



Core Module 7: Basic Investment Principles Learner Resource Guide

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Chapter 1

Investment Principles

Introduction

Many new investors don't understand that saving money and investing money are entirely different things. They have different purposes and play different roles in your financial strategy and your balance sheet. Making sure you are clear on this fundamental concept before you begin your journey to building wealth and finding financial independence is vital because it can save you from a lot of heartache and stress. You can still lose everything despite having a wonderful portfolios because you don't appreciate the role of cash in your portfolio.

Cash deserves respect. The goal of cash is not always to generate a return for you.

1. What Is the Definition of Saving Money?

Saving money is the process of putting cold, hard cash aside and parking it in extremely safe, and liquid (meaning they can be sold or accessed in a very short amount of time, at most a few days) securities or accounts.¹

Above all, cash reserves must be there when you reach for them; available to grab, take hold of, and deploy immediately with a minimal delay no matter what is happening around you. Many famous wealthy investors actually advocate keeping a lot of cash hidden on hand somewhere that only you know about even if it involves a major loss.²

Only after capital preservation is accounted for do you worry about secondary considerations for money you have parked in savings. Namely, keeping pace with inflation.

2. What Is the Definition of Investing Money?

Investing money is the process of using your money, or capital, to buy an asset that you think has a good probability of generating a safe and acceptable rate of return over time, making you wealthier even if it means suffering volatility, perhaps even for years. True investments are backed by some sort of margin of safety, often in the form of assets or owner earnings. As you know, the best investments tend to be so-called productive assets such as stocks, bonds, and real estate.

3. How Much Should I Save vs. Invest?

Saving money should almost always come before investing money. Think of it as the foundation upon which your financial house is built. The reason is simple. Unless you inherit a large amount of wealth, it is your savings that will provide you with the capital to feed your investments. If times get tough and you require cash, you'll likely be selling out your investments at the worst possible time. That is not a recipe for getting rich.

There are two primary types of savings programs you should include in your life. They are:

1. As a general rule, your savings should be sufficient to cover all of your personal expenses, including your mortgage, loan payments, insurance costs, utility bills, food, and clothing expenses for at least three to six months.³ That way, if you lose your job, you'll be able to have sufficient time to adjust your life without the extreme pressure that comes from living pay cheque to pay cheque.
2. Any specific purpose in your life that will require a large amount of cash in five years or less should be savings-driven, not investment-driven. The stock market in the short-run can be extremely volatile, losing more than 50% of its value in a single year.

Only after that these things are in place, and you have health insurance, should you begin investing. The only possible exception is putting money into a 401(k) plan at work if your company matches your contributions. That's because not only will you get a substantial tax break for putting money into your retirement account, but the matching funds basically represent free cash that is being handed to you on a silver tray and there are material bankruptcy protections in place for assets held within such an account should you be wiped out entirely.⁴

4. Investing Principles Fundamental to Successful Outcomes

There are *fundamental investing principles* that apply to each of us whether we are seasoned portfolio managers or a novice investor. It never hurts to take time to periodically review these important principles and improve the foundations upon which we make investment decisions.

Here are 10 investing principles fundamental to successful outcomes. Notice many of these principles are inter-linked.

4.1 10 Fundamental Investing Principles

4.1.1 Embrace an Investing Strategy

It's important to know what kind of investor you are and adhere to the principles of your investing strategies. What kind of investor are you; value, contrarian, growth at a reasonable price, growth, or momentum?

If you choose to be a value investor you are at the right place to learn more. I believe investment decisions should be valuation-based. Whichever investing strategies you choose, maintain a consistent approach. In other words, a value investor should not be participated in momentum investing.

4.1.2 Invest With a Margin of Safety

If you buy an asset for less than its real value you have a margin of safety. One of my favourite sayings is: Price Matters! The best plan to lower risk is to buy investments at a price that is lower than the real or intrinsic value.

A low price means greater upside appreciation if conditions are favourable. At the same time, a low price provides a margin of safety if circumstances are not ideal. Always plan on less than ideal conditions, something usually goes wrong.

Margin of Safety

Graham called margin of safety "the secret of sound investment" and "the central concept of investment". He also devoted a whole chapter to the concept and, I am confident, placed it last because it is the most important.

Margin of safety is, as he put it, "the thread that runs through all the preceding discussion of investment policy". They are the 3 most important words in The Intelligent Investor.

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Exponentially Higher Returns

The margin of safety for an investment is the difference between the real or fundamental value and the price you pay. The goal of the value investor is pay less (hopefully, much less) than the real value.

The greater the margin the more leeway you have for negative conditions before you lose money. On the other hand, if conditions are as you expected or better, profits are exponentially higher the greater the original margin.

Here is an example of exponentially higher returns. You have estimated the fundamental value of a stock to be R50 and you purchase it with a 20% margin of safety (R40). If your stock reaches your fundamental value you have a 25% return (R50 divided by R40). However if you purchased the stock with a 50% margin (R25), you have a 100% profit (R50 divided by R25).

Function of Margin of Safety

Almost anyone, with a little knowledge and hard work, can analyze the past. Mr. Graham demonstrates the importance of this exercise throughout *The Intelligent Investor*. However, even the best analysts are unable to consistently and accurately forecast the future.

The function of having a margin of safety is to make accurate forecasts of the future unnecessary. In other words, having a safety buffer allows for inaccurate forecasts. It gives you leeway for conditions that are less than optimum because that is usually what happens.

The Price Paid

The amount of safety is completely contingent upon the price paid. Every investment (there are few exceptions) has a price where the margin of safety would be sufficient for purchase. Determining what your purchase price is, and having the discipline to only buy at or below that price, is where the difficulty rests.

There is risk in paying too high a price for a good quality investment. However, Graham noted that investors suffer more often from buying low quality investments during times of economic stability and growth.

Investors draw incorrect conclusions about the earnings and viability of a company because of a few good years. A true safety buffer requires making sufficient allowances for economic cycles and the possibility the company is not on a permanent upswing.

In addition, Graham recognized a similar folly with buying growth stocks. Investors seem to project future earnings of growth companies at rates far above average and place a high multiple (premium price) on these stocks. This leaves little room for error or changes of conditions. Growth stocks should only be bought when the price provides a margin of safety based on conservative projections.

Almost any investment has a price point at which the margin of safety is sufficient for purchase. However, these investments are usually unpopular and out of favor with market. The key is to require a safety buffer that is large enough to prevail against adverse conditions.

4.1.4 Diversification

Diversification is a key companion of safety. Diversification is the margin of safety for your portfolio as a whole.

First, we have put the odds heavily in our favor by requiring a margin of safety on each individual investment. However, regardless of how well we have done, some will fail to live up to our expectations. Having a safety buffer improves our probability, but some investments will still be losses.

The idea of diversification is that the combined gains will be much higher than the losses. The more opportunities we find that meet our safety requirement, the greater the probability that the portfolio will have above average gains. Therefore diversification is an important part of intelligent investing.

4.3. Asset Allocation is #1

Your asset allocation, how you divide your portfolio among different asset categories, will be the biggest determinant of your investment returns. I find this is where many investors fail because they put little thought or effort into their asset allocation strategy.

If you place your money into overvalued asset categories you will experience poor long term returns. It's important to overweight asset categories that are bargain priced and underweight or avoid asset categories that are expensive.

4.3.1 Asset Allocation Categories & Guidance



Asset Allocation is where investors make their biggest investing mistakes. How you choose to divide your portfolio on a percentage basis is crucial to determining returns and portfolio risk.

4.3.2 What is Asset Allocation?

Asset Allocation is dividing an investment portfolio on a percentage basis among different asset categories. The concept of asset allocation is to combine investments whose asset correlation is low or negative. The idea is that when some asset categories are decreasing, others will be increasing.

By combining different assets with low or negative correlations, the volatility of the portfolio as a whole is lowered. Proper asset allocation can lower risk and increase returns at the same time. This makes asset allocation the highest priority in portfolio risk management.

4.3.3 Why Divide Your Assets?

“A diversified portfolio of investments, each of which is unlikely to produce significant loss, is a good start toward investment success.” Howard Marks

“Divide your portion to seven, or even eight, for you do not know what misfortune may occur on earth”. Ecclesiastes 11:2

One of the best approaches to lowering risk is to own a variety of assets. In other words, divide your assets among different asset categories. Owning a variety of assets, especially non-correlated assets, lowers portfolio volatility. This is why asset allocation is so important. When one or two asset categories are performing poorly, you may have one or two that are doing well. The idea is to have a portfolio of assets that minimize risk and maximize opportunities for positive returns.

You know the saying “There is no free ride”? There are exceptions. Proper asset allocation and diversification provide benefits that can be harvested with little or no cost.

Many investors spend considerable time picking individual stocks but put little or no effort into thinking about how each holding affects the portfolio as a whole. Each individual investment should play a complementary role in the total portfolio.

Additional Reading: Investment Diversification Definition & Purpose

“Understanding and anticipating the power of correlation — and thus the limitations of diversification — is a principal aspect of risk control and portfolio management.” Howard Marks

4.3.4 Asset Categories

There are an unlimited number of different approaches to asset allocation. In the interest of simplicity I’m going to divide a global investment universe into 7 asset categories. Each of these categories would have sub-categories.

- **Fixed Income**

Fixed income examples include Certificates of Deposit (CD’s), S.A. Treasury Bonds, Notes, and Bills; Treasury Inflation Protected Securities (TIPS), Corporate Bonds, and Foreign Bonds. Historically Bonds have had a low correlation with other major asset categories.

- **Domestic Stocks (Large, Mid-Cap, Small-Cap, and Micro-Cap)**

Owning S.A. Stocks is an important asset category for obvious reasons. However, many S.A. residents have too large an allocation. If you aren’t invested in other asset categories (i.e. international stocks) you are missing out on opportunities and not taking advantage of the “free ride” diversification provides.

- **Foreign Developed Markets Stocks**

The value of including foreign stocks is a greater universe of choices and increased diversification. Other regions and countries have different cycles. Their unique problems and opportunities create a wider variety of choices.

- **Emerging & Frontier Markets**

The last couple of decades emerging and frontier economies have gravitated towards free market economics. In general, this has tilted investment capital toward these markets; increasing both the opportunities and their volatility. This is the perfect asset category for ETFs.

- **Commodities & Precious Metals**

Commodities & Precious Metals have the advantage of low and sometimes even negative correlations with other investments. They also can be very volatile, providing opportunities and risks.

- **Real Estate**

Depending on the size of your portfolio, many investors who own real estate directly, including your home, may want to ignore this in their investment securities portfolio. The concept of owning different assets is diversification; and for many investors the real estate they own would be more than sufficient diversification. If not, Real Estate Investment Trusts (REITS) and ETFs are readily available.

- **Cash and Cash Equivalents**

Cash provides an asset category with a zero correlation to most assets and provides preservation of capital in bear markets. The zero correlation makes cash an important asset allocation category even during periods of low interest rates. In fact, it may be the most underrated and beneficial asset category in the current environment.

4.3.4 Asset Allocation Guidance

The importance of asset allocation can't be ignored. Obviously there is not just one correct approach. Your asset allocation model might be very different from my example.

The goal is to implement asset allocation strategies that lower your overall portfolio volatility. While it may be more fun to pick individual investments, your asset allocation decisions will have the largest effect on your long term returns.

4.3.5 Guidance for your asset allocation plan

- **Have Patience and a Long Term Horizon**

In our fast paced world, with internet trading and instant gratification, it is popular to look for quick returns through schemes and strategies that carry undue risk. Benjamin Graham and Warren Buffett have taught the virtue of patience and the willingness to hold investments for long periods of time.

The markets will not always recognize the value in an investment immediately after your purchase. Sometimes patience, time, and a longer term horizon are required before your investment is ready to harvest.

- **Take Advantage of Mis-priced Markets**

Graham used the parable of Mr. Market to illustrate the fact that investments are often mis-priced, sometimes overvalued, and other times undervalued. It makes sense to capitalize on mis-priced investments in order to increase your probability of making a profitable investment.

Valuation Analysis is the discipline of weighting your asset allocation based on valuation. Asset categories which are expensive should be avoided or underweighted, and categories that are bargains may deserve an overweighting.

- **Require a Margin of Safety**

The core concept of margin of safety is: price matters! The lower the price you pay, compared to the real value of the investment, the greater the probability that your investment will be profitable.

Purchasing investments at a deep discount reduces the risk of owning that asset. The margin of safety allows for problems, mistakes, or unforeseen disasters. Negative surprises may have less impact on an asset that is already priced low.

At the same time there is more upside to investments bought at a large discount to its real or intrinsic value. As time passes, eventually the market should realize the true value of the investment, and provide a sales price closer to that value. The larger the margin of safety the higher your probability of above average returns.

- **Rebalance Your Portfolio (Often)**

Portfolio rebalancing is a risk management strategy in which you buy or sell investments to achieve your desired asset allocation percentage. As asset prices increase or decrease the total value will depart from your desired asset allocation target.

Portfolio rebalancing helps an investor to buy low and sell high. This is because the strategy involves achieving your target asset allocation by selling a portion of the assets that have risen in price and buying more of the assets that have fallen in price.

- **Preserve Your Capital**

Preservation of Capital should be an investors highest priority. Warren Buffett famously said “Rule # 1: Never Lose Money; Rule # 2: Never forget Rule #1.”

Related Reading: Portfolio Risk Control Strategies – Focus On What You Can Control

To be a successful investor you need to understand how compounding works for you and against you. If you lose 50% and gain 50%, you still have a 25% loss! These rules of mathematics make capital preservation extremely important.

Conclusion: Thinking Differently From the Crowd

These 5 value strategies provide a foundation for making sound asset allocation decisions. Use the value strategies of time and long term investing, valuation analysis timing, margin of safety, portfolio rebalancing, and capital preservation to lower your risk and improve your probability of above average returns.

Investors with the ability to develop patience and focus on value strategies will avoid investments at high prices when everyone else is bullish. However, when investments are being crushed by pessimism an astute value investor has the ability to snap up good values at bargain prices.

Many investors invest too aggressively, especially when valuations are not favorable for high returns. If you keep bear market losses small it's easier to get back to break even and the move to a positive return. But if you lose a large portion of your portfolio you have lost the

investment capital to buy at favorable prices and make it difficult to recover your portfolio losses.

4.4 Diversification is Vital

Investment diversification in small numbers provides enormous benefits. In other words, five investments is much better than two, ten investments is better than five. However, the marginal benefits of adding additional investments decreases as the numbers get larger until the costs become greater than the benefits.

Both under diversification and over diversification are common mistakes made in portfolio management. Most studies show optimization occurs somewhere between 15 and 30 individual investments.

4.5 Invest For the Long Term

Short term investing is one of the biggest downfalls of current investing strategies. The truly great investors realize if you buy an investment at a favorable price it may take time for the market to recognize its true value.

Long term investing is one of the most important investing principles because short term trading usually leads to poor long term performance. This is common because many investors let fear and greed cause them to make bad decisions. The long term will take care of itself if you make wise investment decisions.

4.6 Keep Expenses Low

Most investors don't realize how much difference high expenses make to their portfolio. Take a look at the what happens to your returns with a 1% higher expense ratio;

Assume:

-R100,000 lump sum investment for 30 years.

-6.5% real rate of return less 0.4% expense ratio for self directed investor.

-6.5% real rate of return less 1.4% expense ratio for investor with high fees.

=Real Rate of Return of 6.1% for self directed portfolio grows to R590,829

=Real Rate of Return of 5.1% for investor with high fees grows to R444,715

The Difference is over R146,000!!!

In other words, over a 30 year period, an increase in expenses of 1% can cost your portfolio more than the original principal!

4.7 Use Compounding to Your Advantage

Compounding or exponential growth (they mean the same thing) is a powerful financial concept. Understand how it works for you and why dividend growth compounding multiplies the value of compounding.

It's equally important to understand the devastation of reverse compounding. The more of your portfolio you lose the harder it is to make it back because you lose your principal. A 10% loss only requires an 11% gain to get back to break-even. However, a 50% loss requires a 100% gain to get back to break-even.

4.8 Employ Risk Management Strategies

Because it is so important to not lose your principal you must employ risk management strategies. Portfolio volatility is an investment return killer. If you don't control risk you will suffer greatly in bear markets. Avoiding large portfolio drawdowns should be one of your preeminent investing principles.

4.8.1 Portfolio Risk Management Strategies

You can't control the direction or volatility of stock prices. We're going to focus on 5 portfolio risk management strategies that you can control.

Everyone wants high investment returns. Volumes of books, articles, and blog posts can be found on how to "beat the market". But is that the right goal to have? Or should you think differently and focus more on portfolio risk management instead of returns?

The best investors focus on risk, not returns. The good returns will come if you manage your risk properly. We only want to take prudent risks; those risks which offer probabilities which are in our favour.

Avoiding large drawdowns is the same as Warren Buffett's famous rules:

Rule No. 1: Never Lose Money

Rule No. 2: Never Forget Rule #1

Sometimes rules seem so simple some investors tend to overlook them. However, there is a profound reason why Buffett and other successful investors make this priority #1.

Drawdowns cause exponentially greater damage the larger the drawdown. In other words:

It takes an 11% gain to recover a 10% loss. Not a problem.

It takes a 25% gain to recover a 20% loss. Harder.

It takes a 43% gain to recover a 30% loss. Problem.

It takes a 67% gain to recover a 40% loss. Big problem.

It takes a 100% gain to recover a 50% loss. Devastating.

It takes a 300% gain to recover a 75% loss. Catastrophic.

The best approach to make money in the long term is not losing it in the short term.

Five Portfolio Risk Management Strategies:

- **Establish a Probable Maximum Loss Plan**

A probable maximum loss plan is the first step in avoiding losing a large chunk of your portfolio. Bear markets can destroy portfolios for years to come. Many investors just give up and avoid equities after their portfolio is decimated.

If you have a probable maximum loss plan it may cause you to invest more conservatively. Hopefully, it will cause you to take only risks that are prudent and fit into your long term plan. This means valuation should be a major consideration in your asset allocation. It does not make sense to have a fixed asset allocation with no regard for the valuation of the asset. An adaptive asset allocation should be used for portfolio risk management.

Learn How to Establish a Probable Maximum Loss Plan:

Maximum Drawdown and Concept of Probable Maximum Loss

- **Implement a Tactical Asset Allocation**

Studies show that close to 90% of investment returns are determined by portfolio asset allocation. Yet most value oriented guidance focuses on choosing individual investments.

Don't get me wrong. I spend a great deal of time looking for individual undervalued investment opportunities. Finding individual investments with a margin of safety is an important aspect of value investing. However, choosing your asset allocation is more important and therefore deserves your serious attention.

Simply stated, investment allocation is how you divide your assets between different investment classes or groups. A tactical asset allocation provides the investor a dynamic strategy that adjusts to favourable and unfavourable valuations. Instead of a strict fixed percentage you have greater flexibility because you can choose from a range based on valuation levels.

Different valuation levels should require a different investment allocation of your capital. One of the most important concepts in investing is to be careful or prudent about the price you pay. It's not possible to do this without changing your allocation to asset categories after they make large price swings.

The value oriented investor would want to allocate more to assets that were priced the farthest below their real or intrinsic value. Assets that are priced above their real worth can be completely avoided or minimized.

We know from history that when valuations are high the expected long term (7 – 10 years) rate of return is lower than average. But when valuations are low the expected long term rate of return is much higher than average.

Consider your investment allocation during the first decade of this century. Should your portfolio have held the same percentage of equities when valuations were sky high (i.e. 2000) compared to after they fell 57% in 2008-09? Of course not.

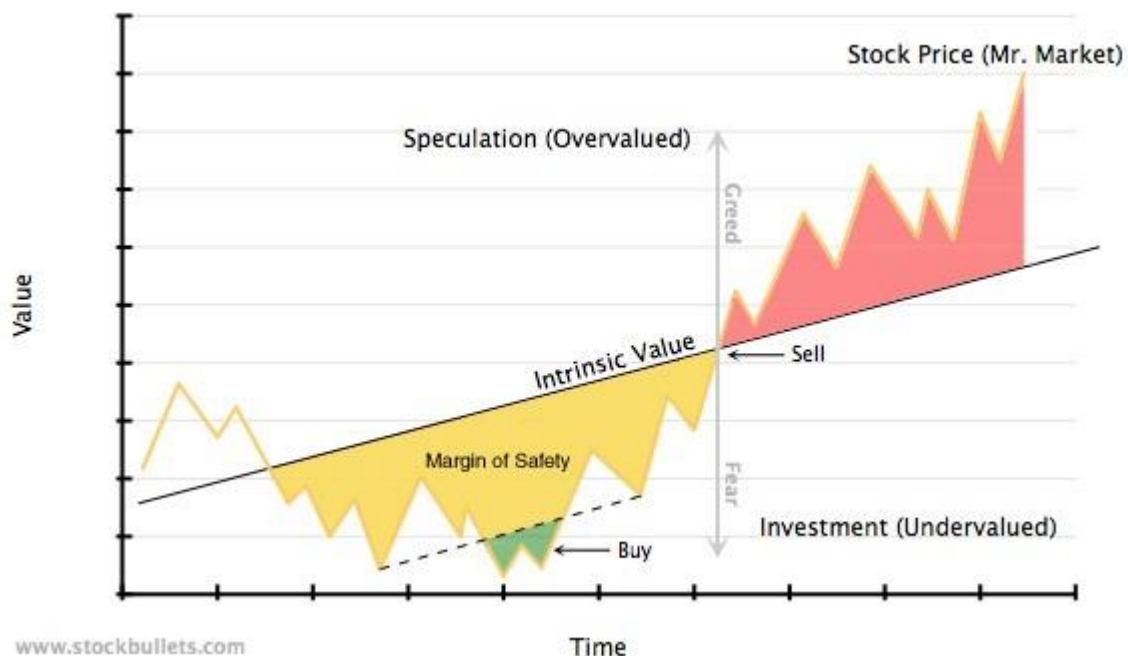
We live in the best era in history for investing. Competition has reduced transaction costs on individual investments and produced new investment vehicles (i.e ETFs). This allows investors

to move from overvalued assets to undervalued assets with relative ease. It no longer makes sense to maintain positions in grossly overvalued assets.

A tactical asset allocation is an effective means to portfolio risk management. During time periods when investment assets are overvalued an adaptive allocation allows an investor to increase cash positions. Cash can help protect your portfolio in bear markets. *You cannot buy low and sell high by allocating money to assets that are expensive.*

At the same time, having cash available when market valuations are low provides investors the ability to take advantage of favourable opportunities. Think about how much better you would do if you bought more when prices are low and less when prices were unfavourable. Many investors do just the opposite and wonder why long term returns suffer.

You should expect volatility and take advantage of it. Make it a point to understand how volatility affects performance. Here is a post that will help you understand why you MUST control your portfolio losses and reduce your portfolio volatility.



- **Require a Margin of Safety**

Require a margin of safety for each individual investment.

Margin of safety is the difference between the fundamental or intrinsic value and the price of your investment. “Price is what you pay. Value is what you get.” (Warren Buffett)

The larger the margin of safety the less risk you assume, the greater your potential capital gains, and the higher your income percentage (i.e. dividend yield). A margin of safety leaves room for judgement errors, mistakes, or unforeseen adverse conditions.

Finding bargains is not always enough. Ideally we want to find stocks with the characteristics of quality companies: good management, strong balance sheets, innovation, competitive advantages, returns to shareholders, earnings stability, and efficient operations.

When a company is deficient in quality we have to 1) analyse the probability of the deficiency being rectified and adjust the price we are willing to pay by increasing the required margin of safety.

Be certain the company has one or more sustainable competitive advantages, otherwise your bargain may be a value trap. Competitive advantages can be key company assets, attributes, or abilities that are difficult to duplicate. These could include being a low cost provider, pricing power, powerful brands, strategic asset, barriers to entry, adapting product line, product differentiation, strong balance sheet, or outstanding management/employees.

- **Avoid Portfolio Volatility**

Portfolio volatility has a large negative effect on long term returns. If you have a positive return of 50% and a negative return of 50%, the arithmetic average is 0%. But you have actually lost 25%, or one-quarter, of your portfolio.

This means that it's in your long term interest to lower the volatility of your investment portfolio. The mathematics of compounding make it compelling to avoid downside volatility. In a previous post we established portfolio volatility (see post below) lowers portfolio returns. I demonstrated how 3 portfolios with the identical arithmetic average returns (i.e. 5%) can provide different portfolio total returns, depending on their volatility. The *more* volatile portfolios underperform the *less* volatile portfolios.

You must comprehend this concept to understand why you need to control portfolio volatility or suffer the consequences. Two portfolios, with the same average rate of return can produce dramatically different portfolio values because of portfolio volatility.

You should expect volatility and take advantage of it. Make it a point to understand how volatility affects performance.

Portfolio Volatility and the Impact On Performance

- **Rethink Your Time Horizon**

I contend, in the long run, that most investors fail because they try to outperform the market in too short of a time horizon. Investing is a marathon, not a sprint. Put less focus on short term performance and greater emphasis on high probability strategies that create long term wealth.

Yes, I want my portfolio to do really well just like anyone else. But does it matter if I outperform the market this month, or this year, or even over several years? Or, are there more important considerations?

Understanding some simple truths about mathematics can help you be successful in the long run.

The problem with trying to beat the market in the short term is that it causes you to invest too aggressively when prices are expensive. The more expensive the market, the greater your emphasis should be on capital preservation.

What really matters is how your portfolio performs over a long period of time. Too short of a time horizon causes investors to focus on factors other than valuation and forget their investing principles .

How your portfolio performs over your entire investment time horizon is what's important. Long term performance requires long term solutions and valuation should be the primary determinant of your investment decisions .

Both bull and bear markets move in long term cycles. An investor will find more opportunities (bargain prices) at the end of bear markets and at the beginning of bull markets. Therefore, a value investors portfolio may be more volatile during times when bargains are available. This is because you should be more aggressive when prices are low.

However, there will be fewer opportunities (bargain prices) at the end of bull markets and the beginning of bear markets. An investor should have a portfolio that is less volatile when investment prices are expensive. This is because you should lower portfolio volatility and preserve your capital when investment prices are expensive.

4.8.2 Implementing Your Portfolio Risk Management Strategies – Focus on What You Can Control

Volatility has and always will be a part of the stock market. There is nothing you can do about volatility or the direction of the market. In other words you can't control stock market returns. Therefore, you need to *focus on what you can control through portfolio risk management.*

- Focus on a probable maximum loss plan.
- Implement an adaptive asset allocation.
- Require a margin of safety by focusing on valuation and price and keep your emotions in check.
- Understand how volatility degrades portfolio returns.
- Focus on long term instead of short term (proper time horizon).

4.9 Anticipate Market Volatility and Make it Your Friend

Despise portfolio volatility but embrace market volatility. You can control portfolio volatility, but you cannot control the inevitable volatility of investment markets.

Therefore, you should be prepared to take advantage of investment opportunities. At the same time, you need to be cognizant of overvalued assets and be willing to move to cash when conditions are unfavourable.

4.10. Control Your Own Destiny

No one cares about your money more than you do. Fraud, conflicts of interest, and outrageous fees make self-directed investing an attractive alternative.

Technology and the internet have brought down transaction costs and provide the means to get information and guidance at a very low cost. There has never been a better time period for the self-directed investor who is willing to put a little effort into investing.

Chapter 2

Investment Vehicles and Structures

2.1 What Is an Investment Vehicle?

An investment vehicle is a product used by investors to gain positive returns. Investment vehicles can be low risk, such as certificates of deposit (CDs) or bonds, or they can carry a greater degree of risk, such as stocks, options, and futures. Other types of investment vehicles include annuities; collectibles, such as art or coins; mutual funds; and exchange-traded funds (ETFs).

2.2 Investment Vehicles Explained

Investment vehicles refer to any method by which individuals or businesses can invest and, ideally, grow their money. There is a wide variety of investment vehicles, and many investors choose to hold at least several types in their portfolios. Holding different types of investment in a portfolio minimizes risk through diversification because a portfolio constructed of different types of assets will, on average, yield higher long-term returns.

2.3 Types of Investment Vehicles

The different types of investment vehicles are subject to regulation in the jurisdiction in which they are provided. Each type has its own risks and rewards. Deciding which vehicles fit particular portfolios depends on the investor's knowledge of the market, skills in financial investing, risk tolerance, financial goals, and current financial standing.

KEY TAKEAWAYS

- Investment vehicles are used by investors to gain positive returns on their money.
- Investment vehicles can be low risk, such as CDs or bonds, or high risk such as options and futures.

- Other investment vehicles include lending investments, such as bonds, CDs, and TIPS; cash equivalents; and pooled investments, such as pension plans and hedge funds.

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2.3.1 Ownership Investments

Investors who delve into ownership investments own particular assets that they expect to grow in value. Ownership investments include stocks, real estate, precious objects, and businesses. Stocks, also called equity or shares, give investors a stake in a company and its profits and gains. Real estate owned by investors can be rented or sold to provide higher net profits for the owner. Precious objects such as collectibles, art, and precious metals are considered ownership investments if they are sold for a profit. Capital used to build businesses that provide products and services for profit is another type of ownership investment.

2.3.2 Lending Investments

With lending investments, people allow their money to be used by another person or entity with the expectation it will be repaid. The lender typically charges interest on the loan so that they earn a profit once the loan is repaid including the interest charges. This type of investment is low risk and provides low rewards. Examples of lending investments include bonds, certificates of deposit, and Treasury Inflation-Protected Securities (TIPS).

Investors investing in bonds allow their money to be used by corporations or the government with the expectation it will be paid back with profit after a set period with a fixed interest rate.

Certificates of deposit (CDs) are offered by banks. A CD is a promissory note provided by banks that locks the investor's money in a savings account for a set period with a higher interest rate.

Treasury Inflation-Protected Securities (TIPS) are bonds provided by the U.S. Treasury and crafted to protect investors against inflation. Investors who put their money in TIPS get their principal and interest back when their investment matures over time. Both principal and interest are indexed for inflation.

2.3.3 Cash Equivalents

Cash equivalents are financial investments that are considered as good as cash. These are savings accounts or money market funds. The investments are liquid but have low returns.

2.3.4 Pooled Investment Vehicles

Multiple investors often pool their money to gain certain advantages they would not have as individual investors; this is known as a pooled investment vehicle and can take the form of mutual funds, pension funds, private funds, unit investment trusts (UITs), and hedge funds.

In a mutual fund, a professional fund manager chooses the type of stocks, bonds, and other assets that should compose the client's portfolio. The fund manager charges a fee for this service.

A pension plan is a retirement account established by an employer into which an employee pays part of their income.

Private funds are composed of pooled investment vehicles, such as hedge funds and private equity funds, and are not considered investment companies by the Securities and Exchange Commission (SEC).

Unit investment trusts provide a fixed portfolio with a specified period of investment. The investments are sold as redeemable units.

Hedge funds group together client money to make what are often risky investments using a long and short strategy, leverage, and exotic securities in the aim of achieving higher than usual returns known as alpha.

Conclusion

The vehicles that investors can use to try to obtain returns are wide-ranging. However, the investor should understand the risks of any vehicle that they choose. A financial advisor can assess an investor's current financial situation, their goals, and their needs to develop the most appropriate portfolio and investment strategy.

2.4 Investment Terms

If you are a new investor, you are likely to encounter terms that you do not understand. It may seem overwhelming at first, but once you become familiar with them, you will realize there is no reason to be intimidated. This is an introduction to some of the more common investing terms you may encounter.

2.4.1 Types of Investments

There are various ways to invest your money, such as stocks, bonds, and property. You should have a clear understanding of each option to make the best decision for growing your money.

1. **Common Stock:** A share of common stock represents ownership in a legally formed corporation. For most companies, there is a single class of stock that represents the entire company. However, some companies have multiple classes of stock, including dual classes of stock. Often, one class of stock will have more voting rights than another class of stock.¹

Owners of common stock are entitled to their proportionate share of a company's earnings, if any, some of which may be distributed as cash dividends. The best stocks are usually referred to as blue-chip stocks.

1. **Preferred Stock:** Preferred stock is a class of ownership that allows shareholders of a company to get a larger dividend, and that dividend is often guaranteed. Holders of such stock do not have voting rights, but they can receive special status if a company heads into insolvency. If a company is being liquidated and creditors need to be paid, preferred stock shareholders must be paid before common stock shareholders. In some cases, companies can repurchase shares of preferred stock from shareholders, often at a premium. It is also possible to convert shares of preferred stock into common stock, but not vice versa.² There are also different types of preferred stock, such as convertible preferred stock.
2. **Bonds:** In simple terms, a bond is like a loan. When you buy a bond, you are usually agreeing to lend money to a government or a company. Typically, the bond issuer promises to repay the entire principal loan amount on a future day, known as the maturity date, and pay interest income in the meantime based upon a coupon rate.³⁴ There are many types of bonds, including those issued by governments, such as Treasury bonds and tax-free municipal bonds.⁵⁶ These bonds are often used to fund government operations and capital projects. There are corporate bonds, which help companies fund their operations and invest in themselves.⁷ There are also savings bonds, such as the Series EE savings bond and the Series I savings bond.⁸ There are investment-grade bonds, the highest being AAA-rated bonds, and on the opposite end of the spectrum, junk bonds.⁹¹⁰ If you do not want to buy bonds individually, you can invest in bond funds.
3. **Real Estate:** Real estate is tangible property, such as land or buildings, that the owner can use or allow others to use in exchange for payment. When you own a house, you own real estate. When you own a plot of land, you own real estate.

2.4.2 Types of Investment Structures

An investment strategy may include pooled or grouped classes of assets.

1. **Mutual Funds:** A mutual fund is a pooled portfolio. Investors buy shares or units in a fund, and the money is invested by a professional portfolio manager. The fund itself holds individual stocks, in the case of equity funds, or bonds, in the case of bond funds.

Mutual funds are a great way to get exposure to different groups of stocks or bonds, and it frees the investor from the need to research and purchase shares of each company individually.

1. Mutual funds do not trade throughout the day to avoid allowing people to take advantage of the underlying change in net asset value. Instead, buy and sell orders are collected throughout the day, and once the markets have closed, they are executed based upon the final calculated value for that trading day.
2. **Exchange-Traded Funds:** Exchange-traded funds (ETFs) are very similar to mutual funds, except that they trade throughout the day on stock exchanges as if they were stocks. You can actually pay more or less than the value of the underlying holdings in the fund.¹¹ In some cases, ETFs might have certain tax advantages, but most of their benefits compared to traditional mutual funds are largely a triumph of marketing over substance.¹² You can use these or traditionally structured mutual funds in your portfolio.
3. **Index Funds:** An index fund is a type of mutual fund, sometimes trading as an ETF, that allows an individual to "invest" in an index, such as the S&P 500. Index funds are designed to give investors returns that are in line with the index. So if you are investing in an S&P 500 index fund, your returns should mirror those of the S&P 500. There are many funds designed to track a whole host of indices that may include small-cap stocks, emerging markets, and specific industries. Index fund investing is an example of "passive" investing, as there are no fund managers actively trying to "beat" the market. The funds are simply designed to mirror the returns of an index. As a result, they usually have low expense ratios, making them cost-effective investments.¹³

The simplicity and low cost of index funds make these funds optimal investments for people who do not want to spend a lot of time researching stocks and managing their portfolio. In fact, many financial advisors recommend index funds as a core component of investment portfolios.

1. **Hedge Funds:** A hedge fund is a type of investment partnership. Often, it is formally listed as a limited partnership or limited liability company, and the partners pool money from investors and engage in a wide range of investing activity. Commonly, hedge funds engage in investment activity that is riskier than typical investments. Hedge funds will often use leverage (*i.e.*, borrowed money) to amplify their returns, but they can also place bets against the market to make money—even if the market

goes down.¹⁴ There are a variety of different hedge fund structures, but it is common for fund managers to charge investors 20% of profits plus 2% of assets as a management fee each year.¹⁵ This is controversial because managers of large funds can make millions of rands in management fees, even if investments perform poorly. Due to government regulations meant to protect the inexperienced investor, investing in hedge funds can be difficult for most ordinary investors.¹⁶

2. **Trust Funds:** A trust fund is a special type of legal entity that allows a person or organization to hold assets they will eventually give to another. For example, a grandparent could hold R100,000 in stock for a grandchild, with the stipulation the grandchild receive the money when they reach age 18. Trust funds offer tremendous asset protection benefits and, at times, tax benefits. Trust funds can hold almost any asset imaginable from stocks, bonds, and real estate to mutual funds, hedge funds, and art.¹⁷

There is a perception trust funds are only used by the wealthy, but they are available to anyone who wants to intelligently transfer assets to another person.

1. **Real Estate Investment Trusts:** Some investors prefer to buy real estate through real estate investment trusts (REITs). They trade as if they are stocks and have special tax treatment. There are different types of REITs that specialize in various types of real estate. For example, if you wanted to invest in hotel properties, you could consider investing in a hotel REIT. REITs allow you to invest in real estate without having to buy or maintain actual buildings or land.¹⁸
2. **Master Limited Partnerships:** Master limited partnerships (MLPs) are limited partnerships that trade similarly to stocks. Given the unique tax treatment and complex rules surrounding them, inexperienced investors should generally avoid investing in MLPs, particularly in retirement accounts where the tax consequences can be unpleasant if not masterfully managed.¹⁹
3. **Portfolio Management:** Portfolio managers are experienced investment professionals, who strategically group or pool together different types of assets into portfolios they manage to generate a profit for investors.²⁰ You should keep in mind the following concepts associated with portfolio management.
4. **Investment Mandate:** An investment mandate is a set of guidelines, rules, and objectives used to manage a specific portfolio or pool of capital. For example, a capital preservation investment mandate is meant for a portfolio that cannot risk meaningful volatility—even if it means accepting lower returns.²¹
5. **Asset Allocation:** Asset allocation is an approach for managing capital that involves setting parameters for different asset classes, such as equities (*e.g.*, ownership or

stocks), fixed-income (e.g., bonds), real estate, cash, or commodities (e.g., gold or silver).²²

Asset classes are believed to have different characteristics and behavior patterns. In turn, getting the right mix for a specific investor can increase the probability of a successful outcome in accordance with the investor's goals and risk tolerance. For example, stocks and bonds play a different role in an investor's portfolio beyond the returns they may generate.

1. **Fiduciary Duty:** In the U.S. legal system, a fiduciary duty is the highest duty owed to another person. It requires the fiduciary to put the interest of the principal, often the client, above its own. This involves disclosing conflicts of interest.²³
2. **Custodial Account:** A custodial account is an account that an institutional custodian operates on behalf of an investor to hold the investor's portfolio of securities.²⁴ The custodian will record cash flows from interest and dividends, submit instructions on behalf of the investor for proxy voting or corporate events, and take delivery of spin-offs and make sure the shares end up in the custody account.²⁵ Custody accounts are assessed custodial fees.²⁶ However, some investors do not realize they pay them because brokers may offer custody services for free or at reduced prices if the investor has a minimum account size or places a certain number of stock trades each year.
3. **Asset Management Company:** An asset management company is a business that invests capital on behalf of clients, shareholders, or partners. For instance, Vanguard's asset management business buys and sells the underlying holdings of its mutual funds and ETFs.²⁷ The asset management business of J.P. Morgan's private client division builds portfolios for individuals and institutions.²⁸
4. **Registered Investment Advisor:** A registered investment advisor (RIA) is a firm that is engaged, for compensation, in providing advice, making recommendations, issuing reports, or furnishing analyses on securities.²⁹ RIAs can include asset management companies, investment advisory companies, financial planning companies, and a host of other investment business models.

2.5 The Basics of Investing

Learning the basics of investing is like learning a new language. It is easy to get lost or feel overwhelmed. You may understand when discussing stocks, bonds, and mutual funds. However, when the advisor starts throwing out investment terms like structures, entities, some ratio or the other, and rand-cost averaging you may begin to feel in over your head.

it's no wonder many beginning investors feel like they're in uncharted waters. The good news is that once you have mastered the language and certain investing basics, you'll better understand how your money is being invested for your future plans. To assist you on that

journey, here is a look at the handful of the most common types of investments you will encounter in your lifetime: stocks and bonds, mutual funds, and real estate.

We'll also talk about a few other relevant topics, such as the legal entities for businesses like limited liability companies and limited partnerships.

2.5 1 Basics of Stocks (Shares)

Without a doubt, owning stocks has been the best way, historically, to build wealth. And for more than a century, investing in bonds has been considered one of the safest ways to make money.

Stocks are shares of ownership in a specific company. When you own a share of Apple, for example, you own a tiny piece of that company. Stock prices fluctuate with a company's fortunes, and also with the economy at large. Public companies list and share their shares on exchanges. There are several exchanges around the globe. Some companies issue shares but are private—meaning they do not trade on an exchange.

You can buy and sell a stock—in any quantity you like—without the requirement to hold it for any specific length of time. The market price of one share is determined by the supply and demand for that share on the open market exchange. Your broker will usually charge a service charge or commission to process your order to buy or sell a stock.

These investments come in different quality depending on the underlying company's financial stability. Some stocks pay a regular return of company profits in the form of dividends, and others do not. Investors can realize capital gains if the shares appreciate in value above what they paid for them.

2.5.2 Bond Fundamentals

When you buy a bond, meanwhile, you are lending money to the company or institution that issued it. Bonds are debt securities and can be in the form of Treasury's, municipal bonds, corporate bonds, and other types of debt. You are lending money that the borrower will pay back by a stated date. Until they pay you back, the borrower will pay you interest on a regular basis.

Like with stocks, bonds come in different quality with the best being AAA. Rating agencies like Moody's set the rating on a bond. Some bonds are called junk bonds due to the instability of the underlying company and are riskier to own.

Bonds have to be held for a period before they mature. However, you can resell them on the secondary market through your broker. Once again, your broker will charge a commission to transact the deal.

In the case of a school bond, for instance, you are lending money to the school district to build a new high school or improve classroom conditions. Buying a bond issued by a company means you're lending money to that company, which it can use to grow the business.

2.5.3 Investing in Mutual Funds

One of the most popular ways to own stocks and bonds is through mutual funds. In fact, most people are statistically less likely to own individual investments than they are shares of companies through mutual funds held in their 401(k) or Roth IRA.

Mutual funds offer many benefits to investors, particularly to beginners who are just mastering investing basics. They're pretty easy to understand and allow you to diversify your investments over more companies. However, mutual funds also have a few serious drawbacks: they charge fees, which can eat into your profits, and with some funds, they may boost your tax bill, even in a year when you don't sell shares.

Mutual funds are pooled money investments that will have a primary focus. As an example, you may see a mutual fund that follows a particular index, invests primarily in a specific region of the world, or focuses their holdings on a specific size of company.

You and hundreds of other people give a fund manager money which they invest in various holdings. The manager uses the pooled money to purchase investments that align with the stated goal of the fund. This professional will buy or sell portfolio holdings and periodically return profits to the investors. These investments will charge various types of fees to pay for the management and promotion of the fund.

Mutual funds price once per day using the net asset value (NAV) at the market's close. Any transaction you made with the fund executes at that time and at that price. In most cases, there is a broker fee to buy or sell these holdings.

2.5.4 Real Estate Investments

The world is full of people who are convinced that real estate is the only investment that makes sense. Whether you subscribe to that philosophy or not, there are more ways than ever to add real estate to your portfolio.

Yes, you can buy a home for yourself, or properties to rent. But you also can purchase securities called a real estate investment trust (REIT). REITs have a structure much like a mutual fund where a professional manager handles the individual assets held within the trust's portfolio. However, in this case, all the investments are only in real estate.

You will see REITs that focus on the tangible property of land, shopping malls, apartment buildings, senior community facilities, and even medical marijuana facilities. To qualify as a REIT, a fund must meet specific benchmarks set by the Internal Revenue System (IRS).

2.6 Investing Structures and Entities

When you move beyond stocks, bonds, mutual funds, and real estate, you encounter different types of investment entities. For example, millions of people will never own a share of stock or a bond. Instead, they invest their money in a family business, such as a restaurant, retail shop, or rental property. Yes, these are businesses, but you also should consider them investments, and treat them accordingly.

More experienced investors likely will invest in hedge funds or private equity funds or trade in futures and options contracts. Others will buy shares of publicly traded limited partnerships through their broker. These special legal structures can have big tax implications for you, and it is important you understand how investing through them can both benefit, and potentially harm your pocketbook.

2.7 Investing in a Bad Economy

It's the nature of the world that sometimes bad things happen. When they happen to your investments or savings, you don't need to panic. Sometimes, you need to take a hit before you can make some money again, and holding on until the recession ends is the best plan.

Besides reading and learning as much as you can, one of the best things you can do is talk to a financial planner or accountant who can help you better understand the world of investing.

2.8 Ways to Invest Money as a Beginner

In most cases, the best way to begin investing is to decide which asset classes you want to own: real estate, stocks, or fixed income. Each has unique risks, opportunities, and tax rules. While building a complete portfolio might seem difficult, the dividends, interest, and rents can be worth it.

You likely will gravitate toward specific asset classes based on your preferences, but it also is important to understand that different asset classes can meet different needs at certain times

in your life. For example, when you're younger and have more time ahead of you, the high growth potential of stocks makes more sense. If you're 70 and retired, the more stable income from bonds is reasonable.

Almost all major assets you're likely to consider when investing money fall under the categories of business ownership, lending money, or real estate.

2.8.1 Acquiring an Ownership Stake in a Business

Historically, ownership of a successful business has been a great source of wealth accumulation. Owning stock in a successful business can be accomplished in several different ways.

Buy stock in a publicly traded business. This is done by purchasing common stock in a corporation traded on one of the stock exchanges, such as the Johannesburg Securities Exchange(JSE)

An easy way for new investors to acquire a stake in a business is simply by purchasing some of its stock.

Start your own company. You can do this by establishing a sole proprietorship, general partnership, limited partnership, limited liability company, or corporation. If you have the talent, skill, discipline, and luck of an excellent operator, it is often the most lucrative path to investment riches because you can buy into the firm at book value with your compounding rate equal to the return on equity, or ROE.

Buy into someone else's privately held company. Consider becoming a partner or otherwise buying into a private company, perhaps in exchange for cash or labor, on privately negotiated terms. Some investors specialize in private equity, restricting themselves to specific sectors of the economy where they feel like they have an advantage, such as technology or manufacturing.

2.8.2 Lending Your Savings

Money lending is as old as civilization. An investor saves up wealth and then lets others borrow it with the promise of repayment plus interest based on the risk and length of the loan. Issuing a loan, whether to a business, a person, or a bank, is a common way of investing money.

There are multiple ways to loan money:

Purchase bonds. Bonds are debt issued by sovereign governments—these include Treasury bonds or savings bonds—as well as municipalities, corporations, nonprofits, or other entities. They are easily purchased through a brokerage account.¹

There are a number of ways to lend money and receive interest, but one of the easiest for new investors is by buying bonds.

Make a direct loan. This is a privately negotiated loan with a borrower based upon a written or verbal contract which details terms, conditions, a repayment schedule, and the interest rate.

Make a peer-to-peer loan. Lending through market platforms such as Lending Club or Prosper allows you to bid on a small percentage of a given loan and fund a piece of it.²

Acquire a certificate of deposit (CD). When you buy a CD, the bank or other financial institution offers you interest in exchange for your deposit, which you agree to leave in place for a specified amount of time.³

Just like investing money in a business, the compound annual growth rate you can earn when lending money depends on your skill.

Take one example: A retiree shrewdly acquires homes that she rents out on lease-to-own terms to families who otherwise couldn't qualify for a mortgage. After adjusting for various factors such as taxes and maintenance, her cap rate is 13%. That's a much better return than 2% interest for a CD or the 0.10% offered on savings bonds.⁴

When evaluating real estate, the "cap rate," or capitalization rate, helps you understand a property's profit potential. To find the cap rate (expressed as a percentage), divide the property's net operating income by its current market value.

Nobody advertised such an investment; she created it on her own. She saw an opportunity and with a pen, a lawyer, a notary, and her savings, found a way to solve other peoples' needs.

2.8.3 Investing Money in Real Estate

Behind lending money, making a profit from owning real estate is among the oldest recorded financial activities. If you own a property—whether a home, an office, or a plot of land—you can make money by charging rent.

In the modern economy, there are several ways to acquire real estate for your investments:

Buy a home for your family. This is more cost mitigation than it is an investment, but it falls into this category nonetheless.

Businesses that pool money to invest in real estate this way are known as Real Estate Investment Trusts (REIT), and often can be acquired just like any other stock through a brokerage account. There are even ETFs and mutual funds that specialize in REITs, and you can buy them like any other equity.

Buy a property and rent it. When you own property, you can rent it to tenants.

Buy a property and sell it for profit. This is sometimes called "flipping," which means improving or developing a property in some way and then selling it.

Fund lease/buyback transactions. In these situations, you buy a property and then lease it back to the seller.

Pool money to buy real estate through a trust. The most common technique with this method is to put money down with other investors to buy real estate through special tax-advantaged businesses exempt from corporate taxes (under most circumstances).

Chapter 3

The Stock Market

3.1 An Introduction to the Stock Market

Understanding the stock market is essential to making informed trading decisions. You need to know how to choose the right stocks, which requires an in-depth understanding of a company's annual report and financial statements. Learn how to understand what stock represents in a company and how to determine the true value of any stock.

This allows you to make better investing decisions by avoiding the costly mistake of purchasing a company's stock when the market has pushed its share price too high relative to its value.

3.2 The Johannesburg Securities Exchange (JSE)

3.2.1 Historical overview

The JSE was formed in 1887 during the first South African gold rush. Following the first legislation covering financial markets in 1947, the JSE joined the World Federation of Exchanges in 1963 and upgraded to an electronic trading system in the early 1990s. The bourse demutualised and listed on its own exchange in 2005.

In 2003, we launched an alternative exchange, AltX, for small and mid-sized listings, followed by the Yield X for interest rate and currency instruments. The JSE then acquired the South African Futures Exchange (SAFEX) in 2001 and the Bond Exchange of South Africa (BESA) in 2009. Today we offer five financial markets namely Equities and Bonds as well as Financial, Commodity and Interest Rate Derivatives.

3.2.2 The Functions of the JSE:

- Gives opportunities to financial institutions such as insurance companies to invest their funds in shares.
- Serves as a barometer/indicator of economic conditions in South Africa.
- Keeps investors informed on share prices by publishing the share prices daily.
- Acts as a link between investors and public companies.
- Shares are valued and assessed by experts.
- Small investors are invited to take part in the economy of the country through the buying of shares.
- Venture capital market is made possible.
- Orderly market for securities serves as a disciplined market for securities.
- Encourages new investments.
- Mobilises the funds of insurance companies and other institutions.
- Raises primary capital.
- Regulates market for dealing with shares.
- Plans, researches and advises on investment possibilities.
- Ensures that the market operates in a transparent manner.
- Provides protection for investors.
- Encourages short-term investment.
- Facilitates electronic trading of shares/STRATE.

3.2.3 Our Markets

South Africa has mature capital markets that serve the domestic economy and the wider continent. As one of the world's 20 largest exchanges by market capitalisation (\$1,007bn at end-2013) and the largest exchange in Africa, the Johannesburg Stock Exchange strives to offer secure, efficient primary and secondary capital markets across a diverse range of instruments, supported by cost-effective services.

- **Equity market**

While a number of heavyweights like British American Tobacco (BAT), SABMiller, GlencoreXstrata and BHP Billiton account for a large share of the market, The Exchange caters for a diverse variety of offerings. There are almost 400 companies listed on The Exchange across the Main Board and AltX.

The JSE index series is called the FTSE/JSE Africa Index Series, and is a partnership between JSE and the FTSE Group. The two benchmark indices are the FTSE/JSE All Share Index, covering 99% of market capitalisation, and the FTSE/JSE Top 40 Index which tracks the top listings in a representative spread of sectors.

- **South African bond market**

South Africa's interest rate market is the largest on the continent. The majority of South African bonds are issued government and state owned entities but the number of corporate bonds issued is growing.

The JSE also offers a variety of Bond-based Derivatives, including Bond futures, Forward-rate Agreements, Vanilla Swaps and standard bond options. The Exchange hopes to attract new bond issuers to the bourse, seeking to partner with other African exchanges with a dual-issuance model. In November 2012, the Namibian government floated a R850m (\$78m) 10-year bond priced at 8.26%, the first tranche of a R3bn (\$275.2m) programme, and the JSE hopes to encourage other African countries to list debt on The Exchange.

- **Derivatives**

The JSE offers trading of a variety of Derivatives, including Futures and Options on Equities, Bonds, Indices, Interest Rates, Currencies and Commodities. The JSE was ranked the 6th largest exchange by number of Single Stock Futures traded and 9th by the number of Currency Derivatives traded in 2012 in the World Federation of Exchanges Annual Derivatives Market Survey.

- **Membership**

There are 62 equities members, 120 Equity Derivatives members, 92 Commodity Derivatives members and 102 Interest Rate and Currency Derivatives members licensed in South Africa, a mix of local and international operations.

- **Technology**

The JSE has undertaken major technological upgrades over the past few years on a consistent drive to upgrade trading, clearing and settlement which is still continuing. In July 2012, the JSE implemented a new trading platform the Millennium Exchange in the Equity Market, while at the same time moving the trading system from London to Johannesburg. Following this successful transition, trades can now be executed up to 400 times faster than under the previous TradElect system. The change allows for increased liquidity and more algorithmic traders.

- **Regulation**

The JSE is the frontline regulator for the exchange, setting and enforcing listing and membership requirements and trading rules. The Financial Services Board (FSB) supervises the JSE in the performance of its regulatory duties.

The regulatory landscape is set to change significantly in the future, as South Africa looks to implement a twin peaks model of oversight. Under the new system, prudential supervision will be transferred to the South African Reserve Bank (SARB) and market conduct regulation will be led by a bolstered FSB.

South Africa is currently ranked 1st in the world in terms of regulation of securities exchanges in the World Economic Forum's Global Competitiveness Survey for 2013-2014. This is an accolade for both the JSE and its regulators.

- **Foreign listings**

Another regulatory change that could have widespread implications is the 2011 decision to alter South Africa's inward listing rules, allowing foreign domiciled companies to be treated as domestic listings. While foreign firms had been allowed to list on the JSE since 2004, they were previously subject to foreign exchange rules, which limited the amount of these equities that local investors could hold. The lifting of these restrictions has been an important regulatory shift for The Exchange and makes the JSE a more attractive listings destination.

3.3 Stock Market Terms

The first step to understanding the stock market is knowing the lingo. Here are a few commonly used words and phrases:

1. **Earnings per Share:** The total company profit divided by the number of stock shares outstanding.
2. **Going Public:** Slang for when a company plans to have an IPO of its stock.
3. **IPO:** Short for Initial Public Offering, when a company sells its shares of stock for the first time.
4. **Market Cap:** Short for Market Capitalization, the amount of money you would have to pay if you bought every single share of stock in a company. To calculate market cap, multiply the number of shares by the price per share.
5. **Share:** A share, or a single common stock, represents one unit of an investor's ownership in a share of the profits, losses, and assets of a company. A company creates shares when it carves itself into pieces and sells them to investors in exchange for cash.
6. **Ticker Symbol:** A short group of letters that represents a particular stock as listed on the stock market. For example, The Coca-Cola Company has a ticker symbol of KO, and Johnson & Johnson has a ticker symbol of JNJ.
7. **Underwriter:** The financial institution or investment bank that does all of the paperwork and orchestrates a company's IPO.

The workings of the stock market can be confusing. Some people believe investing is a form of gambling and feel that, if you invest, you will likely end up losing your money.

These fears can stem from the personal experiences of family members and friends who suffered similar fates or lived through the Great Depression. These feelings are understandable but aren't grounded in facts. Someone who believes in this line of thinking may not have an in-depth understanding of the stock market, why it exists, and how it works.

Other people believe that they should invest for the long run but don't know where to begin. Before learning about how the stock market works, they look at investing like some sort of magic that only a few people know how to use. More often than not, they leave their financial decisions up to professionals and cannot tell you why they own a particular stock or mutual fund.

This investment style could be called blind faith, or perhaps it's limited to a sentiment such as, "This stock is going up—we should buy it." Though it may not seem so on the surface, this group is in far more danger than the first. They tend to invest by following the masses and then wonder why they only achieve mediocre, or, in some cases, devastating results.

Upon learning a few techniques, the average investor can evaluate the balance sheet of a company and, following a few relatively simple calculations, arrive at their own interpretation of the real value of a company and its stock.

This allows an investor to look at a stock and know that it is worth, for instance, R40 per share. This gives each investor the freedom to determine when the market has undervalued stocks, increasing their long-term returns substantially, or overvalued it, making it a poor investment candidate.

3.3.1 Why Do Companies Sell Stock (Shares)?

When learning how to value a company, it helps to understand the nature of a business and the stock market. Almost every large corporation started as a small, mom-and-pop operation and, through growth, became a financial giant.

Consider Walmart, Amazon, and McDonald's. Walmart was originally a single-store business in Arkansas. Amazon.com began as an online bookseller in a garage. McDonald's was once a small restaurant that no one outside of San Bernardino, California, had ever heard of. How did these small companies grow from tiny, hometown enterprises to three of the largest businesses in the American economy? They raised capital by selling stocks.

As a company grows, it continues to face the hurdle of raising enough money to fund ongoing expansion. Owners generally have two options to overcome this: They can either borrow the money from a bank or venture capitalist or they can sell part of the business to investors and use the money to fund growth. Companies often take out a bank loan because it's typically easy to acquire and very useful, up to a point.

Banks won't always lend money to companies, and over-eager managers may try to borrow too much, which adds a lot of debt to the company balance sheet and hurts its performance metrics. Factors such as these often provoke smaller, growing businesses to issue stock. In exchange for giving up a tiny fraction of ownership control, they receive cash to expand the business.

Going public provides a company with money that doesn't have to be paid back. It also gives the business managers and owners a new tool. Instead of paying cash for certain transactions, such as the acquisition of another company or business line, they can use their own stock.

3.3.2 How Is Stock (Shares) Issued?

To better understand how issuing stock works, take the fictional company ABC Furniture, Inc. After getting married, a young couple decided to start a business. This allows them to work

for themselves and arrange their working hours around their family. Both husband and wife have always had a strong interest in furniture, so they decide to open a store in their hometown.

After borrowing money from the bank, they name their company ABC Furniture, Inc. and go into business. During the first few years, the company makes little profit because they invest the earnings back into the store, buying additional inventory, remodelling, and expanding the building to accommodate the increasing level of merchandise.

3.3.3 Making the Decision to Sell Shares

Ten years later, the business has grown rapidly. The couple has managed to pay off the company's debt and have profits of more than R500,000 per year. Convinced that ABC Furniture could do as well in several larger neighboring cities, the couple decides they want to open two new branches.

They research their options and find out that they need over R4 million to expand. Not wanting to borrow money and make debt and interest payments again, they decide to raise funds by offering equity to potential shareholders, so they sell stock in their company.

The company approaches an underwriter for the stock offering, such as Goldman Sachs or JP Morgan, who digs into their financial statements and determines the value of the business. As mentioned before, ABC Furniture earns R500,000 after-tax profit each year. It also has a book value of R3 million, which means the value of the land, building, inventory, and other assets, after covering the company's debt. The underwriter researches and discovers the average furniture stock trades on the market at 20 times its company's earnings.

What does this mean? Simply stated, you would multiply the company's earnings of R500,000 by 20. In ABC's case, this results in a market value estimation of R10 million. If you add in the company's book value, you arrive at R13 million. This means, in the underwriter's opinion, that ABC Furniture has a total value of R13 million.

Deciding How Much of Their Business to Sell

The young couple, now in their 30s, must decide how much of the company they are willing to sell. Right now, they own 100% of the business. The more company shares they sell, the more cash they'll raise, but they must keep in mind that by selling more, they'll be giving up a larger part of their ownership. As the company grows, that ownership will be worth more, so a wise entrepreneur would not sell more than he or she had to.

After discussing it, the couple decides to keep 60% of the company and sell the other 40% to the public as stock. When you do the math, this means that they will keep R7.8 million worth of the business (60% of the R13 million value). Because they own a majority of the stock, greater than 50%, they will still be in control of the store.

The other 40% of the stock that they want to sell to the public has a value of R5.2 million. The underwriter finds investors who want to buy the stock and gives a check for R5.2 million to the couple.

Although they own less of the company, the owners' stake will hopefully grow faster now that they have the means to expand rapidly. Using the money from their public offering, ABC Furniture successfully opens two new stores and has R1.2 million in cash left over, since they raised R5.2 million but only used R4 million.

3.3.4 Using the Income to Expand and Grow

Their business performs even better in the new branches. The two new stores make around R800,000 a year in profit each, while the old store still makes the same R500,000. Between the three stores, ABC now makes an annual profit of R2.1 million.

Although they no longer have the flexibility of a small business or the freedom to simply close shop, their company is now valued at R51 million. You would reach this by multiplying their new earnings of R2.1 million per year by 20 (the average furniture stock multiple mentioned earlier) and add the company's latest book value of R9 million since each store has a book value of R3 million. The couple's 60% stake now has a total worth of R30.6 million.

With this example, it's easy to see how small businesses seem to explode in value when they go public. The original owners of the company, in a sense, become wealthier overnight. Before, the amount they could take out of the business was limited to the profit that was generated. Now, the owners can sell their shares in the company at any time, raising cash quickly.

3.4 Investing in Index Funds

You may have heard about index funds from a friend, on TV, or on a podcast. But what are they, exactly? An index fund is a type of mutual fund or exchange-traded fund (ETF). It's made up of stocks or bonds attempting to earn the same return as a particular index.

But are index funds right for you? Learn the pros and cons, how index funds compare to actively managed funds, and how to choose an index fund for your portfolio.

3.4.1 What Is an Index Fund?

Thousands of indexes track the movements of various sectors, markets, and investment strategies on a daily basis, and are used to determine that market's health and performance. For example, the Dow Jones Industrial Average is a broad market index made up of 30 blue-chip stocks, while the U.S. Global Jets Index tracks the global airline industry as a sector index. The index can also act as a market's benchmark, or way of measuring performance.

You can't directly invest in an index, as it's purely a mathematical construct. However, you can invest in an index fund, either through an index mutual fund or an ETF. Most index funds copy the index exactly by holding all the index's securities, but sometimes a fund approximates the index with a sample of the securities, or additional derivatives, such as options and futures.

Index funds represent less than 40% of assets invested in mutual funds.¹

Index funds are passively managed, which means they typically hold what's in the index (which rarely changes) to maximize returns and minimize costs. Most mutual funds and a few ETFs are actively managed, giving fund managers the ability to trade any security in their market segment as often as they like in an effort to beat the benchmark.

Here are a few examples of index funds and what each one tracks:

1. **Vanguard 500 Index Fund (VFIAX):** 500 of the largest companies in the U.S.
2. **iShares Russell 2000 ETF (IWM):** 2000 U.S. small-cap stocks
3. **Fidelity Sustainability Bond Index Fund (FNDSX):** Bonds that meet environmental, social, and governance criteria
4. **Global X Millennials Thematic ETF (MILN):** U.S. companies benefiting from millennial generation spending habits
5. **Direxion Work From Home ETF (WFH):** U.S. companies benefiting from people working at home

3.4.2 Pros and Cons of Index Funds

Pros of Index Funds

1. **Dependable performance:** Investors should get the same return as the index, minus fund-management costs. Historically, index funds have better returns than actively managed funds.
2. **Lower costs:** The composition of an index fund's portfolio rarely changes, which results in lower trading costs and lower taxes for the investor. As well, the fund's

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operating costs are reduced, as there's no need to hire portfolio managers, stock researchers, and pay commissions from constant trading. On average, active fund costs are about 1.3%, or R1.30 for every R100 in the fund.²

3. **Transparency:** Many index funds simply hold what's in the index (which rarely changes) so investors can see the fund's holdings anytime. This transparency lets you better judge an index fund's risk based on those holdings. For instance, an index fund tracking the volatile oil and gas sector may be much riskier than a bond index fund.
4. **Simple diversification:** Rather than buying individual stocks and attempting to create your own portfolio, you can buy slices of hundreds or thousands of companies at once. The diversification inside that ready-made portfolio minimizes risk—if one stock or bond is down (for the day or a year), another is probably up.

Cons of Index Funds

1. **Lack of flexibility:** Because the fund's mandate is to track the index, the fund typically holds the same securities, no matter the market's direction. The fund manager can't sell stocks that are underperforming, especially during a broad market decline.
2. **Rarely outperforms the index:** The lack of flexibility means index funds are unlikely to post a return higher than the benchmark. And while investors are guaranteed the index's return when the market (or sector) rallies, they are also guaranteed the index's loss when the market falls.
3. **Tracking error:** The difference between an index fund's return and the performance of its parent index is a reflection of the costs to run a portfolio. This is called a "tracking error." When comparing index funds that track the same index, always go for the one with a smaller tracking error.
4. **Management differences:** Indexes are not objective scientific measurements, but created by companies that determine an index's makeup. The decision-making process isn't heavily regulated and not always transparent and can be influenced by overall management approaches. Sometimes the index funds and the index have the same managers, which can create a conflict of interest.

3.4.3 How Should I Choose an Index Fund?

Before buying an index fund, investors need to evaluate a few important factors:

1. **Risk tolerance:** How much risk are you willing to take for the anticipated return, and what are the specific risks associated with the fund? Does this fund's strategy fit your investment goals?

2. **Fees:** How much will you pay for buying, owning, and selling the fund? Comparing funds that cover the same sector is a good way to compare costs.
3. **Time horizon:** How soon will you need the money?

As with any investment vehicle, the investor should read all the information available about the fund, especially the fund's prospectus.

The Bottom Line: Are Index Funds a Good Investment?

Over the past 10 years, index funds, ETFs, and mutual funds have consistently outperformed actively managed funds. In general, index funds can be a very good investment. However, before investing, carefully research possible index funds or ETF buys, as they're not all alike. Some investors can find their own answers, and others may need the help of a financial advisor.

Investing in stocks can be an efficient way to build wealth over time. Learning how to invest wisely and with patience over a lifetime can yield returns that far outpace the most modest income. Nearly every member of the Forbes 400 wealthiest Americans made the list in 2019 because they owned a large block of shares in a public or private corporation.¹

It all starts with understanding how the stock market works, what your investment goals are, and if you can handle a lot or just a little bit of risk.

You might have to settle for lesser results if you don't have much time or interest in managing your investments.

3.5 Equity Funds vs. Individual Shares

One of the most important and difficult choices you will face as a new investor is whether you should invest in equity funds or individual stocks. Investing in an equity fund means buying shares of a portfolio overseen by a professional portfolio manager. The portfolio manager is responsible for picking the stocks in the portfolio, as well as the buy, sell, and hold decisions.

Once you've chosen a good equity fund, your responsibility is to continue buying shares, reinvesting your dividends and capital gains, and checking the mutual fund annual report each year to ensure the management company is sticking to the financial philosophy in which you believe; that you are comfortable with the holdings. In a lot of ways, it would be like checking the performance of a building manager you hired to oversee your rental properties.

On the other hand, picking individual stocks means it is your responsibility to build a portfolio, pour over annual reports and 10k filings, make acquisition and disposition decisions, and keep up to date with what is happening at each of the companies in which you maintain an investment. It is, after all, your hard-earned money! For a lot of people, that sounds like the equivalent of intellectual torture.

Here are a few ways to tell if you should invest in equity funds or, instead, pick your own individual common stocks.

a) Reading and Understanding Financial Statements

Can you read GAAP financial statements, including the income statement and balance sheet? If you have that skill, selecting your own individual stocks shouldn't be any more difficult than analyzing a division or private business opportunity such as investing in a limited liability company. In such a situation, it seems a little silly to hire a professional money manager to sit around and research businesses for you all day unless you would rather focus on your primary occupation.

Studying, Understanding, and Analyzing Companies

There are very few things more enjoyable for some as much as finding a great company, then learning about its business, industry, products, cost inputs, strategy, and how it fits into the world. Do you love being able to walk into a grocery store and know the gross profit margins for the company that distills a certain brand of whiskey, or pass a hotel and know its average cost per room to construct it? What about discussing the total pre-tax profit it should be generating if it is well run and moderately successful?

Studying businesses (and individual stocks, by extension) is a way to understand the world and what people truly value.

If you don't care about those things, it doesn't make a lot of sense to waste your time trying to find individual companies in which you can become a partial owner. Pay a professional their management fee and acquire good, well-diversified equity funds, instead.

b) Multiple Positions vs. a Handful of Funds

Even a focused investment portfolio will likely include 10 to 20 stocks; a widely diversified portfolio could contain 30 to 100 stocks. Do you want to have to keep track of all those securities? The dividend dates and income? The cost basis for each position? If you don't mind and have a large enough portfolio to justify it, individual stocks might be for you. If you

want to be able to build your entire investment portfolio history on a single, short spreadsheet, equity funds are probably the better selection.

c) Which Should I Choose? Equity Funds or Stocks?

If you aren't able to think like a long-term investor, you might want to build in a layer of protection and choose equity funds over individual stocks. Unless you go the ETF route (exchange-traded fund), mutual funds only adjust their stock price, or Net Asset Value, once per day, after hours. It frees you from the need to be glued to a screen or panicking over a fifty-cent move in a blue-chip stock that shouldn't cause you any consternation.

By the time you're done reading this content and working through the linked resources, you should know enough about bond investing to ask informed questions of your broker, financial adviser, registered investment advisor, or asset management company. The biggest benefit is that you can feel more confident, objective, and less emotional about your investment decisions when you understand the language and risks.

Bonds are a type of investment that results in an investor lending money to the bond issuer in exchange for interest payments. Bonds are one of the most important investments available for those who follow an income investing philosophy, hoping to live off the money generated by their portfolio. With the variety of different options available to you, including municipal bonds, commercial bonds, savings bonds, and treasury bonds, you need to know which is right for your unique situation as well as the dangers presented by owning different types of bonds.

3.6 Bonds

Ways to Invest in Bonds

There are several types of bonds in which you can invest and even more ways you can hold these bonds. Below are some resources and articles that you may want to use as you form your investment plan. Benjamin Graham, known as "the father of value investing" and a mentor to billionaire investor Warren Buffet, believed that defensive investors should never have less than 25% of their portfolio in bonds but price and terms matter;¹ e.g., look at the insanity of investors investing in bonds with record-low fixed yields and maturities of 50 to 100 years.

1. Investing in Corporate Bonds: By lending money to companies, you can often enjoy higher yields than you get on other types of bonds. For most investors who are in middle to higher tax brackets, it's better to buy these in a tax shelter.

2. **Investing in Municipal Bonds:** This complete beginner's guide to investing in municipal bonds, which are exempt from certain state taxes under certain situations. It is a great place to begin if you are in a middle to high tax bracket. By investing in your local schools, hospitals, and municipalities, you can not only help your community but also make money. Once you're ready to move beyond the very basics, you can read Tests of Safety for Municipal Bonds. This article will teach you some of the calculations you can do, the considerations you should make when looking at a municipal bond investment.
3. **US Savings Bonds:** Get a broad education on savings bonds, their history, considerations before adding them to your portfolio, and tax notes.
4. **Series EE Savings Bonds:** These unique bonds offer tax advantages for education funding, the guarantee of the United States Treasury, a fixed rate of return for up to thirty years, and more.
5. **Series I Savings Bonds:** Series I savings bonds feature an interest rate based, in part, on changes in inflation, are guaranteed to never lose money and are backed by the taxing power of the United States Government.² This collection of articles will teach you how to invest in Series I savings bonds, tell you who is eligible to own them, and explain the annual purchase limits.
6. **Bond Funds vs. Bonds:** Many new investors don't know whether they should own bonds outright or invest in bonds through a special type of mutual fund known as a bond fund. What are the differences, benefits, and advantages? Take a few moments to read the article to discover the answers.
7. **Junk Bonds:** One of the most alluring types of bonds new investors often spot is something known as a junk bond. Boasting high, double-digit yields during ordinary interest rate environments, these dangerous bonds can lure you in with the promise of big cheques in the mail, yet leave you high and dry when the companies that issue them miss payments or go bankrupt. Stick to investment-grade bonds, instead. If you don't know what you are doing, be extra safe and reserve your holdings to Triple-A rated bonds.
8. **The Many Flavors of Preferred Stock:** The preferred stock of many companies is actually very comparable to bond investments because both types of investments tend to behave the same way. To understand bond investing, you need to understand preferred stocks because the tax laws allow you to pay between 0% and 20% on dividend income received from preferred stocks, compared to full 39.6%+ depending upon your tax bracket on interest income on bonds.³

3.6.1 Dangers of Investing in Bonds

Although bonds have a reputation that makes people believe they are safer than stocks, there are some real dangers that can hurt new investors who don't know how to reduce risk.

1. **How Bond Spreads Can Hurt Investors:** Bond spreads are a hidden commission charged to you when you buy or sell bonds. They can sometimes cost you hundreds of rands every time you buy a single bond! Learn how to identify them and ways they can be minimized.
2. **Understanding Bond Duration:** This seemingly simple term actually refers to the fact that if you buy a bond that matures in 30 years, it could fluctuate far more violently than a bond that matures in two years. In some cases, bonds with high durations can actually fluctuate as much as stocks! Learn what bond duration is and how you can calculate it in this important article.
3. **The Danger of Investing in Foreign Bonds:** When you buy bonds of other countries or even companies located in other countries, there are very real dangers that you are not exposed to when you purchase in your home country. If you owned bonds in oil companies headquartered in Venezuela, for instance, you would have found your assets nationalized and seized by former dictator Hugo Chavez (1954-2013) without any way to recover what you lost.⁴ This article explains those dangers and some of the things you can do to reduce them.

3.6.2 Advanced Bond Investing Topics

Bond prices are often used as a valuation tool to help professional investors determine how expensive stocks and other assets are. This is done by comparing bond yields on certain types of government bonds to earnings yields on a stock.

3.7 The Basics of Mutual Funds

A mutual fund is a pool of money provided by individual investors, companies, and other organizations, and is one of the easiest and least stressful ways to invest in the market.¹ A fund manager is hired to invest the cash the investors have contributed, and the fund manager's goal depends on the type of fund; a fixed-income fund manager, for example, would strive to provide the highest yield at the lowest risk. A long-term growth manager, on the other hand, should attempt to beat the Dow Jones Industrial Average or the S&P 500 in a fiscal year, although very few funds achieve this.

3.7.1 Closed vs. Open-Ended Funds

Mutual funds are divided into closed-end and open-end funds, and the latter is subdivided by load and no load. Closed-end funds have a set number of shares issued to the public through

an initial public offering. Because these shares trade on the open market and closed-end funds don't redeem or issue new shares like a typical mutual fund, the fund shares abide by the laws of supply and demand and normally trade at a discount to the net asset value.²

A majority of mutual funds are open-ended, meaning that the fund does not have a set number of shares. Instead, the fund will issue new shares to an investor based upon the current net asset value and redeem the shares when the investor decides to sell. Open-end funds always reflect the net asset value of the fund's underlying investments because shares are created and destroyed as necessary.¹

A load, in mutual fund speak, is a sales commission. If a fund charges a load, the investor will pay the sales commission on top of the net asset value of the fund's shares. No-load funds tend to generate higher returns for investors due to the lower expenses associated with ownership.

3.7.2 Benefits of Investing in a Mutual Fund

Mutual funds are actively managed by a professional money manager who constantly monitors the stocks and bonds in the fund's portfolio. Because this is their primary occupation, they can devote considerably more time to selecting investments than an individual investor. It provides the peace of mind that comes with informed investing without the stress of analyzing financial statements or calculating financial ratios.

3.7.3 Selecting a Fund

Every fund has a particular investing strategy, style, or purpose. Some, for instance, invest only in blue-chip companies, while others invest in start-up businesses or specific sectors. Finding a mutual fund that fits your investment criteria and style is vital; if you don't know anything about biotechnology, you probably shouldn't be investing in a biotech fund. You must know and understand your investment.

After you've settled on a type of fund, turn to Morningstar or Standard & Poor's (S&P) for more information.⁴ Both of these companies issue fund rankings based on past records. You must take these rankings with a grain of salt, though; past success is no indication of the future, especially if the fund manager has recently changed. If you already have a brokerage account, you can purchase mutual fund shares as you would a share of stock. If you don't, you can visit the fund's web page or call them and request information and an application.

While some funds don't have a minimum initial investment, most funds have a minimum initial investment, which can be as low as R25 or as high as R100,000. The minimum initial

investment may be substantially lowered or waived altogether if the investment is for a retirement account—like a 401k, traditional IRA, or Roth IRA—or the investor agrees to automatic, reoccurring deductions from a checking or savings account to invest in the fund.

3.8 The Importance of Rand-Cost Averaging

The rand-cost averaging strategy is used to offset the negative impacts of market volatility by spreading out when you buy mutual fund shares into intervals, purchasing approximately the same amount each time. For example, instead of putting R4,000 into a mutual fund at once, you may decide to put in R1,000 every quarter.

This strategy helps to ensure you don't dump large amounts of money into a mutual fund while the price point is high or overvalued, and it is just as applicable to mutual funds as it is to common stock. Establishing such a plan can substantially reduce your long-term market risk and result in a higher net worth over a period of 10 years or more.

Chapter 4

Insurance Investment Vehicles

Introduction – Article

<https://businesstech.co.za/news/finance/349447/pension-fund-vs-provident-fund-vs-retirement-annuities-in-south-africa/>

The National Treasury calculates that only around 6% of South Africans are on track to retire comfortably, which means it is crucial to start saving towards one's retirement as early as possible, says CEO of Fedgroup Walter van der Merwe.

He said that the hard truth is that most people have to retire, whether they have a choice in the matter or not.

“Even if you still have a bond or car to pay off, and a family to support, once you hit the retirement age, most companies will send you packing,” he said.

To maintain your standard of living, a proper retirement plan will help ensure sufficient income once permanent employment is no longer an option, said van der Merwe.

He said that the general rule is that you should consistently save between 15% and 20% of your monthly salary between the ages of 20 and 60, to retire comfortably.

An increasing number of funds in South Africa offer their employees variable contribution rates, from 5% to 20% of their annual salary, he said.

“A carefully considered retirement plan needs to take into account all your expenses – big and small, as well as planned and unplanned, to ensure that you put away sufficient savings every month.”

Van der Merwe said that one of the most commonly asked retirement questions is, what is the difference between a pension fund, a provident fund and a retirement annuity fund?

Currently, the differences between these three savings vehicles are substantial, but coming legislation may make them very similar, he said.

4.1 Pension fund

A pension fund can only be joined through a company that employs you, and your money is managed by the trustees of the fund.

“Your contributions as well as your employer’s contributions, are tax-deductible up to a point. Upon retirement, you can take up to a third of your savings in a cash lump sum, which is taxable. The rest must be used to purchase an income/annuity, which is also taxable.

“If you leave the company before retirement, you can move your retirement savings out of the company fund, either to your new employer’s fund, a preservation fund or a retirement annuity fund, or take a cash payout, which is taxed,” the financial expert said.

4.2 Provident fund

A provident fund is different to a pension fund in that you are able to withdraw the entire savings amount as a lump sum when you retire.

Government is intending to align the benefits of provident funds to those of pension and retirement annuity funds. This means that provident funds will ultimately be essentially identical to pension funds.

The result is that you will only be able to withdraw a third of your provident fund savings as a lump sum upon retirement, while the rest has to be invested in an income/annuity fund that pays you a monthly income.

However, this legislation has not been applied and has been postponed until 1 March 2021.

Retirement annuity

A retirement annuity fund, to which you also make monthly contributions, is completely independent of your employer, allowing you to choose what funds you invest this money in (limited by retirement fund regulations), said van der Merwe.

“Upon retirement, you are allowed to take a maximum of a third of your savings as a cash lump sum and the balance must be used to purchase an income/annuity.

“If you change jobs before retirement, this will not impact your retirement annuity, as you are not permitted to access any portion of these funds before retirement,” he said.

4.3 Annuities

4.3.1 What are annuities?

An annuity is a contract between you and an insurance company that requires the insurer to make payments to you, either immediately or in the future. You buy an annuity by making either a single payment or a series of payments. Similarly, your payout may come either as one lump-sum payment or as a series of payments over time.

4.3.2 Why do people buy annuities?

People typically buy annuities to help manage their income in retirement. Annuities provide three things:

- Periodic payments for a specific amount of time. This may be for the rest of your life, or the life of your spouse or another person.
- Death benefits. If you die before you start receiving payments, the person you name as your beneficiary receives a specific payment.
- Tax-deferred growth. You pay no taxes on the income and investment gains from your annuity until you withdraw the money.

4.3.3 What kinds of annuities are there?

There are three basic types of annuities, fixed, variable and indexed. Here is how they work:

- Fixed annuity. The insurance company promises you a minimum rate of interest and a fixed amount of periodic payments. Fixed annuities are regulated by state insurance commissioners. Please check with your state insurance commission about the risks and benefits of fixed annuities and to confirm that your insurance broker is registered to sell insurance in your state.
- Variable annuity. The insurance company allows you to direct your annuity payments to different investment options, usually mutual funds. Your payout will vary depending on how much you put in, the rate of return on your investments, and expenses. The SEC regulates variable annuities.
- Indexed annuity. This annuity combines features of securities and insurance products. The insurance company credits you with a return that is based on a stock market index, such as the Standard & Poor's 500 Index. Indexed annuities are regulated by state insurance commissioners.

4.3.4 What are the benefits and risks of variable annuities?

Some people look to annuities to “insure” their retirement and to receive periodic payments once they no longer receive a salary. There are two phases to annuities, the accumulation phase and the payout phase.

- During the accumulation phase, you make payments that may be split among various investment options. In addition, variable annuities often allow you to put some of your money in an account that pays a fixed rate of interest.
- During the payout phase, you get your payments back, along with any investment income and gains. You may take the payout in one lump-sum payment, or you may choose to receive a regular stream of payments, generally monthly.

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All investments carry a level of risk. Make sure you consider the financial strength of the insurance company issuing the annuity. You want to be sure the company will still be around, and financially sound, during your payout phase.

Variable annuities have a number of features that you need to understand before you invest. Understand that variable annuities are designed as an investment for long-term goals, such as retirement. They are not suitable for short-term goals because you typically will pay substantial taxes and charges or other penalties if you withdraw your money early. Variable annuities also involve investment risks, just as mutual funds do.

4.3.5 How to buy and sell annuities

Insurance companies sell annuities, as do some banks, brokerage firms, and mutual fund companies. Make sure you read and understand your annuity contract. All fees should be clearly stated in the contract. Your most important source of information about investment options within a variable annuity is the mutual fund prospectus. Request prospectuses for all the mutual fund options you might want to select. Read the prospectuses carefully before you decide how to allocate your purchase payments among the investment options.

Realize that if you are investing in a variable annuity through a tax-advantaged retirement plan, such as a 401(k) plan or an Individual Retirement Account, you will get no additional tax advantages from a variable annuity. In such cases, consider buying a variable annuity only if it makes sense because of the annuity's other features.

Note that if you sell or withdraw money from a variable annuity too soon after your purchase, the insurance company will impose a "surrender charge." This is a type of sales charge that applies in the "surrender period," typically six to eight years after you buy the annuity. Surrender charges will reduce the value of -- and the return on -- your investment.

4.3.6 Understanding fees

You will pay several charges when you invest in a variable annuity. Be sure you understand all charges before you invest. Besides surrender charges, there are a number of other charges, including:

- **Mortality and expense risk charge.** This charge is equal to a certain percentage of your account value, typically about 1.25% per year. This charge pays the issuer for the insurance risk it assumes under the annuity contract. The profit from this charge sometimes is used to pay a commission to the person who sold you the annuity.

- Administrative fees. The issuer may charge you for record keeping and other administrative expenses. This may be a flat annual fee, or a percentage of your account value.
- Underlying fund expenses. In addition to fees charged by the issuer, you will pay the fees and expenses for underlying mutual fund investments.
- Fees and charges for other features. Additional fees typically apply for special features, such as a guaranteed minimum income benefit or long-term care insurance. Initial sales loads, fees for transferring part of your account from one investment option to another, and other fees also may apply.
- Penalties. If you withdraw money from an annuity before you are age 59 ½, you may have to pay a 10% tax penalty to the Internal Revenue Service on top of any taxes you owe on the income.

4.3.7 Avoiding fraud

Variable annuities are considered to be securities. All broker-dealers and investment advisers that sell variable annuities must be registered. Before buying an annuity from a broker or adviser, confirm that they are registered using the free and simple search tool on Investor.gov.

In most cases, the investments offered within a variable annuity are mutual funds. By law, each mutual fund is required to file a prospectus and regular shareholder reports with the SEC. Before you invest, be sure to read these materials.

4.4 Endowments

4.4.1 What is an Endowment Fund?

Definition: An endowment fund is a financial asset, typically held by a non-profit organization, which contains the capital investments and related earnings leveraged by the non-profit organization to fund the overall mission.

What Does Endowment Fund Mean?

What is the definition of endowment fund? While endowment funds are typically structured by strict contractual obligations and rules to be followed by the non-profit organization, the primary purpose of the fund is to ensure the long-term financial health of the non-profit organization and its beneficiaries.

Typically speaking, endowments are most notably associated with organizations such as hospitals, universities, churches, and scholarship funds. While specific rules and obligations apply, the most common trait of a fund is the organizations inability to leverage the principal balance for operations, rather, only income generated by the capital investments is available

to the organization for use in operations. These rules help to ensure the long-term growth of the financial asset, which in turn helps to expand on the achievement of the non-profit organization's overall mission.

Let's take a look at a basic example of how endowment funds work!

4.4.2 Example

Some of the largest endowment funds in the world are held by universities, who leverage the funds to offset certain portions of their operating expenses. Let's say for example, a university has a lot of generous and wealthy alumni who like to donate money to the university's endowment each year. The financial donations accumulate in the fund as the principal balance, and certified fund managers ensure the principal balance of all donations are invested into a variety of different investment options that are typically restricted by the investment policy of the endowment.

In our example, let's assume the fund principal balance is R50,000,000 and the policy of the fund states that the university cannot leverage the principal balance to fund operations. During the year, the principal balance of the fund was invested based on the fund manager's investment strategy, and the investments generated interest and dividend earnings of R2,500,000. So, how much of the endowment can the university use? The answer is R2,500,000. The university can utilize the investment earnings to pay for things such as expanding academic programs or building new school facilities.

Summary Definition

Define Endowment Funds: Endowment fund means is an investment made by or on the behalf of a foundation that uses the earnings from the investment to fund its operations.

GLOSSARY

A

ACCOUNTING POLICIESThe specific principles, conventions, rules and practices applied by a company in preparing and presenting its financial statements.

ACCRETIONThe increase in value of an asset over a period of time in a predictable or pre-determined way. The opposite of amortisation.

ACQUISITION COSTS/EXPENSESExpenses related to the procurement and processing of new business. Includes both direct costs such as commission payments and indirect costs such as product development and advertising.

ACTUARYSomeone who uses mathematics (in particular, probability) to provide solutions to insurance-related problems. Actuarial techniques are used to design new insurance products and to assess the profitability of new and existing business.

ADDITIONAL VALUE OF IN-FORCE LONG-TERM BUSINESSAn estimate of future profits that will emerge over the remaining term of all existing life and pensions policies for which premiums are being paid or have been paid at the financial reporting date.

ADJUSTED HEADLINE EARNINGS (AHE)A key performance indicator for Old Mutual. Adjusted Headline Earnings is calculated as headline earnings, as defined by SAICA Circular 2/2015, adjusted for items that are not reflective of the economic performance of the Group

ADJUSTED NET WORTH (ANW)Represents the market value of the net shareholders' net assets held in respect of an insurance business and forms part of the embedded value of a life company.

AFFILIATEAn investment firm specialising in offering specific services to a select number of individuals (term is interchangeable with "boutique").

AIIMAfrican Infrastructure Investment Managers, a member of Old Mutual Alternative Investments.

AMORTISATIONAn accountancy term for the reduction in value of an asset by the systematic allocation of its depreciable value over its projected useful life.

ANNUAL GENERAL MEETING (AGM)The meeting for shareholders at which routine matters, such as the election of directors and approval of reports and accounts, are put to the vote of shareholders. Old Mutual generally holds its AGM in May.

ANNUAL PREMIUM EQUIVALENT (APE)A standardised measure of the volume of new life insurance business written. It is calculated as the sum of (annualised) new recurring premiums and 10% of the new single premiums written in an annual reporting period.

ANNUITYA regular payment from an insurance company made for an agreed period of time (usually up to the death of the recipient) in return for either a cash lump sum or a series of premiums which the policyholder has paid to the insurance company during their working lifetime.

APPLICATION LEVEL CThe level of compliance with the Global Reporting Initiative guidelines, a template for good corporate governance, that states a company should report fully on at least 10 performance indicators including at least one from each Indicator Dimension (economic, environmental and social).

ASSETAnything of value controlled by a business. Usually divided into four types: fixed (e.g. land, buildings and machines); current (eg cash, stock and payments owing); liquid (cash or funds that can be quickly converted into cash); intangible (eg goodwill and trademarks).

ASSET MANAGEMENTAn investment management service provided by financial institutions on behalf of their customers.

ASSETS UNDER MANAGEMENTThe total market value of the assets (shares, bonds, property, cash) managed by a company on behalf of itself and investors.

ASSUMPTIONSVariables applied to data used to project expected outcomes. In the life insurance business, when calculating the level of reserves required assumptions are made about the future outcome of events. These could include average life expectancy and policy surrender rates. These assumptions are then applied to the data, compiled from the business written, to project expected outcomes.

ASSURANCEA term sometimes used instead of "insurance", generally in connection with life business.

AUDITORA firm of accountants who check ("audit") a company's and Group financial statements and provide an opinion on the appropriateness of the financial statements.

B

BALANCE SHEETA statement showing the financial position of a business on a specific date by listing its assets (what it owns) and its liabilities (what it owes). This is also referred to as the statement of financial provisions.

BANCASSURANCEAn arrangement whereby banks and building societies sell life, pension and savings products on behalf of other financial providers.

BASIS POINTUsually one hundredth of a percentage point (0.01 per cent), most often used in quoting movements in interest rates or yields on securities.

B-BBEEBroad-Based Black Economic Empowerment relates to activities associated with the South African Government's Broad-Based Black Economic Empowerment Act of 2003 to distribute wealth across as broad a spectrum of South African society as possible.

BENCHMARK Typically a stock market index (for example, the JSE Top40 index) against which an investment fund compares its performance and mix of assets.

BID PRICE The price at which shares may be bought in the market.

BOND Typically a certificate of debt issued by a government or company in return for a loan from an investor. Bonds are sometimes known as fixed income securities, as they often have a fixed rate of interest and a predetermined repayment date or call date.

BOUTIQUE An investment firm specialising in offering specific services to a select number of individuals (term interchangeable with affiliate).

BUY BACK The purchase by a listed company of its own shares either through purchases in the open market or through making an offer to all shareholders to repurchase their shares.

BUY-SIDE A term used to refer to investment institutions concerned with buying various forms of listed and or unlisted securities. It is a term commonly used to refer to the institutional investors in South Africa.

C

CAPITAL ADEQUACY REQUIREMENT (CAR) The level of capital required by Old Mutual Life Assurance Company (South Africa) Limited to support its insurance business. It is mostly driven by the capital required to absorb investment risk, ie a fall in the value of investments of the business, and generally exceeds the level of capital required by the South African regulator (which is called the "Statutory Capital Adequacy Requirement").

CAPITAL GAIN The profit made on the sale of investments, such as shares or property.

CAPITAL GAINS TAX The tax required to be paid on any profit or gain made by selling something for more than it was bought.

CARBON DISCLOSURE PROJECT The Carbon Disclosure Project (CDP) is an independent not-for-profit organisation holding the largest database of primary corporate climate change information in the world. Thousands of organisations from across the world's major economies measure and disclose their greenhouse gas emissions, water use and climate-change strategies through CDP. Corporations are rated and the information helps investors, corporations and regulators to make more informed decisions.

CARBON EMISSIONS The release of carbon dioxide into the atmosphere. An increase in global atmospheric levels of carbon dioxide has been linked to climate change. All FTSE listed companies are required to report their corporate carbon emissions.

CASH FLOW The amount of cash a company generates and uses during a period.

CASH FLOW STATEMENT A mandatory part of a company's financial statements. The cash flow statement records the amounts of cash and cash equivalents entering and leaving a company and allows users to understand the ability of the company to generate cash and

how that cash is being spent. Cash flows are presented in terms of operating, financing and investing activities.

CERTAINTY EQUIVALENT METHODThis is a technique used to calculate embedded value which involves risk-adjusting future earnings rather than allowing for risk separately using an appropriate risk discount rate. The earnings from the assets in the business are calculated using risk-free reference rates, before tax and investment management expenses. All cash flows are discounted using risk-free reference rates, which are gross of tax and investment management expenses.

CLAIMNotification to an insurance company of a call by a policyholder to the benefits due under the terms of an insurance policy or scheme.

CLAIMS EXPENSESExpenses incurred while investigating and settling an insurance claim, over and above the cost of the claim itself. Can include legal and other professional fees.

CLAIMS INCURREDThe total of all claims sustained during an accounting period, whether paid or not. Also known as losses incurred.

CLAIMS RATIOClaims incurred, adjusted for any reinsurance, expressed as a percentage of net premiums earned.

CODE FOR RESPONSIBLE INVESTING IN SOUTH AFRICA (CRISA)CRISA is a voluntary code that applies to institutional investors such as pension fund and insurance companies as the owners of assets, and their service providers including asset managers and consultants. The code supports the integration of environmental, social and governance issues into investment decisions.

CODE OF CONDUCTOur Code of Business Conduct sets out details of the standards we will adhere to when dealing with others, including shareholders, employees, customers, suppliers, competitors and the wider community. It ensures that we maintain the highest ethical standards in carrying out our business activities.

COMBINED OPERATING RATIOA financial measure of insurance underwriting profitability that expresses the total of claim costs, commission and expenses as a percentage of premiums.

COMMISSIONPayment made to a salesman, agent or other intermediary, normally in return for selling an insurance or investment policy

COMMON EQUITY TIER 1 (CET)A banking term. Common Equity Tier 1 (CET1) is a component of Tier 1 capital that consists mostly of common stock or equity. It is a capital measure that was introduced in 2014 as a precautionary measure to protect the economy from a financial crisis.

COMMUNITY INVESTMENT PRINCIPLESThese principles help guide our community investment decisions, which in turn helps ensure we maximise the long-term impact and

strategic relevance of our investments. The Principles also provide us with a framework by which to measure and monitor our community investment activities.

CONSTANT CURRENCY Expressing results in constant currency removes exchange rate volatility and present results, for reference purposes, at unchanged exchange rates compared to prior period. This provides a clearer perspective of the underlying business performance relative to the prior reporting period.

CORRELATION Correlation is a statistical measurement of the relationship between two variables. Possible correlations range from +1 to -1. A zero correlation indicates that there is no relationship between the variables. A correlation of -1 indicates a perfect negative correlation, meaning that as one variable goes up, the other goes down. A correlation of +1 indicates a perfect positive correlation, meaning that both variables move in the same direction together.

COST OF CAPITAL Measures the opportunity cost incurred by a company for holding the level of required capital. The cost arises because the capital can only earn broad market-related returns while tied up in the business, potentially missing out on more profitable opportunities elsewhere.

COST TO INCOME RATIO/EFFICIENCY RATIO A banking term. Total operating expenses as a percentage of total income of the banking operations (net interest income and non-interest revenue).

COVERED BUSINESS A concept defined in the Market Consistent Embedded Value (MCEV) Principles and Guidelines. It generally refers to long-term business, which includes traditional life insurance, long-term healthcare and accident insurances, savings, pensions and annuities.

CREDIT LOSS RATIO

A banking measure. Total impairment losses on loans and advances, divided by the total average loans and advances.

CREDIT RATING A measure of the ability of an individual, organisation or country to fulfil its debtor obligations, usually in respect of debt. The highest rating is typically AAA, and the lowest D. Ratings are usually issued by a credit rating agency (eg Moody's, Fitch or Standard & Poors) or credit bureau.

CULTURAL ENTROPY Measures the amount of negative or limiting values that exist within an organisation resulting in unproductive employees.

CULTURE SURVEY A survey that enables Old Mutual to measure and manage the culture within its organisation. At Old Mutual the survey is conducted annually and covers all employees.

CURRENT ASSET Assets of a company which can be realised in cash, sold or consumed within one year. Typically there sum of cash, cash equivalents, receivables, inventories, prepaid expenses and other current assets.

CURRENT LIABILITIES Liabilities of a company that the company expects to satisfy within one year. Typically accounts payable, short term debt, notes payable, taxes payable, dividends payable and other current liabilities.

CYBER-CRIME Crime committed online or using a computer. This may involve stealing a person's identity, funds or digital property, network intrusions and the dissemination of computer viruses.

D

DEFERRED ACQUISITION COSTS (DAC) A method of accounting whereby the acquisition costs on insurance business with an extended contractual period are recognised over the life of the contracts rather than upfront at the time of sale. An example of this would be sales commission payable to an insurance broker. The costs are aggregated and capitalised on the balance sheet as an asset and amortised through the accounts over the contract's life.

DEFERRED ANNUITY An annuity due to be paid from a future date or when the policyholder reaches a specified age. A deferred annuity may be funded by the policyholder by payment of a series of regular contributions or by a capital sum.

DEFERRED FEE INCOME A method of accounting whereby fee income is recognised over the term of the contract with customers, rather than up front at the time of sale. The fees are aggregated and recorded on the balance sheet as a liability and amortised through the accounts over the term of the contract.

DEMUTUALISATION The process by which a mutual organisation owned by its members, such as a building society or insurance company, converts to a public limited company owned by its shareholders. Old Mutual demutualised in 1999.

DEPRECIATION The value of an asset in a company's accounts is reduced to reflect the passage of time and the rate at which it is being used.

DISCOUNTING Calculating the present value of a future amount to reflect that the value of money changes over time; ie. that money available at the present time is worth more than the same amount in the future due to its potential earning capacity.

DIVIDEND An amount based on a company's profits paid out to shareholders, usually in the form of cash, for each share they hold. Old Mutual generally pays an interim dividend in November, based on its half-year results, and a final dividend in May, based on its full-year results.

DIVIDEND COVER Expressed as how many times the company could pay its most recent dividend from its profit (after tax).

DIVIDEND YIELD The dividend payable on a share expressed as a percentage of the market price.

E

EARNED PREMIUMS Premium payments received by an insurer for cover provided during the current accounting period. Premiums received which relate to cover which will be provided in a future period are known as unearned premiums.

EARNINGS Another word for profit. It is calculated as revenues minus costs, operating expenses and taxes, minority interests and extraordinary items.

EARNINGS PER SHARE (EPS) Earnings per Share (EPS) is calculated as post-tax adjusted operating profit divided by the adjusted weighted average number of shares (WANS) held by our investors. EPS is an indicator of our profitability that measures how much we earn for each share held.

ECONOMIC CAPITAL Economic capital is the capital that an insurer holds internally as a result of its own assessment of risk. It differs from regulatory capital, which is determined by regulators. It represents an estimate of the amount of economic losses an insurer could withstand and still remain solvent with a target level of confidence over a specified time horizon.

EFFICIENCY RATIO/COST TO INCOME RATIO A banking term. Total operating expenses as a percentage of total income of the banking operations (net interest income and non-interest revenue).

EMBEDDED VALUE (EV) Life insurance contracts are usually long term and may involve complex payment flows. This means it is difficult to measure the value of a life insurance business or how much income it is likely to generate over time. EV is a way of indicating what the underlying existing business is worth, based on the total of the net assets already invested in the business and the profits expected to emerge in the future from that business. It does not include the value of any future new business.

EMBEDDED VALUE PER SHARE Embedded value divided by the weighted average number of shares in issue.

EMPLOYEE ENGAGEMENT The degree to which an employee is involved and engages with the company's corporate values.

ESG Environmental, social and governance factors that can affect the long-term returns on investment and can be integrated into investment analysis and decision making.

EUROPEAN EMBEDDED VALUE (EEV) EEV provides a common set of guidelines for insurance companies to use in calculating their embedded value. It attempts to measure the value of

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business in-force based on a set of best estimate assumptions, allowing for the impact of uncertainty in future investment returns. It is designed to provide an accurate reflection of the performance of long-term savings business and a method of comparing companies on a consistent basis.

EXCEPTIONAL ITEMA non-recurring event that materially affects a company's finances in a reporting period.

EXCHANGE RATEThe rate at which one currency may be converted into another.

EX-DIVIDENDThe ex-dividend date is the time when the registrar of a company draws up the list of shareholders who qualify for a dividend payment. If you hold or buy shares before the ex-dividend date, you are entitled to the most recently-announced dividend; if you buy after that date, the dividend goes to the previous owner of the shares.

EXPENSE RATIOExpenses associated with running an insurance business (eg. commission, professional fees and other administrative costs), expressed as a percentage of premiums. The annual operating costs of an investment fund, expressed as a percentage of assets.

EXPERIENCE VARIANCEIn calculating embedded value of life business, it is necessary to make assumptions about items such as lapses or surrenders, mortality experience, etc. In any period the actual result for these items will differ from the assumed experience; this is known as the experience variance.

EXTRAORDINARYA non-recurring event that materially affects a company's finances in a reporting period. This is expected to be extremely rare.

F

FAIR MARKET VALUEThe price that a reasonable buyer would be willing to pay and a reasonable seller would be willing to accept for a product on the open market.

FINANCIAL CONDUCT AUTHORITY (FCA)The regulator for UK financial services firms and financial markets in the UK.

FINANCIAL SERVICES BOARD (FSB)The regulator of financial services in South Africa.

FIXED ANNUITYWhere the insurance company guarantees to return the original investment and a minimum rate of interest which is fixed for a specified period of time.

FREE SURPLUS GENERATIONA key performance indicator for Old Mutual. Calculated as the difference between Adjusted Headline Earnings and the amount of capital required by the businesses to grow in line with the Group's strategy. This metric includes adjustments for non-fungible earnings and only includes Nedbank's contribution as a dividend and as such is a measure of surplus cash generated by the Group available for distribution or investment.

FTSE 100 INDEXAn index comprised of the 100 largest companies by market capitalisation on the London Stock Exchange. It is the benchmark index for share prices in London.

FTSE ALL-SHARE INDEX Regarded as the main benchmark for professional investors and widely used for index-tracking purposes. Today the FTSE All-Share index includes around 700 companies weighted by market capitalisation.

FTSE4GOOD The FTSE4Good is an index that measures the performance of companies that meet globally recognised corporate responsibility standards.

FUNDA pool of financial assets into which premiums are invested to produce an investment return. Examples include property funds, managed funds and with-profit funds.

FUND MANAGEMENT Management of money invested in funds, typically in stocks and shares, fixed interest, property and cash, on behalf of individual and institutional customers. Also known as asset management or investment management.

FUND SUPERMARKET A company that sells funds over the internet. Both fund groups and stockbrokers have set up fund supermarkets.

FUNDS UNDER MANAGEMENT (FUM) The total value at market prices of funds managed by a company on behalf of shareholders and customers.

G

GEARING/LEVERAGE Measure of the extent to which a company is funded by borrowings in relation to shareholders' equity. A highly geared or leveraged company carries higher amounts of debt, relative to equity.

GENERAL INSURANCE/PROPERTY AND CASUALTY INSURANCE (SHORT-TERM INSURANCE) Non-life insurance mainly concerned with protecting the policyholder from loss or damage caused by specific risks. Examples include motor, contents and buildings insurance. Property insurance covers loss or damage through, for example, fire or theft. Casualty insurance covers losses arising from accidents that cause injury to other people or damage to their property.

GLOBAL REPORTING INITIATIVE (GRI) The Global Reporting Initiative provides companies and organisations with a comprehensive sustainability reporting framework that is widely used around the world.

GOODWILL An intangible asset, arising from other assets acquired in a business combination that are not individually identified and separately recognised. In an acquisition it represents the difference between the fair value of the consideration transferred and the fair value of its net assets.

GREENHOUSE GAS EMISSIONS (GHG) Gases that absorb and emit radiation within the thermal infrared range which cause the greenhouse effect. The burning of fossil fuels contributes to this effect, which has been linked to climate change. The most common greenhouse gas is carbon dioxide.

GREENHOUSE GAS PROTOCOLThe Greenhouse Gas Protocol is an international accounting tool to help governments and businesses understand, quantify and manage their greenhouse gas emissions. It provides a consistent methodology by which companies can report their greenhouse gas emissions.

GROSSThis represents a total before deductions, for example the amount before tax has been deducted.

GROSS PREMIUM INCOMEIncome from business written during the period, before any reinsurance is taken into account.

GROSS PREMIUMS WRITTENThe total premiums that an insurer is contractually entitled to receive in relation to insurance contracts sold during the period, before any reinsurance is taken into account. Those premiums that will be paid or relate to insurance cover for a later financial period will not be treated as income immediately.

H

HEADLINE EARNINGS PER SHARE (HEPS)The SAICA Circular 2/2015, defines Headline Earnings as an additional earnings number permitted by the International Financial Reporting Standards (IFRS). The starting point is earnings as determined in IFRS (IAS 33), excluding separately identifiable re-measurements, net of related tax (both current and deferred) and related non-controlling interest, other than re-measurements specifically included in headline earnings. Headline earnings per share is a company's Headline Earnings divided by the weighted average number of shares in issue.

HEDGINGProtecting against the risk of losses in one investment by taking up other investment positions that will reduce that risk.

I

IFRSInternational Financial Reporting Standards. Accounting regulations that all publicly listed companies in the EU are required to use. These standards are designed to ensure companies prepare their accounts in the same way so that there is a common basis for comparison.

IMPAIRMENTImpairments are recognised in the income statement where the value of an asset as shown in the prior period balance sheet exceeds the value that the asset could be sold for currently. The amount shown in the balance sheet needs to be reduced through an impairment charge in the income statement.

INDEPENDENT FINANCIAL ADVISER (IFA)An IFA is a person or organisation authorised to give advice on financial matters and to sell the products of financial services providers.

INDEXED ANNUITYAnnuities designed to mirror the performance of an index (e.g. the JSE TOP40, S&P 500) by tracking the ups and downs of that index.

IN-FORCEAn insurance policy is said to be in-force from its start date until the date it is terminated.

INSTITUTIONAL INVESTORLarge financial institutions such as pension funds, unit or investment trusts, asset managers and insurance companies.

INSURANCEA contract taken out with an insurer to give financial protection against loss from a perceived risk. The person taking out the insurance is called the insured. Payments for the policy are called premiums.

INTANGIBLE ASSETSAssets that do not have a physical, tangible existence. For example goodwill, brand name, trademarks. The assets have a value to a company and an estimate of the value must be included in the company's accounts.

INTEGRATED REPORTAn integrated representation of both a group's financial and non-financial data and performance.

INTERIM RESULTSAccounts and other figures issued during the financial year, usually relating to the first six months of the financial year, to indicate business performance during that period. Old Mutual generally publishes its interim results in August.

INTERNAL RATE OF RETURN (IRR)A measure of the rate of return on an investment and therefore an indicator of the efficiency with which the company uses its capital.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)Accounting regulations that all publicly listed companies in the EU are required to use. They are designed to ensure companies in the European Union prepare their accounts in a similar way so that there is a common basis for comparison.

INVESTMENTBuying and holding assets, such as shares, bonds, property and commodities, to earn income or to make capital gains.

INVESTMENT INCOMEIncome such as share dividends and interest payments arising from the ownership of assets.

J

JAWS RATIOThe difference between the year-on-year rate of growth in income and the year-on-year rate of growth in costs. An increase in the ratio signifies increasing profitability.

JSEAcronym for the Johannesburg Stock Exchange (which is technically the JSE Limited)

JSE SRI INDEXAcronym for the Johannesburg Stock Exchange Socially Responsible Investment Index.

K

KEY RISK INDICATOR (KRI)A forward looking metric that is indicative of the trend of risk exposures for a particular risk or group of risks.

KING IIIA South African code of corporate governance issued in 2009. It recommends, among other things, that organisations produce an integrated report in place of an annual financial report and a separate sustainability report.

KING IVA South African code of corporate governance issued in 2016. It builds on its predecessors' positioning of sound corporate governance as an essential element of good corporate citizenship.

L

LAPSES/SURRENDERS/WITHDRAWALS The voluntary termination of a policy or the cessation of premiums payable by a policyholder before the maturity date.

LEVERAGE/GEARING Measure of the extent to which a company is funded by borrowings rather than shareholders' equity. A highly leveraged company carries a lot of debt.

LIABILITIES The debts of a company and other financial obligations.

LIFE INSURANCE An insurance contract which promises the payment of an agreed sum of money upon the death of the insured within a specified period of time.

LIQUID ASSET Cash or assets that can be readily converted into cash.

LIQUIDITY A measure of the ease with which a company's assets can be converted into cash, and therefore represents a company's ability to meet expected or unexpected cash calls.

LIQUIDITY HEADROOM Unencumbered available free cash and committed facilities available to Old Mutual Limited, which are available to meet expected and unexpected cash calls.

LIQUIDITY PREMIUM A liquidity premium can be viewed as compensation for the lower market liquidity of some bonds, particularly for longer dated and less actively traded bonds.

LOCAL CURRENCY TERMS The performance of overseas business calculated in the currency of that country to remove the effects of exchange rate volatility and give a clearer picture of underlying business performance and trends.

LONG-TERM BUSINESS A term used to describe our life, health and pensions business and includes both insured and non-insured business. The term is broadly used throughout the industry, for example it is a regulatory expression broadly equivalent to life insurance and pensions.

M

MANAGEMENT ACTION PLAN

An action or actions developed by management that are usually triggered by one or more of the following:

Risk exposure greater than risk appetite

Control breakdowns or weaknesses

Key risk indicator threshold breaches

Loss events

Audit findings

MARKET CAPITALISATIONThe value at current market prices of a company's share capital. Calculated by multiplying the current share price by the number of shares outstanding.

MARKET CONSISTENT EMBEDDED VALUE (MCEV)A standard of reporting for life insurance companies that provides a common set of principles and guidelines for use in calculating embedded value. MCEV attempts to measure the value of business in-force based on a set of best estimate assumptions, allowing for the impact of uncertainty in future investment returns. It is designed to provide an accurate reflection of the performance of long-term savings business and a method of comparing companies on a consistent basis.

MARKET LIQUIDITYThe volume of a company's shares being traded on the stock exchange. May affect the ability of investors to build or sell large holdings without a substantial impact on the share price.

MARK-TO-MARKET ADJUSTMENTAn accounting adjustment to the book value of an asset or liability to reflect its current market value.

MATURITYThe date that an insurance policy or other financial contract finishes or 'matures' and when the benefit under it becomes payable.

MINORITY INTERESTSThese are the proportion of our earnings on the balance sheet net assets that are not owned by our ordinary equity shareholders, for example preference shareholders or the minority shareholders of Nedbank. Another term that is commonly used is non-controlling interests.

MORTALITY TABLESActuarial tables showing life expectancy and death rates for an individual by sex and age. Mortality tables are used by life insurance companies for setting premiums and to ensure they have an appropriate level of reserves.

MULTI-MANAGER FUNDA fund that aims to invest in the best funds on the market rather than making investments directly into company shares or other assets.

MUTUALA business organisation, such as an insurance company or building society, owned by its members or policyholders. Profits are shared among the members through bonus payments, dividends or reductions in future premiums.

MUTUAL FUND/UNIT TRUSTA fund of shares, bonds and other assets held by a manager for the benefit of investors who buy units in the fund, effectively pooling their money with that of other investors. It enables investors to achieve a more diversified portfolio than they might have done by making an individual investment.

N

NETThe amount that the post the deduction of tax.

NET ASSET VALUEThe value of a company calculated by subtracting the value of its liabilities from its assets. The difference is the amount of money that would be available to ordinary shareholders if the company was wound up.

NET CLIENT CASH FLOW (NCCF)The difference between money received from customers (eg premiums, deposits and investments) and money given back to customers (eg claims, surrenders, maturities) during a period.

NET INTEREST INCOME (NII)The income a bank has received in a period less the interest it has paid.

NET PREMIUMS EARNEDThose net premiums written which relate to cover provided in the accounting period and are therefore treated as income in that period.

NET PREMIUMS WRITTENThe total premiums that an insurer is contractually entitled to receive in relation to insurance contracts written in the period less the cost of premiums paid to reinsurers.

NET PROFITThe amount a company has left over after deducting tax, interest, depreciation, fees, minority interests and extraordinary charges from its income in the financial period.

NET RISK (ALSO KNOWN AS 'RESIDUAL RISK')A net risk is the result of an assessment of the potential impact and frequency of a risk, after taking account of the controls put in place to manage the risk.

NEW BUSINESSThe value of long-term savings policies (including life assurance contracts) sold to new and existing customers in the period. Also includes any increases to the premiums on existing contracts.

NON-INTEREST REVENUE (NIR)The revenue received by a bank from sources other than interest; eg revenue from brokerage commission and capital management fees.

NON-PROFIT POLICYInsurance cover guaranteeing certain benefits, but where the policyholder bears no investment risk and does not gain or lose if returns differ from expectations. Pure risk business such as annuities and health insurance is normally written on a non-profit basis.

O

OFFER PRICEThe price at which shares may be sold in the market.

OPEN ARCHITECTUREWhere a company offers investment products from a range of other companies in addition to its own products. This gives customers a wider choice of funds to invest in and access to a larger pool of money management professionals.

OPERATING COSTS/OPERATING EXPENSESThe day-to-day expenses involved in running a business; eg sales and administration costs.

OPERATING PROFITThe difference between total income and total operating costs. Excludes non-operational items, such as one-off gains or losses from the sale of assets or acquisition costs.

OPERATIONAL RISK SCENARIOSForeseeable, hypothetical events relating to failure of people, processes, systems and/or external events that potentially could have a significant impact on an organisation's risk profile or capital.

ORGANIC GROWTHGrowth which excludes the impact of acquisitions or divestments or movements in exchange-rates.

OVERHEADSThe administrative costs of running a business that cannot be attributed to any specific activity but are still necessary for the business to function - eg rent, insurance, electricity and water.

OWN FUNDSRefers to a (re)insurance undertaking's available financial resources, calculated in accordance with the Solvency II rules, which can serve as a buffer against risks and absorb financial losses, where necessary.

P

PENSIONA regular payment received by an individual during their retirement until their death. A pension is usually bought through the payment of regular contributions during the individual's working lifetime. It may be a legal insurance contract, but this is not always the case.

PENSION FUNDA pool of pensions contributions invested for growth. A type of institutional investor who administers and invests funds for pension plans.

PLATFORMOnline services used by intermediaries and consumers to view and administer their investment portfolios. Platforms usually provide facilities for buying and selling investments and for viewing an individual's entire portfolio to assess asset allocation and risk exposure.

PREMIUMThe payment a policyholder makes in return for insurance cover. A single-premium contract involves a single lump sum payment made at the start of the contract. Under a regular-premium contract, the policyholder agrees at the start to make regular payments throughout the term of the contract.

PRESENT VALUE OF NEW BUSINESS PREMIUMS (PVNBP)A measure, using the MCEV methodology, of the present value of new business premiums written during the reporting period. Calculated as 100% of new single premiums plus the discounted present value of new regular premiums.

PRICE/EARNINGS RATIO (P/E RATIO)A simple measure for comparing the valuations and potential of different companies. Calculated as the share price divided by earnings per share

(EPS) in the latest financial year. In general a relatively high P/E ratio suggests that investors think a company's earnings have strong growth potential.

PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)The Principles for Responsible Investment are a set of principles which provide a recognised framework for the incorporation of environmental, social and governance issues into investment and ownership decision making practices.

PRIVATE EQUITYA financial asset made up of securities, shares and bonds that are not publicly traded or listed on a stock exchange.

PRIVATE SHAREHOLDER/INVESTORAn individual who buys and sells relatively small amounts of shares for their own benefit. Also known as an individual, retail or small investor.

PRO FORMA RESULTSA set way of restating a company's financial results when circumstances have changed, for example after a flotation, merger or takeover.

PROBABILITY DISTRIBUTIONA mathematical description of a range of possible values for a certain variable, identifying the likelihood of each possible value occurring.

PROFITThe amount by which income exceeds costs for a particular period.

PROFIT AND LOSS ACCOUNTAn account compiled at the end of a financial period showing the company's income and costs for the period and indicating gross and net profit or loss. This is also called an income statement or earnings statement.

PROPERTY AND CASUALTY INSURANCEAlso known as non-life or general insurance. Property insurance covers loss or damage through fire, theft, floods or other specified risks. Casualty insurance covers losses arising from accidents that cause injury to other people or damage to their property.

PROXY VOTINGA process whereby investors delegates their voting powers to Old Mutual to vote, on behalf of these investors, on a variety of issues relating to companies in which the investors have shares.

Q

QUARTILEInvestment funds are ranked on the basis of the total returns (income and growth) that they have produced for investors. The best performing are in the top 25% of the list (first quartile) and the worst performing are in the bottom 25% (fourth quartile).

R

RATE OF RETURNThe change in the value of an investment over a period of time, taking into account income arising from it and any change in its market value. Normally expressed as a percentage of the total amount invested.

RATING PROVIDER Provides Old Mutual investment managers with insights, metrics, ratings and analysis of environmental, social and governance-related information to help them integrate ESG factors into their investment processes.

REAL WORLD ECONOMIC ASSUMPTIONS A term used in the calculation of MCEV. The expected return is based on a projection from beginning of period to end of period for investment return. This requires assumptions regarding the investment returns expected to be achieved over the period. The investment return assumptions (for this purpose only) are based on the 'real world' returns in excess of the risk-free reference rate. The use of real world investment assumptions gives a more realistic basis for the expected return calculation and allows for returns commensurate with the risk underlying each asset class. Any under or over-performance of actual investment returns over the real world economic assumption will be reported through economic variance. These have no bearing on the calculated MCEV other than the calculation of the expected existing business contribution in the analysis of MCEV earnings.

RECORD DATE The date by when an investor must be recorded as an owner of shares to qualify for a forthcoming dividend or share distribution.

REGISTRAR Responsible for maintaining the register of a company's shareholders including their names and addresses and the number of shares that each shareholder owns. The registrar updates the register when a shareholder's personal circumstances or shareholding change, and also send out dividend cheques and share certificates.

REGULAR PREMIUM A regular premium contract (as opposed to a single premium contract) is where the policyholder agrees at the start to make regular payments throughout the term of the contract.

REINSURANCE A form of insurance bought by insurance companies to protect themselves from the risk of large losses.

RENEWABLE ENERGY Energy that comes from natural resources such as sunlight, wind, tides and geothermal heat, and is not derived from fossil or nuclear fuel. Renewable energy does not directly produce greenhouse gases which are linked to climate change.

REPORTED CURRENCY The currency in which a business reports its results. Old Mutual Limited's reporting currency is the South African Rand (ZAR).

RESPONSIBLE BUSINESS The way Old Mutual does business that takes account of its responsibilities to its stakeholders. Old Mutual has five responsible business pillars and introduced our Positive Futures Plan in 2015. This states our ambition in our two focus areas of financial wellbeing and responsible investment.

RESPONSIBLE BUSINESS FORUM The Responsible Business Forum champions and challenges Old Mutual's approach to Responsible Business. It provides a robust system to manage and discuss responsible business risks.

RESPONSIBLE BUSINESS POLICY Sets out the approach principles and mandatory minimum standards for the management of Responsible Business.

RESPONSIBLE INVESTMENT The incorporation of environmental, social and governance factors into investment and ownership decision-making processes.

RESPONSIBLE INVESTMENT (RI) STANDARD Our Responsible Investment Standard is an agreed aspirational standard for RI practices across Old Mutual.

RESPONSIBLE INVESTMENT COMMITTEE The Responsible Investment Committee is responsible for formalising Old Mutual's approach to Responsible Investment. Each member of the Committee is responsible for driving the implementation of Responsible Investment in their respective business.

RESPONSIBLE OWNERSHIP GUIDELINES These Guidelines set out Old Mutual Investment Group's approach to responsible ownership of its investments which integrates environmental, social and governance factors into the investment and ownership process.

RESULTS FROM OPERATIONS (RFO) A key performance indicator for Old Mutual. Results from Operations is calculated as Adjusted Headline Earnings before tax and minority interest, excluding net investment return on shareholder assets and finance costs. It is the primary measure of the business performance of the Old Mutual's individual segments and will quantify the segments' contribution to the Group's Adjusted Headline Earnings.

RETAIL DISTRIBUTION REVIEW (RDR) The RDR aims to drive structural change throughout the retail investments industry in order to ensure consumers can have confidence in their retirement and investment planning. Its ultimate aim is customer protection.

RETURN ON CAPITAL EMPLOYED (ROCE) Indicates the efficiency with which a company uses its assets to generate profits. Usually calculated as pre-tax profit divided by capital employed (total assets minus current liabilities) and expressed as a percentage.

RETURN ON EMBEDDED VALUE (ROEV) The annualised post tax operating profit calculated on an MCEV basis expressed as a percentage of the opening embedded value adjusted for dividends paid to equity holders.

RETURN ON EQUITY (ROE) A measure calculated by dividing profit after tax by the average amount of equity in the business. Equity indicates how much capital provided or belonging to shareholders is tied up in the business.

RETURN ON NET ASSET (RONAV) A key performance indicator for Old Mutual. Return on Net Asset Value is calculated as Adjusted Headline Earnings divided by average Adjusted IFRS equity. Adjusted IFRS Equity is calculated as total Group equity attributable to ordinary equity shareholders. It excludes equity related to Residual plc and discontinued operations and is further adjusted to recognise the equity attributable to the retained 19.9% interest in Nedbank.

REVERSE STRESS-TESTING Reverse stress-tests are stress tests that require a firm to assess scenarios and circumstances that would render its business model unviable, thereby identifying potential business vulnerabilities.

RIGHTS ISSUE A method by which a company raises additional capital by inviting existing shareholders to buy new shares in proportion to their existing holding, usually for less than the current market price of the shares.

RISK The threat of an event that will limit an organisation's ability to achieve its business objectives.

RISK ADJUSTED PERFORMANCE MEASURES A metric that measures returns based on the quantum of risk taken to generate those returns.

RISK APPETITE The level of risk that we are prepared to accept in the achievement of our objectives. Limits and early warning thresholds are set and we manage our risks within this.

RISK ASSESSMENT A forward-looking assessment whereby risks are identified and exposures assessed or measured in the context of the business objectives.

RISK CATEGORISATION A process for classifying risks possessing common qualities or quantities.

RISK MANAGEMENT FRAMEWORK A set of principles that provide the foundations and organisational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management processes throughout the organisation.

RISK POLICIES Policies that set out the minimum mandatory requirements that businesses must follow to mitigate key Group risks.

RISK PROFILE The entire portfolio of risks organised by risk category that are found within a particular organisation.

RISK QUANTIFICATION Attaching a probability or impact to the occurrence of a negative event. Risks are assigned a probability between 0 and 1. If it is certain that an event cannot occur, it is given a probability of 0; if it is certain that it will occur, it is given a probability of 1.

RISK-BASED CAPITAL Risk-based capital is the minimum amount of capital that an organisation needs to support its overall business operations. Risk-based capital is used to set capital requirements considering the nature, scale and complexity of the organisation.

RISK-FREE REFERENCE RATE The rate at which earnings are discounted in the MCEV calculation.

RUN OFF The process of managing accounts and settling claims for an insurance business or investment fund that has stopped accepting new risks or has been closed to new business.

S

SCENARIOA predicted sequence of events.

SCENARIO ANALYSISScenario analysis is a process of analysing possible future events by considering possible outcomes or scenarios.

SCOPE 1Emissions that are direct greenhouse gas emissions from sources owned or controlled by the company (eg the burning of diesel as a generator fuel).

SCOPE 2Emissions that are indirect, and associated with the purchase of electricity, cooling, heating or steam.

SCOPE 3Other indirect emissions not covered in scope 2 (eg employee business travel, purchased materials and waste).

SCRIP DIVIDENDSThe payment of dividends in the form of extra shares rather than cash.

SELL-SIDESell side refers to the part of the financial industry that is involved in the creation, promotion and sale of equities, bonds, foreign exchange and other financial instruments. Sell-side analysts and firms work to create and service products and research that are made available to the buy-side of the financial industry.

SHAREHOLDERS' FUNDSTotal shareholders' interests in a company, including issued share capital, retained profit and reserves.

SINGLE PREMIUMA single premium contract (as opposed to a regular premium contract) is where the policyholder makes one payment at the start of the contract and has no obligation to make any further payments.

SOLVENCY ASSESSMENT AND MANAGEMENT REGIME (SAM)SAM is the new risk-based solvency regime for the South African long-term and short-term insurance industries to align the South African insurance industry with international standards. SAM will be based on Solvency II that has recently been implemented for European insurers, but it will be adapted to South African circumstances.

SOLVENCY CAPITAL REQUIREMENT (SCR)The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%, calculated in accordance with the Solvency II rules.

SOLVENCY IISolvency II is the EU risk based solvency regime for EU (re) insurance companies. The rules are primarily concerned with the amount of capital that EU insurance companies must hold to reduce the risk of insolvency, and also with risk management standards.

SPREADUsually the difference between the price at which shares can be bought in the market (bid price) and the prices at which they can be sold (offer price).

STAKEHOLDERS Any person or organisation that has an interest or is affected in some way by Old Mutual. This includes employees, local communities or other businesses, non-governmental organisations, regulators and government.

STAMP DUTY A UK tax on the purchase of shares and other assets, such as houses.

STANDARD FORMULA A non-entity-specific risk-based mathematical formula used by insurers to calculate their Solvency Capital Requirement under Solvency II, if the company is not using an internal model.

STATISTICAL DISTRIBUTION An arrangement of values of a variable showing their observed or theoretical frequency of occurrence, eg frequency distribution - a distribution of observed frequencies of occurrence of the values of a variable.

STATUTORY ACCOUNTS The accounts that every public limited company is required by law to produce.

STRESS AND SCENARIO TESTING Stress and scenario tests test the organisation's resilience in the face of adverse conditions. For example, to test adverse market conditions, a set of economic stresses are defined, such as a rise in interest rates or drop in markets, and the organisation must then calculate whether it has sufficient capital to withstand these stresses.

SUM ASSURED The lump sum benefit payable under an insurance policy or contract in circumstances which are defined within the policy; eg the amount payable on the death of the policyholder.

SURRENDER Cancelling an insurance contract before it becomes payable (eg on the death of the policyholder) or reaches its maturity date.

SURRENDER VALUE The amount of money payable to the policyholder on cancellation of an insurance policy which has an investment element. Surrender values depend on premiums paid and time elapsed.

T

TANGIBLE FIXED ASSET Assets that physically exist such as property, plant and equipment. They are presented on the balance sheet net of any depreciation charges or impairment losses.

TAX WRAPPED A way for an individual to hold funds such that they gain certain tax benefits.

TECHNICAL PROVISIONS Amounts set aside on the basis of actuarial calculations to meet forecast future obligations to policyholders. Otherwise known as reserves.

TERM INSURANCE A type of life insurance where the benefit is paid only if death occurs within a specified period of time.

TICKER Abbreviations used to identify different companies traded on a stock exchange. Old Mutual is represented on the Johannesburg Stock Exchange by the ticker "OMU".

TIER 1 CAPITAL A banking term. TIER 1 capital the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock or equity and retained earnings, but may also include non-redeemable non-cumulative preferred shares.

TOTAL SHAREHOLDER RETURN The overall value to shareholders of their investment in the company over a given period of time. Includes movement in the share price and any dividends paid and reinvested and is usually expressed as a percentage of the share price at the start of the period.

U

UK STEWARDSHIP CODE The UK Stewardship Code is a best practice code from the Financial Reporting Council that aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders.

UNCLAIMED ASSETS Funds held by financial institutions that have been left untouched by their owners for a considerable period of time - eg dormant bank accounts or forgotten life insurance policies. Also known as orphan assets.

UNDERLYING PROFIT A profit measure used to provide a more meaningful analysis of underlying business performance. Underlying profit is calculated by adjusting profit before tax for items such as impairments and exceptional or one-off items such as restructuring expenses.

UNDERWRITER Someone willing to take on an insurance risk in exchange for a payment.

UNDERWRITING The process of deciding which risks an insurance company will cover, the terms of acceptance and the premiums it will charge.

UNDERWRITING PROFIT/LOSS (GENERAL INSURANCE) A generally accepted non-life insurance term, also referred to as underwriting result, representing earned premiums minus the cost of claims and operating expenses. It indicates whether premiums cover claims and expenses or not.

UNEARNED PREMIUMS Premiums received by an insurer which relate to cover provided outside the current accounting period. Such premiums are normally treated as income in the period to which they relate.

UNIT TRUST Fund of shares, bonds and other assets held by a manager for the benefit of investors who buy units in the fund, effectively pooling their money with that of other investors. The price of the units is determined by the market value of the assets that the pooled funds are invested in. See also Mutual Fund.

UNITED NATIONS GLOBAL COMPACT (UNGC) Businesses that are signed up to UNGC have committed to aligning their operations and strategies with ten principles in the areas of human rights, labour, environment and anti-corruption. The Global Compact is a practical framework for the development, implementation and disclosure of sustainability policies and practices for businesses. Each business must report their actions on progress against the principles annually in a "Communication on Progress".

UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT (UN PRI) The UNPRI is a set of principles that provides a recognised framework for the incorporation of environmental, social and governance issues into investment and ownership decision making practices.

UNIT-LINKED POLICY A type of long-term savings plan where premiums are used to buy units in an investment fund, such as a unit trust, and the benefits will be linked to the value of the underlying units rather than being fixed or guaranteed at the start of the plan.

UNREALISED The profit or loss expected to be achieved through selling an asset but where the transaction has not yet taken place. The profit or loss is "realised" when the transaction takes place.

V

VALUE OF IN-FORCE BUSINESS (VIF) Part of the embedded value of a life insurance company. It represents the discounted value of the profits expected to arise from the in-force business. VIF is calculated using a set of actuarial, economic and operational assumptions.

VALUE OF NEW BUSINESS (VNB) The discounted value of the future profits expected to arise from all new business sold during a reporting period. VNB is calculated by using actuarial, economic and operational assumptions.

VARIABLE ANNUITY A long-term unit-linked investment suitable for retirement savings. Payouts are dependent on the change in value of the investments that underly it.

VOLATILITY The amount by which a share price or market index rises and falls during a period of time. If it is stable or rarely changes it has low volatility; if it changes quickly or unpredictably it has high volatility.

W

WEIGHTED AVERAGE COST OF CAPITAL (WACC) The average cost of the capital invested in a company, weighted by that company's capital structure of debt and equity funding.

WHOLE LIFE INSURANCE A type of life insurance where the benefit is payable on death, whenever it occurs.

WITH-PROFIT POLICY A type of investment policy in which extra amounts (bonuses) may be added to the sum assured to reflect profits earned during the course of the contract.

Regular bonuses are usually added each year and, once declared, are usually guaranteed. A final or 'terminal' bonus may be added when the policy becomes payable.

WRAP ACCOUNTAn account in which a broker or fund manager executes investment decisions on behalf of a client in exchange for a fee. These decisions might include share holdings, investment funds, pensions and life insurance contracts.

WRAP PLATFORMAn investment platform which enables investment funds, pensions, direct equity holdings and some life insurance contracts to be held in the same administrative account rather than as separate holdings.

WRITE DOWNThe reduction in the value of an asset on the balance sheet to reflect its current market value.

WRITE OFFTo acknowledge the loss or worthlessness of an asset by removing it entirely from the balance sheet.

X

XAn abbreviation used to indicate that a share is trading ex-dividend - ie. that people who buy the share now will not receive the most recently declared dividend.

Y

YIELDRate of return on an investment in percentage terms, taking into account annual income and any change in capital value

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