

# Basic Investment Course

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## Unit 3: Why should I invest in shares?



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## 3.1. Return

### 3.1.1. What is a return?

The reason we invest our money in shares is to increase our wealth. We increase our wealth by getting a good “return” on our investment. Let’s investigate what we mean by the concept of return.

The return on an investment consists of any dividend, interest, rent or other income added to the increase in the value of the asset over a set period, usually expressed as an annualised percentage of the original investment. For example, if you bought shares for R10.00, received a dividend of 25 cents and then sold them 6 months after the date of purchase for R11.75 cents, then your return consists of 25 cents dividend, plus R1.75 of capital growth, which is 20% ( $2/10$ ) of your original investment of R10.00 . This is 40% ( $12/6 \times 20\%$ ) on an annualised basis.

When we make an investment in a share or any asset, we all want to get a good return on our investment.

In simple language a return is the excess you get back over and above your initial investment and the higher that is the better.

We investigate the concept of return further.

### 3.1.2. The concept of the required rate of return and the components of an investor’s required rate of return

As an investor, the required rate of return is one of the factors to consider when selecting securities for your share portfolio. The required rate of return is the minimum rate of return you should accept from an investment, in order to compensate you for not buying something today. In other words, an investor invests in an investment today in order to enjoy the benefits and rewards at a later stage.

The components of an investor's required rate of return that will compensate him/her for the risk taken are:

The time value of money during the investment period

The expected rate of inflation during the investment period

The risk involved

Let us examine each of these components one by one.

1. **The time value of money during the investment period.** The time value of money refers to the value of a sum of money at a future date that has been invested at a certain rate of compound interest over a certain period of time.

For example, say you invest R10,000 in a bank account that gives you 5% interest per year.

After one year you will have R10,000 plus the 5% of R10,000 = R500. So in total you will have R10,500.

After two years you will have the R10,500 you had at the end of the first year plus 5% of the R10,500 = R525. So in total you will have R11,025 and so on.

1. Investors generally prefer to receive money from an investment sooner rather than later. Obviously, money received by an investor today can be invested in order to generate a greater or additional return tomorrow. Therefore, the earlier cash is received, the greater the potential for increasing wealth. If an individual is prepared to sacrifice the use of money for a specified time, some compensation is required in return.

So what this means is that when you invest in a share, the share must do well enough in order to take the time value of money into account. The important thing to remember is that time eats away at your money as we see when we discuss inflation below.

In other words, the share must do better for you than simply leaving the money in a bank account.

**2. The expected rate of inflation during the investment period.** The increase (or decrease) in inflation must be included in any calculation in order to properly reflect the value of the investment at a later date.

This means that in times of rising prices the spending power of money decreases over time. Any lender would expect to be compensated for this decline in spending power. If the interest rate does not compensate the lender for inflation, the lender would be poorer when the capital is repaid than at the time when the loan was made.

**3. The risk involved.** This must also be included in the assessment of the required rate of return on an investment. Risk factors vary from one type of investment to another or from one type of environment to another. For example the risk of investing in small cap firms can be high, but the returns expected should compensate for the risk taken.

If there is some uncertainty that the capital amount will be repaid, a premium will be required by an investor. When there is a high degree of certainty about an investment's return, for example, in the case of government bonds, the premium will be low. This is consistent with the most fundamental principles of financial management: that the return must be commensurate with the risk taken.

The minimum rate of return required from any investment changes over time. This means that the rate of return does not remain constant but depends upon expected changes in the three variables that have been discussed. It is important however, for you as an investor to achieve a return that compensates you for the amount invested, when there is any element of risk involved.

### **3.1.3. Risk and return**

We have all heard the saying “ the higher the risk, the higher the return”

In other words, the more risk you are prepared to take when investing in a share the greater the chance of achieving a higher return and vice versa.

Let's analyse this in more detail.

### ***Risk premium and the associated fundamental sources of risk***

**Risk premium** is the excess return required by an investor over and above the risk free rate (risk free is risk free because it is backed by the government who is unlikely to ever go bankrupt) earned in a bank or with a government bond as a result of the uncertainty about the expected rate of return. In other words, if there were no uncertainty about the return that an investment could yield, then an investor's required rate of return would equal the risk free rate. However, we know that there is uncertainty in the environment and therefore investor's seek a risk premium in order to compensate them for bearing this risk.

For example, if we go back to our example in 3.1.2. where we invested R10,000 in a bank, we obtained a risk free rate of return of 5% and we earned just over R1000 over a two-year period in interest.

If we invest the same R10,000 in a share, we are likely to earn a greater return than 5% because we require more return for taking more risk.

Investing in shares is more risky than keeping your money in a bank account, but you are likely to earn a much better return.

What all this means is that the higher the risk the higher the return you require. If you obtain a return of say 11% on your share investment, the risk premium is the additional 6% you earn over and above the risk free rate of 5% you earned in the bank.

Factors that influence risk and create uncertainty include:

**Business risk** - A business does not always have a guarantee of steady income or cash flow and when there is income and cash flow it can fluctuate quite a bit. This makes investing in shares a riskier option than simply putting money in the bank. But as we have said before, a higher risk means a higher return.

For example, a retail-clothing store, such as Edgars may have seasonal highs and lows, but will still receive a steady flow of income over any particular business cycle. On the other hand, a mining company may experience spurts of income on a less frequent basis, and thus its earnings will fluctuate more dramatically over a year. In the latter instance, the business risk is substantially higher for the investor than the former.

**Financial risk** is the uncertainty that relates to how a firm finances its investments. If a company uses ordinary shares to finance the company, then this company will be subject to business risk only. Borrowing money from a bank or other financiers involves interest charges being paid by the company before providing income or returns back to the shareholders, thereby increasing the uncertainty of the return to investors. The use of debt creates a fixed financing cost for the company, as interest has to be paid. The company is therefore exposed to greater risk, as it has to pay its interest. This risk is known as **financial risk**.

**Liquidity risk** refers to the uncertainty or ability of the investor to be able to convert an investment into cash in the secondary market, in order to use that cash for other purposes. In other words what we are talking about here is how easy it is to sell your shares.

**Exchange rate risk** is the uncertainty that investors experience when they purchase securities in a currency other than their own domestic currency. For example, if you invest in a gold mine, you will experience exchange rate risk because the price of gold is linked to exchange rates.

The more volatile the exchange rate between two countries, the less certain an investor would be regarding the exchange rate, the greater the exchange rate risk, and therefore the larger the exchange rate risk premium required.

**Country risk** or **political risk** relates to the uncertainty of returns as a result of political issues or changes in a country that may impact upon the economy. Developed countries such as the USA, UK and Germany are believed to have relative stability in the political environment and hence are regarded as low risk countries to invest in. However, countries like Zimbabwe and Argentina are developing countries with an unstable political environment and therefore present a high country risk for the potential investor.

The risk premium is a composite of all the risk factors mentioned above. Therefore, investors should take all of these issues into consideration when making an investment decision. For example, whilst the country risk may appear to be low, the liquidity risk within the share market of that country may present a high risk.

#### **3.1.4. Historical returns**

As we have mentioned before, one of the main reasons you would invest in shares is that over a long period of time, shares do outperform any other type of investment and they often experience extreme returns.

Let's take a look now at some examples of shares that have recently experienced huge returns on the JSE.

Here are some examples of historical returns achieved by some shares on the JSE during the 2003-2004 year. These are just some shares that have experienced some extreme returns recently.

***The returns below are for the 12 month period up to 15/11/04.***

- Edgars - increased in value by 116%.
- Sasol - increased in value by 40%.
- Standard Bank - increased in value by 63%.
- Massmart - increased in value by 84%.
- Abil - increased in value by 82%.



- Grinrod - increased in value by 262%.
- Foschini - increased in value by 82%.

Telkom - has grown 237% since listing on 4th of March 2003. It has increased in value by 58% for the 12-month period to 15<sup>th</sup> November 2004.

### 3.1.5. Tax advantages

So, when you buy and sell shares, what are the tax consequences and advantages, if any?

When owning shares, you may receive dividend income from the shares.

The good news is that the dividend received is tax-free!

However when you make a capital gain (discussed below) on the sale of the shares, there is tax payable.

Let's learn more about this now.

*Please refer to the important Disclaimer at the front of this booklet: When it comes to tax, we advise you consult a tax adviser.*

### 3.1.6. Capital gains

A capital gain is the amount by which an asset's selling price exceeds its initial purchase price or base cost. A realised capital gain is an investment that has been sold at a profit. An unrealised capital gain is an investment that hasn't been sold yet but would result in a profit if sold. Capital gain is often used to mean realised capital gain. For most investments sold at a profit, including exchange-traded funds, bonds, options, homes, and businesses, the taxman is owed money called capital gains tax.

Capital appreciation thus occurs when shares or other investments are sold at a higher market price than they were purchased at. Until the shares are sold, no capital gain has been realised.

### 3.1.6.1. Capital gains tax (CGT)

Capital gains tax is a tax on profits realised from buying a security at one price and selling it (or holding it to redemption and then redeeming it) at another.

A persons' taxable capital gain for the year of assessment is-

- In the case of an individual, 25% of the net capital gain for that year of assessment
- Companies and trusts are taxed on 50% of the net capital gain for that year of assessment

### 3.1.6.2. Example – Computing CGT

An individual taxpayer acquired shares (or units in a unit trust) for investment purposes six months after the implementation of CGT for R10,000 and disposed of all those shares two years later for R30,000.

The gain is computed as follows:

Proceeds on sale	R30,000
Cost	<u>R10,000</u>
Gain	<u>R20,000</u>

There is an annual exclusion of R10,000 for a natural person.

Thus the capital gains tax payable is computed as follows

Gain	R20,000
Exclusion	<u>R10,000</u>

Taxable gain	<u>R10,000</u>
Amount subject to CGT	R2,500 (R 10,000 @25%)

To determine the taxes payable, you would now apply the marginal tax rate to the R2500.

Say for example, your marginal tax rate is 40%.

The tax you would pay is thus 40% of R2,500 = R1,000.

This is equivalent to 5% (1,000/20,000) tax instead of the high marginal rate of 40%.

If you trade very frequently you are probably going to be regarded as a share trader for tax purposes. If you are classified as a share trader, all the profits you make are income and fully taxed.

If you are an investor who does not trade all the time and you are not classified as a trader, then you are only subject to capital gains tax on profits you make on shares you sell.

It is not always clear as to whether you are deemed to be a trader or not. The South African revenue service will make that determination. If you are unsure whether you will be classified as a trader or an investor, we suggest you seek professional tax advice.

## Summary

In this unit we learnt about the concept of return on investment. We learnt that the return on an investment consists of any dividend, interest, rent or other income added to the increase in the value of the asset over a set period. We also learnt that the more risk you are prepared to take when investing in a share the greater the chance of achieving a higher return and vice versa. We discussed the concepts of risk premium, exchange rate risk, country risk and political risk. We introduced the

concept of a capital gain, which is the amount by which an asset's selling price exceeds its initial purchase price or base cost.

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