Decoding the Investment Universe

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To some the word "*investment*" can be intimidating and something that is only accessible to the wealthy. And as such it can leave those apathetic, resulting in a reluctance to understand the importance of investing and the critical role it plays in one's future prosperity. Other jargon and seemingly technical areas such as taxation, legislation and of course risk scare people even further away from engaging with their investment needs.

However, the truth is that if you are employed and are a member of a retirement (either pension or provident) fund you are already investing. Your employer is deducting a portion of your monthly salary and, through your staff retirement fund, investing it for your retirement. Gone are the days when retirement funds' rules guaranteed an income for life. Current retirement plans invest your contributions into the stock market and other assets to generate growth on these assets. As such it is important that you understand your investment needs and have a strategy behind these, bringing your company provided fund into this consideration as well.

Today, we will try and explain, in as simple terms as possible, what you need to know about investment concepts. Our goal is to clear up any confusion you may have about investing.

Risk

Firstly let's deal with that all important question of "risk". Risk cannot be eliminated. However, it can be measured and managed within an investment portfolio.

Investment risk can be defined as the probability or likelihood of the occurrence of losses relative to the expected return on any particular investment. Simply put, it is a measure of the level of uncertainty of achieving the returns as per the expectations of the investor.

The key for an investor is to decide on the appropriate level of risk appetite that you have. It is absolutely critical to speak to a professional Financial Adviser to determine your risk appetite. This will assist you in achieving your lifestyle goals and objectives.

Asset Classes

One of the most effective ways of reducing the investment risk is to hold a diversified investment portfolio across a number of shares, asset classes and managers. None of these will consistently provide the best performance over all time periods.

Within asset classes, a simple spectrum to consider is one that has 'defensive' assets and 'growth' assets on either end.

Defensive asset classes have a lower potential rate of return over the long-run but also are less likely to lose money. Cash and fixed interest investment (such as bonds) are considered defensive assets.

On the other hand growth asset classes have the potential to earn a higher rate of return but whose returns are less stable in the short term (and as such are more risky, or "volatile" in the short term). Shares and listed property shares are examples of growth asset classes.

So what do the various asset classes entail? The phrase "cash is king" may perhaps stem from the fact that as an asset class it is one of the least volatile investments if you choose to deposit it at your local bank. However, there are other fixed interest investments which are a bit more interesting. Bonds, for example pay a fixed Rand income in the form of a coupon payment for an agreed period of time.

The most important consideration for a long-term investor when considering these investments is the risk that they will not beat inflation. Inflation is the erosion of the value of money over time, as goods and services become more expensive. Long term investors must keep returns in excess of inflation in mind, and the expected return in excess of inflation in the long term for cash and other less volatile asset classes is very low, and sometimes negative.

What you need to know:

- The different maturity terms and forms of bonds may perform differently in varying economic and market conditions and they can rise and fall in value.
- If you sell fixed interest investments prior to maturity and interest rates fall during the time you hold the investment, you could enjoy a gain on the original investment.
- If interest rates fall, the capital value of the fixed interest investment is likely to rise and the income return should gradually decrease to reflect the lower interest rates available in the market.
- If you sell a fixed interest investment prior to maturity and interest rates rise during the time you hold the investment, you could receive a lower value than you would have received on maturity, therefore incurring a loss.
- If interest rates rise, the capital value of fixed interest investments is likely to drop and the income return should gradually increase to reflect the higher interest rates available in the market.
- If you decide to reinvest a fixed interest investment, your new investment may provide a higher or lower level of income than your original investment, given that interest rates may be higher or lower at maturity than at the time you made your investment.
- Generally, the longer the bond has to maturity, the more sensitive its price will be to changes in market interest rates. Therefore it is generally more appropriate for longer term investors who can tolerate short term volatility.
- As bonds can fluctuate, they are more volatile and offer a higher potential rate of return than cash and short term securities, but they are generally less volatile and offer lower potential rate of return over the long term than growth assets.

If your appetite for risk is larger, or more aggressive and you have a longer time horizon, you may want to consider growth assets such as South African shares, international shares, and South African or international property securities.

Owning shares in a South African company makes you part owner of that company. They can offer sound long-term value in the form of capital growth.

Although shares can be expected to outperform any other investment classes over the long-term, you must be prepared for volatility and fluctuations particularly in the short to medium term. Investing in international shares enables you to diversify your share market exposure, not only across a broader range of countries but also into companies and industries that do not exist on the South African share market. International shares also allows you to hedge against currency deflation.

Investing in property securities as an asset class is different to buying a house or an investment property. South African listed property company are an investment that is listed on the Johannesburg Stock Exchange and provides exposure to a portfolio of direct property investments. Whereas, an International listed property company is an investment that is listed on international stock exchanges. Listed property companies own a range of properties such as residential, commercial, retail and industrial. Some investments across all those property types and others focus on specific sectors.

Some managed investment funds invest in a portfolio of listed property companies. The advantage of this is that investors access the benefits of investing in property (for example, capital growth and income) whilst their investment remains liquid. Also, managed property security funds spread investors' risk, as they provide a more diversified property portfolio.

What you need to know:

- Investing in a single share, or very small number of individual shares, is likely to expose you to greater fluctuation in the value of your investment than investing across a range of shares.
- If your long-term investment strategy includes this asset class, it is important to resist selling your shares in response to short term market movements.
- International shares: The income return from international shares generally does not provide a dividend tax benefit.
- International shares: Both the capital value and the income return of the investment may be influenced by currency exchange rates.
- In the short to medium term, the values of listed property companies are expected to increase or decrease in value in accordance with movements in both the listed property sector and the share market generally. As a result property securities are more volatile than defensive assets and should be viewed as a long term (5 year plus) investment.
- Property securities tend to generate higher returns in income than capital growth.
- International Property Securities: Both the capital value and the income return of the investment may be influenced by currency exchange rates.

As always, an NMG Financial Adviser is at hand to walk you through your options and educate you further about investing.