employer contributions are tax deductible.
- Any excess contributions can be carried over to the following tax year and deducted, subject to the annual limit of R350 000.

6.2 PENSION AND PROVIDENT PRESERVATION FUNDS

Historically, there was no retirement saving option for members who left employment for one reason or another but required to preserve their benefits in a retirement product. The Taxation Laws Amendment Act 3 of 2008 established the framework for an employee leaving an occupational retirement fund to preserve their benefit outside of an employer/employee

relationship. A member leaving an occupational fund (provident and pension) before retirement has the following options:

- Cash out the entire proceeds.
- Transfer the benefit to an occupational fund of an employer.
- Transfer the full benefit to a preservation fund.
- Cash out a portion of the proceeds from the occupational fund and transfer the remainder to the preservation fund.
- The member is only allowed a single withdrawal from the preservation fund.
- The member cannot make additional contributions to the preservation fund, that is, the preservation fund only accepts the single lump sum transferred to it.

As a result, the following benefits can be transferred to a pension or provident preservation fund:

- Benefits from termination of service other than through retirement, that is, a member can transfer a benefit to a preservation fund in the event of resignation, dismissal or retrenchment.
- A benefit that arises when a business is transferred from one employer to another.
- A benefit that is payable when an occupational fund is being partially or fully wound up, that is, liquidation of fund.
- Unclaimed benefits for a period of 24 months.
- Amounts that are awarded to non-member spouses in the event of divorce.

One of the major benefits of transferring benefits to a preservation fund is that the transfer is tax free under the following circumstances:

- Transfer from a pension to a pension preservation fund.
- Transfer from a provident preservation to a pension preservation of provident preservation fund.
- Transfer from a pension preservation fund to a pension fund, provident preservation fund or retirement annuity fund.
- Transfer from a provident preservation fund to a provident fund, provident preservation fund, pension fund, pension preservation fund or retirement annuity fund.

Transfers to and from a pension preservation fund are restricted in order to prevent the splitting of a benefit into amounts that are less than R247 500, which would allow the retiree to commute the full amount thus circumventing the rules of the pension fund. As a result, transfers from a pension preservation fund are restricted to the following:

- Pension preservation to one pension fund.

- Pension preservation to one pension preservation fund.
- Pension preservation to one retirement annuity.
- Pension preservation to a combination of one pension fund and one retirement annuity.
- Pension preservation to a combination of one pension fund and one preservation fund.
- Pension preservation to a combination of one pension fund and one retirement annuity.

6.2.1 Guidelines for Investment strategy for retirement funds

Regulation 28 of the Pension Funds Act gave effect to section 36(1) (bB) of 1956. This applies to all funds issued after 1 April 2011. Any retail pension funds that existed before this date should comply with the limits when certain changes are made, such as when there is an increase in recurring contributions or changing of the payment frequency of contributions.

This provides that the Minister of Finance may make regulations relating to the following:

- Limit the amount and the extent to which a fund manager may invest in a particular asset class.
- Prescribe the basis on which the limit invested in a particular asset class will be determined.
- Define the categories of assets which this limit applies to.

Following the financial market crisis triggered by the subprime mortgage collapse in the United States in 2008, Treasury saw the need to tighten the amount of money that retirement funds could invest in one asset class, and in particular assets that are volatile during market collapses. In addition to protecting the member from risk of capital loss, the Regulation also seeks to promote economic growth by ensuring that retirement funds are channeled to achieve economic growth.

6.2.2 Application of Regulation 28

The current asset limits that a retirement fund investor can invest in as per the 2019/2020 Budget are as follows:

Asset Class	Exposure Limit
Equity	75%
Listed property	25%
Offshore Assets	30%
Hedge Funds	10%

Impact of Regulation 28 on investment decision making

We see the application of the law to enforce investment decision making through the application of Regulation 28. An investor in a retirement product has no option but to diversify in order to stay compliant. Although the legislation has diversification benefits from the spreading of assets in a retirement fund, there is some opposition to it. One of the arguments by critics is that in the pursuit of channeling retirement funds to assets that promote economic growth, the legislation is prioritizing government objectives over investment principles. They point out that the requirement to invest 75% in local equities even at times when the local bourse is overvalued results in a “buy high” scenario which detracts from investment returns. Although the above points may be valid, the protection of retirement funds through the requirement to diversify risk cannot be understated. Retirement savings form a significant portion of most individuals’ total wealth and the risk of capital loss would have life changing implications on both retirees and the government which would have to foot a higher bill in welfare support.

6.2.3 Taxation of retirement fund lump sums (retirement stage)

Upon retirement, the following options are available to the retiree:

- For a provident preservation fund, the full lump sum can be commuted. The retiree could opt to partially commute and purchase an annuity with the remainder.
- For retirement annuities and pension preservation funds, a maximum of 1/3 can be commuted and 2/3 should purchase an annuity to give an income during retirement.

Effective 1 March 2016, a lump sum from a retirement fund is taxed as a retirement lump sum in the event of attainment of retirement (including early and ill health retirement), upon death of a member or upon severance of employment. Although many of us are familiar with the tax retirement tax tables, the actual process in calculating the tax on the retirement lump sum is as follows:

- The current retirement lump sum to be received is calculated.
- Any contributions that were not allowed as a tax deduction are subtracted from the retirement lump sum.
- Previous retirement fund **withdrawal** lump sums received or accrued on or after 1 March 2009 are added to the current lump sum.
- Previous retirement lump sums received or accrued after 1 October 2007 are added to the current lump sum.
- Any severance benefits received or accrued after 1 March 2011 are added to the current lump sum.
- The amount of tax payable on the current lump sum should be reduced by the tax that would be levied on previous lump sum withdrawals after 1 March 2009, previous

retirement lump sums after 1 October 2007 and previous severance benefits after 1 March 2011 based on current tax tables.

Having followed these steps, the following tax tables would be applied as at 2019/2020 tax year:

2019/2020 retirement tax tables

Taxable income	Rate of tax
0- 500 000	0% of taxable income
500 001-700 000	18% of taxable income above 500 000
700 001-1 050 000	36 000+27% of taxable income above 700 000
1 050 001 and above	130 500+36% of taxable income above 1 050 000



John worked for Company A for 10 years before becoming self-employed in 2015. He belonged to Company A's provident fund and transferred the entire proceeds from his provident fund to a provident preservation fund. The value of his provident preservation fund is R2 000 000. Because he could not be a member of any occupational fund as he was self-employed, John contributed to a retirement annuity in his own capacity. The value of his RA is R700 000. John has decided that he will cash out the full proceeds from preservation fund and get the maximum possible cash from his retirement annuity. He is keen to know the maximum he can get from the retirement annuity as well. He also wants to know the amount that he will have after tax from the provident preservation fund. He has no previous retirement fund lump sum withdrawal benefits, retirement fund lump sum benefits and no prior severance benefits.

Solution

The tax on John's provident preservation is calculated as follows:

$$0.36(2\,000\,000 - 1\,050\,000) + 130\,500 \\ = R472\,500$$

He will receive R2 000 000 – R472 500 = **R1 527 500**

The maximum that he can get from his RA is $0.33 \times 700\,000 = R231\,000$

However, because he has already used his lifetime tax free benefit of R500 000 when he cashed out of the provident preserver, the proceeds from the retirement annuity will be taxed from the first Rand.

6.2.4 Taxation of retirement withdrawal lump sums

Members of provident preservation funds have an option to cash out before attainment of retirement age.

The steps to calculate the tax is similar to the calculation of tax on a retirement fund lump sum benefit as follows:

- The current retirement lump sum withdrawal benefit to be received is calculated.
- Any contributions that were not allowed as a tax deduction are subtracted from the retirement lump sum.
- Previous retirement fund **withdrawal** lump sums received or accrued on or after 1 March 2009 are added to the current lump sum.
- Previous retirement lump sums received or accrued after 1 October 2007 are added to the current lump sum.
- Any severance benefits received or accrued after 1 March 2011 are added to the current lump sum.
- The amount of tax payable on the current lump sum should be reduced by the tax that would be levied on previous lump sum withdrawals after 1 March 2009, previous retirement lump sums after 1 October 2007 and previous severance benefits after 1 March 2011 based on current tax tables.

The retirement fund lump sum withdrawal benefits tax table for 2019/2020 tax year is as follows:

Taxable income	Rate of tax
0-25 000	0%
25001-660 000	18% of taxable income above 25 000
660 001-990 000	114 300+27% of taxable income above 660 000
990 000 and above	203 400+36% of taxable income above 990 000



The second schedule of the income tax act requires a taxpayer receiving a retirement fund lump sum benefit to include the following in their gross income:

- For a divorced member where a divorce order was granted on or after 13 September 2007, the amount that has been granted to non-member Spouse. Where divorce order is before 13 September 2007, the amount is tax free both for the member and non-member spouse.
- Any transfer by the member to a retirement fund or retirement preservation fund.
- Any other lump sum that does not fit the criteria in the first two definitions above but that is not as a result of death, retrenchment or retirement.

The following deductions are permissible for retirement fund withdrawal benefits:

- For a retirement fund benefit that has been granted through a divorce decree, the non-member spouse can deduct any amounts transferred to a retirement fund to another retirement fund including transfers to retirement fund preservation funds (provident and pension preservation funds).
- Deductions against lump sums to be transferred are permissible for specific transfers as listed in the second schedule.
- For other lump sums, the taxpayer can deduct contributions that were not deducted in terms of section 11k, specific transfers between the different retirement funds, any previous transfers between funds that were previously taxed, any transfers from preservation funds to unclaimed benefits any tax free portion as a result of a transfer from the Government pension fund pre March 1998 tax free amount.

6.6 Options at retirement

The portion of retail pension product that is not withdrawn at retirement has to be invested in a **compulsory annuity** that provides an annuity during retirement. The retiree needs to consider longevity risk, which is the risk of outliving the capital, when making the decision. Factors such as the need for continuation of payments to a surviving spouse need to be considered. The retiree has an option to invest in a traditional/conventional annuity or a living annuity. The features of these options are discussed below:

(a) Traditional annuities

A traditional life annuity pays a guaranteed income until the death of the annuitant. The income ceases at the death of the annuitant. This presents the risk that the annuitant might die too early and forfeit the capital to the insurance company that has underwritten the annuity policy. Some annuitants may want annuity payments to be paid to surviving spouses in the vent of death. An annuity that provides for payment to the spouse after the death of the main member is called a **joint life annuity**, whilst one that ceases upon death of the main member is called a **single life annuity**. It follows that a single life annuity will pay a higher annuity, as it does not take into

account additional payments to a surviving spouse in the event of death. Further, the annuitant can choose an annuity that is level, meaning it does not increase at all, or one that increases either at a predetermined percentage or according to a reference rate, for example the inflation rate (these are termed inflation linked annuities). A level annuity is initially higher than an annuity that increases over time. An additional feature that an annuitant can opt for is a guarantee period to be built in, that is the annuitant would be guaranteed of payment for a certain period regardless of time of death, for example an annuity with a 10 year guarantee period would payout to a nominated beneficiary should the annuitant pass away before the guarantee period has expired. A traditional annuity is ideal under the following conditions:

- An annuitant requires certainty of an income for life and that the capital will never be lost.
- One requires a reasonable starting income that increases over time as a hedge against inflation.
- Where an annuitant cannot tolerate fluctuations in investment values which would affect the regular annuity. This often applies in a case where the investor has no other source of income and is solely dependent on the annuity for an income.
- When one does not want to outlive retirement savings.
- The annuitant is generally healthy and expected to have a longer lifespan after retirement.

(b) Living annuity

A retiree can consider a living annuity as an alternative. A living annuity gives the annuitant the flexibility to draw from 2.5% to 17.5% of the invested capital. This is known as the **drawdown rate** and is adjustable at every policy anniversary date. The annuitant can nominate a beneficiary to be paid any balance of the capital after death. The proceeds would be payable to the estate of the annuitant in a case where there is no nominated beneficiary. A living annuity does not guarantee an income and how long the capital lasts is a function of the investment performance and the drawdown rates. Poor investment returns and/or high drawdown ratios can result in the annuitant outliving their retirement savings. Generally, a living annuity is ideal under the following circumstances:

- An annuitant requires freedom to chart own investment strategy and needs a market-based performance of their investments.
- One is prepared to risk running out of capital. This usually is the case where one does not rely solely on the income from the retirement savings.
- One requires the flexibility to increase or reduce annuity payments as and when the need arises.

- An annuitant requires to leave the balance of their retirement savings to beneficiaries. This is very important particularly where one has dependents who would be impacted by their death.



1. What is the maximum tax-deductible amount for retirement annuities in a tax year? (2)
2. What happens if a taxpayer contributes more than the maximum deductible amount? (2)
3. A retiree has opted for a traditional annuity but is worried that he will forfeit the capital if he passes away within a few years. Which feature can be included in his annuity policy? (2)

CHAPTER 7: THE FINANCIAL PLANNING ENVIRONMENT



Learning Outcomes

By the end of this learning unit and having completed all the formative assessment activities, you should be able to:

- Explain the concept of treating customers fairly
- Outline the key benefits of compliance to legislation and regulation to an organisation
- Outline the consequences of non-compliance
- Describe the importance and ethics and explain the role of professional bodies in promoting ethics
- Outline the process of enforcing ethical standards in the financial services sector.

Introduction

In 2011, National Treasury, released a white paper titled, “A safer financial sector to serve South Africa Better.” This marked a shift from the fragmented financial regulation at the time to a more comprehensive form of regulation that would plug loopholes in an industry that still had players who were exploiting weaknesses in the system to avoid compliance with regulation. National Treasury rightly termed this behaviour “regulatory arbitrage”. This marked the shift towards the twin peaks model of financial regulation which is in line with international best standards. Twin peaks model has a two-pronged approach, that is, prudential and market conduct regulation. The prudential component falls under the auspices of the SARB. The Prudential Authority oversees the safety and soundness of banks, insurance companies and other financial institutions. The market conduct of all financial institutions now falls under the FSCA which began operating in April 2018. The FSCA has replaced the FSB. One of the key functions of the FSCA is outlined in a discussion document titled” Treating customers fairly in the financial sector: A market conduct-based policy framework for South Africa.”

7.1 Treating Customers fairly Outcomes

At the core of the new regulatory framework is Treating Customers Fairly(TCF) outcomes. The TCF model seeks to embed a client centric culture within a service provider's business processes, and any deviation from the model is punishable by the FSCA. As already discussed,

the information asymmetry that exists between service providers and clients leaves the client in a position of vulnerability. As a result, the TCF outcomes require FSPs and representatives to ensure that adequate information is disclosed through all the phases of the financial planning process. In applying TCF to business processes, service providers would have ensured that clients are treated fairly and this would result in higher confidence in the industry. The TCF outcomes that are expected at all the stages on interaction with the client in the financial planning process are as follows:

TCF Outcome 1 – Consumers can be confident that they are dealing with businesses where the fair treatment of consumers is central to business culture.

TCF Outcome 2 – Products and services marketed and distributed in the retail market are designed to meet the needs of identified customer groups and are marketed accordingly.

TCF Outcome 3 – Consumers are provided with clear information and are kept appropriately informed before, during and after point of sale.

TCF Outcome 4 – Where consumers receive advice, the advice is suitable and takes into account their circumstances.

TCF Outcome 5 - Consumers are provided with products that perform as businesses have led them to expect and the associated service is both of an acceptable standard and what they have been led to expect.

TCF Outcome 6 - Consumers do not face unreasonable post-sale barriers to changing a product, switching a provider, submitting a claim or making a complaint.

The above, when incorporated fully into the business processes of the service providers, should result in clients having greater confidence that their interests are at the core of the financial services industry.

7.2 Retail Distribution Review (RDR)

A press release by the FSB in 2014 titled, “Retail Distribution Review,” was out of the realization by the FSB that the advice and distribution models of FSPs needed to be closely aligned to the TCF outcomes. Of concern to the FSB was the increasing number of cases of unsuitable advice and lack of transparency in as far as the disclosure of fees charged by the businesses were concerned. The intended outcomes for RDR are to:

- Support the delivery of suitable products and provide fair access to suitable advice for financial customers.

- Enable customers to understand and compare the nature, value and cost of advice and other services intermediaries provide.
- Enhance standards of professionalism in financial advice and intermediary services to build consumer confidence and trust.
- Enable customers and distributors to benefit from fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of service.
- Support sustainable business models for financial advice that enable adviser businesses to viably deliver fair customer over the long term.

In order to meet the above outcomes, RDR seeks to revamp the types of services provided by intermediaries, the relationships between product suppliers and intermediaries and how intermediaries are remunerated.

The aim of RDR is to eliminate conflicts of interests that arise due to the nature of the remuneration to advisers whilst at the same time ensuring that clients are treated equitably through transparent disclosure of remuneration structures, relationship between financial planners and service providers and the costs associated with the product proposed. The client is in a better position to make an informed decision.

7.3 The benefits of compliance to an organization

As already seen, the FAIS Act requires service providers and representatives to comply with the law and in the process ensure favourable outcomes for the consumers of financial services products. It is important for service providers to be aware that compliance with the act is not only for the purposes of fulfilling the requirements, but that non - compliance presents risk in different dimensions not only to the service provider, but to the industry as a whole.

Compliance risk refers to the current or future likelihood of reputation damage or financial soundness due to non-compliance with regulation, and the expectations of stakeholders in the industry. Compliance with regulation has immense benefits mainly:

- Efficient business model that delivers value to clients.
- It embeds a culture of treating clients fairly.
- Better reputation for the service provider and the industry as a whole.
- Increased profitability in the long run.
- It boosts the morale of the organization and ultimately the performance.

7.4 Implications of non-compliance

(a) Financial implications

There are severe financial penalties for non-compliance as per section 36 of the FAIS act:

- Any person who contravenes or fails to comply with a provision of sections 7(1), 8(8),13(1),14(1),19(2) or 34(4) or 6 or in any application in terms of this act, deliberately makes a misleading, false or deceptive statement, or conceals any material fact, is guilty of an offence, and is on conviction, liable to a fine not exceeding R10 000 000 or to imprisonment for a period not exceeding 10 years, or to both such fine and imprisonment.
- It is clear from the above that non-compliance has huge financial implications for the business and these penalties could actually trigger a collapse of the business.

(b) Debarment/loss of licence

- For representatives, non-compliance may result in debarment as already discussed in the section on representatives. Debarment, whether initiated by an FSP or the FSCA, has serious ramifications, as it means that the adviser cannot give advice in the entire industry. In other words, debarment means one cannot practice in the profession for the period during which they are debarred.
- The FSCA can declare a business undesirable if the practice by the FSP has the effect of:
 - (a) Harming the relations between authorised financial services providers or any category of such providers, or any such provider, and clients or the general public.
 - (b) Unreasonably prejudicing a client.
 - (c) Deceiving any client.
 - (d) Unfairly affecting any client.

And that if the practice is allowed to continue, one or more objects of the FAIS act will, or is likely to be defeated.

- In a move that will result in closure of the business, the FSCA can revoke the licence of an FSP.

(c) Reputational Risk

The perception of the business and the financial services industry in general is vital for the continued existence of the business. Businesses should therefore be aware that compliance is not only about ticking the rules that have been complied with, but goes a long way in protecting the integrity of the industry. A business that develops a reputation of putting its own interests before the client, will realize a drop in productivity. This is more pronounced in the digital world that we live in where information is easily shared.

7.5 Ethics, the role of professional bodies and the importance of continuous professional development in the industry

Regulation of the financial services industry has become more important than ever following the global financial crisis of 2008 and numerous cases where the reputation of the industry has been harmed by unethical behaviour of representatives and FSPs. The difference between

regulation and ethics, is that the former is an external measure that is meant to dissuade and penalize behaviour that will harm the interests of the public, while ethics are defined by personal and business values that one believes in. In other words, ethics is about doing what is right. The industry could do with members that place ethics first over and above any other objective.

To be ethical is to be able to separate right from wrong and choosing right in all activities related to one's profession. In other words, ethics are the moral principles that govern a person's behaviour or the conducting of an activity. An industry that places ethics first creates an environment that is conducive for ethical individual decision making.

7.5.1 What causes unethical behaviour?

In order to set up processes and procedures that cultivate an ethical culture, businesses need to identify the factors that contribute to unethical behaviour. Once identified, these ethical loopholes can then be plugged for a better financial services industry for all. Below are the factors that can create an ethical dilemma:

a) Conflict of interest

The financial services industry has for long been criticised for some remuneration structures. The introduction of RDR is meant to curb incentive structures that encourage financial planners to prioritize short term profitability ahead of client interests.

b) Complexity of financial products

One of the outcomes of TCF is to ensure that the industry designs products that are easy to understand and designed to suit the needs of a particular group. Historically, an ethical dilemma existed as a result of products that were difficult for clients to understand and as a result the client had to rely on the information provided by the financial adviser regarding the product. Further, the remuneration for the advisers was complex to understand which resulted in clients not being fully informed at the time of purchase of the product. This created a breeding ground for unethical behaviour with non-disclosure being at the forefront.

c) Incompetency

One of the "fit and proper" requirements is competency, which comprises of qualifications, skill and experience. Although regulation has resulted in an increase in the capabilities of financial planners, ethical transgressions have been committed because of incompetency. This has resulted in clients suffering long term losses. It is encouraging to see that regulators have identified this and now require proof that a financial planner is committed to long term continuous professional development in order to remain competent.

d) Social orientation

Society, culture and beliefs can shape an individual's morals. In order to develop an ethical culture in such a person, education programmes and an ethical environment need to be in place.

7.5.2 Examples of unethical behaviour

- Fraud.
- Dishonesty.
- Non-disclosure of important information to client.
- Deliberately misleading client.
- Incorrect advice.
- Lack of diligence and professionalism.
- Violation of the FAIS code of conduct.
- Forging of documents.

7.5.3 The traits of ethical behaviour

- Trustworthiness.
- Professionalism and treating clients with integrity.
- Diligence and care for clients.
- Client confidentiality at all times.
- Full disclosure through every stage of the product lifecycle.
- Having the required knowledge, experience and skill in serving clients.

7.6 The enforcement of Ethical standards in the financial services sector

There are various enforcement efforts that are meant to curb unethical behaviour and these are:

7.6.1 The FAIS Act and subordinate Legislation

The instrument used to curb unethical behaviour in the industry is the FAIS General Code of Conduct. The code of conduct sets a benchmark for acceptable ethical behaviour and all non-adherence to the code has serious consequences to FSPs and advisers. The general duties of an FSP under the FAIS code of conduct requires that FSPs and representatives in rendering financial advice to clients should do so:

- Honestly.
- Fairly.
- With Due skill, care and diligence.
- In the interests of clients and the financial services industry.

In addition to the general requirements, the specific requirements are as follows:

(a) Client Interaction

The code of conduct outlines the required conduct when engaging with a client. The following principles should be applied in all interactions with the client:

- Every transaction or execution of a task should be in accordance to the client's instruction and should be in the client's best interests. In addition, client instructions are supposed to be executed timeously and with the client's best interests at heart.
- All information pertaining to the client is to be treated with confidentiality, except where disclosure is required according to the law.
- This section of the code of conduct prohibits insider trading and execution of client transactions to the benefit of the representative and FSP based on non-public information.

(b) Disclosures to the Client

In order to provide for clients to make informed decisions based on the information provided by the FSP or representative, full disclosure relating to the product supplier, FSP and representatives and the financial service should be made.

(i) Disclosure relating to product suppliers:

When making a recommendation to a client, the following information about the product supplier should be furnished to the client:

- The location of the product supplier as well as contact details.
- The nature of the relationship between product supplier and the FSP.
- Compliance department details of the product supplier.
- Conditions or restrictions if any of the ability of the FSP to sell the product supplier's products.
- Whether the FSP has a financial interest in the product supplier that is more than 10%.
- Whether the FSP has received more than 30% remuneration from the product supplier during the last 12 months.

(ii) Disclosure relating to FSP and its representatives:

- Full names of the business, physical location and all forms of contact details.
- The legal status of the adviser that is who bears responsibility for the actions of the adviser.
- Details of financial services the FSP is authorized to sell and any restrictions, for example whether the representative is working under supervision or not.
- Details of professional indemnity cover for the representative.

(iii) Disclosure relating to the financial service:

All the disclosures relating to the disclosure of the financial service will not be listed here as it is quite a comprehensive section. For a list of the full disclosures required, please refer to Section 7 of the FAIS code of conduct. In a nutshell, full disclosures relating to

the type of financial product, all the related charges and fees, past performance and projections including whether there are guarantees or not should be made to the client in order for the client to make an informed decision.

(c) The requirement to disclose and manage conflict of interest

The code of conduct requires FSPs and representatives to totally avoid putting themselves in a position that creates conflict of interest that could affect their ability to act in the best interests of the client. The Disclosure should be related to the following:

- Financial interest in the financial service rendered.
- Ownership interest of the FSP or representative.
- Any relationship with a third party that creates a conflict of interest.

Section 3 goes on to further list the type of financial interest, that is, remuneration that is acceptable in terms of legislation. The code further prohibits FSPs from remuneration structures that discourage representatives from rendering fair and unbiased financial service. In addition, all FSPs are required to have a conflict of interest management policy that provides rules and regulations on managing conflict of interest, including adequate disclosures where there is a potential conflict of interest.

7.7 The role of professional bodies in cultivating an ethical culture in the financial services industry

A professional body has a code of conduct that members must abide by and one of the conditions of membership is to uphold the code on ethics of the body. Membership to these professional bodies is indication of the commitment by the member to uphold the highest ethical standards in all interactions to stakeholders. There are many professional bodies in the financial services industry that play a key role in cultivating an ethical culture amongst members and this in turn has a ripple effect on the industry in general. One such body is the Financial Planning Institute (FPI). We take a look at its code of ethics and professional standards below:

7.7.1 The Financial planning institute code of ethics and practice standards

Membership of the FPI entails a member making a pledge to adhere by the FPI's code of ethics and practice standards which are built on the 8 principles. By having this requirement, the FPI is actively making ethical conduct a requirement and this has gone a long way in establishing an ethical industry. The principles of the FPI code of ethics are as follows:

- Client first principle: Members of the FPI must ensure that they place the interests of clients above all other interests.

- Integrity principle: The member should have integrity given the position of trust that clients bestows on the member. Integrity entails fairness, honesty and consistency in all professional activities.
- Objectivity principle: This principle requires mitigation or management of conflict of interest that may impair the member's judgement in providing a financial service to a client.
- Fairness Principle: Fairness entails rendering a financial service to the best of one's professional ability, timeously and in unbiased manner including disclosure of conflict of interest when one exists.
- Competence principle: This principle requires members to have the adequate knowledge and skill to execute their duties to the optimal benefit of the client. Further, the member is required to pledge to continuous professional development to ensure that their knowledge is up to date and relevant.
- Confidentiality principle: Members are required to treat clients information confidentially and only disclose information as per client instruction or as required by the law.
- Diligence principle: This principle requires member to be thorough and fully apply themselves in a timeous manner in their dealings with clients.
- Professionalism principle: Members should carry themselves in a dignified and courteous manner in their dealings with all stakeholders in order to enhance the financial planning profession's image in the public arena.

These principles of the code of ethics are supported by the practice standards which outline the steps that a financial planner should take in rendering a financial service to a client. The standards outline what is known as the 6-step financial planning process in the industry. By following the practice standards, the adviser ensures that the financial service rendered is appropriate. The steps are summarized below:

1. Client engagement.
2. Collection of client information.
3. Analysis of client's information.
4. Identify possible solutions to client's situation and develop recommendations.
5. Implementation of recommendations.
6. Ongoing review of the client's position.

Other professional bodies that play a key role in enforcing and cultivating an ethical culture in financial services in South Africa include:

- The insurance institute of South Africa <https://www.iisa.co.za/>

- The Fiduciary society of South Africa <https://www.fisa.net.za/>
- The institute of risk management South Africa <https://www.irmsa.org.za/default.aspx>

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