



## Introduction

The objective of this module is to share some underlying principles and basic rules relating to the many choices investors have to make from time to time in order to gain the maximum benefit from their investment endeavours. It will also attempt to create more understanding of the concept of risk as it applies to investment scenarios.

### ■ The three primary principles of investment

#### 1. The effect of risk and reward

~ **The first principle** ... the higher the return the greater the risk.

However, this does not necessarily mean that the higher the risk the greater the return will be.

Most of the time, many obvious high risk ventures will probably make losses.

#### **Some good rules to abide by when reviewing the risk related to providers:**

- ▶ How long have they been around?
- ▶ What does their track record look like?
- ▶ Do they have acceptable accreditation?
- ▶ How much do you know of the type of business they are involved in?
- ▶ If they offer a higher return than they would pay at a bank, why are they doing it?
- ▶ Are you satisfied that they will be able to fund it?
- ▶ How do their net assets compare with their price or market value?

**Remember ... If the return sounds too good to be true ... it probably is.**

Further on in this module we provide more information on this risk issue.

#### 2. The effect of term and compound returns

~ **The second principle** ... the magic of compound interest

Very few people really appreciate the impact of compound interest on investments.

As unlikely as it may seem there are people, even educated ones, who still think that a 20% compound return over an extended period of time is only twice as good as a 10% compound return over the same period.

If one invested R100,000 for 30 years at **10%** per annum the end value would be **R1.7m**

If one, however, invested it at **20%** per annum the end value would have been **R23.7m**

- It is not twice as good ... it is almost **14 times better**.

It is also interesting to see how concerned most investors are with the compound returns they may obtain from an investment, but they seem to ignore the devastating effect of the compound effect of costs and charges.

Just as beneficial as the effect of compound interest is destructive the effect of compound costs can be to the unwary investor. If this tyranny of costs is not understood properly, it may result in the investor having to sacrifice large portions of the potential profits that could have been made from the investments during the investment term.

Only a small 2% transaction intermediation fee charged by stock brokers or financial consultants who frequently trade with your funds in a bad scenario could result in a client sacrificing as much as up to half their profits over an extended period of time.

**It has been said that one of the differences between a billionaire and a millionaire is the fact that the billionaire understands better what difference 1% can make to the return.**

### 3. The effect of real return

~ **The third principle** ... understanding the difference between gross return and real return

One should not confuse gross return with real return that would be as inappropriate as to say that the car you bought five years ago now is worth more than what you paid for it at the time, especially if a new one now costs twice as much as it did five years ago.

The return on every investment you ever make should be assessed on the real return obtained, in other words what was left *after tax, fees or costs, inflation and any other expenses that may apply*.

Ignorance of this principle amongst property investors is probably the primary reason why so many “buy to let” property transactions turn sour.

Whilst the gross rental may be as high as 6% of the property value, research has shown that the real return is often less than 3%.

This is also the reason why money market investments often turn out to show a negative return. In other words, after several years you may discover that the actual buying power of your initial investment (capital) is actually less than it was when you made the investment.

That is probably the reason why some investment experts often refer to money market investments as capital erosion investments.

### ■ The risk levels of different investment instruments

#### ~Interpreting Risk

Risk is often a relative concept and mostly in the eyes or mind of the beholder. That is why some people will tell you that a specific asset class is very risky, whilst another will tell you with equal conviction that such an asset class has very limited risk.

Our research, during the past ten years, identified the **level of knowledge** one has of a particular investment instrument as the greatest determinant of risk allocated by investors to investment instruments. By way of example, this is also the reason why someone who knows nothing about snakes is generally much more fearful of snakes than a person who is very knowledgeable about reptiles.

In fact, any person who tells you that equity markets are too risky for investment, even over the mid to long-term almost certainly knows very little about investment opportunities in the securities markets (such as the JSE).

If it was so risky one just wonders why more than 80% of all investments are directly or indirectly invested in the stock markets.

The greatest stock market investor of all times, Warren Buffet once said that he never found it necessary to take any risks at all with any of his investments on the markets. In fact, he once said that the most risk he is prepared to take in life will be to eat a piece of blue cheese a few days after the “use by” date displayed on the wrapper.

For almost 30 years Warren Buffet has been telling people that almost all the investment risk **is in their hands** - it is not so much the asset class that determines the risk, it is how you go about it, how you select it and what you do when investing in that asset class.

Many successful stock market investors will probably tell you that investments in the so-called “safe” money markets are the most risky investments one could make, because of all the traditional investment instruments *this is the only one where you are almost guaranteed to experience capital erosion* over time.

#### **~The two most important risk elements**

- ▶ *The first element is the ability you have to identify real value*

The ultimate objective of a successful investor is to obtain a promising asset with great embedded value at a discount price well below its real value. Therefore, you must be able to analyse and identify real value or you must have access to a reliable source or facility to do it for you, such as Penny, SA Investor, Prestige or Valana.co.za.

- ▶ *The second one is the investment term involved*

To enjoy the shade of a tree it should have been planted several years ago.

Patience and time are two very common characteristic amongst all successful investors.

Most serious investors have a fairly long investment horizon. Those with much shorter time horizons are not investors as much as they are traders.

#### **Ω *If you want to get rich quickly the equity market is probably not the best place for you.***

That does not mean that good gains are not possible over short periods of time, because it actually does happen. During 2007, which was not even the best year on the markets, at least 50 listed stocks showed a yield of more than 100% during a 12-month period, and these were traditional stocks, not derivative geared instruments.

The primary reason for not utilising the stock market for quick profits is the danger of being caught in the self-destroying trap of “greed”.

Greed could also entice or tempt the unwary investor to wager large amounts of money in the very risky leveraged derivative markets or products where the unwary punter could “lose his pants before he even had a chance of saying goodbye to it”.

## ■ Investment instrument traditional risk classification

### ~Low Risk Investments

- Money Market Funds
- Fixed Deposits
- Savings Accounts
- Guaranteed Funds
- Government Bonds
- Treasury Bills

### ~Medium Risk Investments

- Endowment Policies
- Retirement Annuities
- Property Investments
- Gilt Funds
- Blue Chip Equity Stocks
- Corporate Debentures
- Special Preference Shares
- Hard Assets (Vintage Cars, Coins, Art, etc)

### ~High Risk Investments

- Futures and leveraged products (Yield Enhanced Securities, Single Stock Futures, etc)
- Options and warrants ("Call & Put" warrants/options)
- Volatile and more speculative stocks (Venture Cap or Newly Listed Small Cap Stocks)
- Forex Trading (Currency Hedging)
- Gambling and/or get rich quick "ponzi" schemes (Casinos, Pyramid Schemes, etc.)

## ■ Spreading the risk in investments

### \* *Diversification amongst asset classes*

Most investors will have the tendency to diversify their investments amongst different asset classes (asset classes are discussed in Module 1).

The asset class they move to will very much depend on their level of fear at the time. The less experience they have, the more they will tend to favour the so-called "safe" asset classes, such as the money markets, capital markets, government stock, etc.

The very astute and seasoned investors seldom take all their money off the table they just move most of it to other "pockets" on the table. That is the reason why, during a crash, they sell risky stocks and buy more defensive stocks or "safe haven" stocks.

### \* *Diversify within the same asset class*

The equity market is the only asset class where sound and effective diversity can be obtained within the same asset class. In fact, this is probably the greatest attribute of the Securities Exchange. One can apply effective diversification strategies within the JSE platform itself.

Such as:

- ♦ Sector spreads (investing in the best of different market sectors on the JSE)
- ♦ Geographical spreads (investing in dual listed stocks in other economies)
- ♦ Foreign Exchange spreads (investing in a variety of Rand Hedge stocks)
- ♦ Defensive spreads (investing in stocks with high defensive characteristics)
- ♦ Safe haven spreads (having exposure to safe haven instruments such as gold, etc)
- ♦ Taking “long” and “short” positions on selected stocks

(We deal with these concepts in more detail in Module 3)

#### \* **The risk of too much diversity**

Another mistake often made is to over-diversify, which is a bit like putting a chip on every number on a roulette wheel - *you will win something each time, but eventually over time you will end up with less than you started with.*

Never forget the risk is not so much related to the diversity in your holdings as it is related to how much embedded value you or your selection source identified before deciding on it.

#### \* **Applying the 5%-rule**

The need for diversity is usually also the reason for the 5%-rule that many portfolio analysts and investment consultants prescribe for private (retail) stock market investors.

Basically, the 5%-rule requires that one should never have more than 5% of your stock holdings in a single stock ... the conventional wisdom behind it seems to be that if that stock should be “wiped out” you will only lose up to 5% of your holdings.

One should keep in mind that if you wish to abide by the 5%-rule you will need to have at least 20 stocks in your portfolio.

Institutional investors usually apply a 2% rule in their portfolio funds, but then they probably hold much more than 20 stocks in their portfolios.

If a private investor applied this 2% rule that investor will need at least 50 stocks in their portfolio and unless it is a large portfolio (R5m plus), it is not advisable or cost effective to have so many stocks in a smaller private portfolio.

#### ■ **What does the “smart money” do?**

These investors seldom take all their money off the table for in case things should turn sour.

*They mostly do the following:*

- ▶ They “short sell” the high quality long-term stocks they wish to hold on to (this basically ensures that a neutral position is maintained in respect of these stocks).
- ▶ They do turn-around investments into more defensive stocks on the market (almost all these stocks showed a positive trend during the 2008 market crash).
- ▶ They shift at least one-third of their holdings to listed “safe haven” instruments (during the 2008 crash, the NewGold ETF, an exchange traded fund listed on the JSE, showed a positive yield of more than 20%).

- ▶ They also often utilise Gilt Investments or other Government Stock options available in the Capital Markets (this will depend on interest rate trends applicable and/or anticipated at the time).

With investments in Gilts and Bonds, capital appreciates if the interest rates go down and it does the opposite if the interest rates go up. One will therefore mostly consider this investment asset class when interest rates are expected to drop.

### **GENERAL COMMENTS**

From the above, it should be clear that the equity markets to a large extent comply with most good investment principles and are not the dangerous and risky minefields so many uninformed people often make it out to be.

In fact, the stock market is a very flexible asset class and trading platform where fairly consistent above average returns are possible if one adheres to the basic rules and principles applicable to stock market trading.

***The more you adhere to these rules and principles ... the luckier you get!***

In the next module we deal with some guidelines and hints for successful investment approaches in the stock markets.