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## Chapter 1

# INTRODUCTION TO COLLECTIVE INVESTMENTS

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**Overview** This chapter introduces the basic concepts of collective investments and provides a broad introduction to the collective investment schemes.

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## Know and explain the concept of a collective investment

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain the concept of a collective investment scheme.
- Explain the role of diversification.
- Explain basic terms associated with collective investments.
- List the advantages and disadvantages of collective investment schemes.

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The concept of a collective investment is illustrated graphically.
- The role of diversification in an investment is explained in relation to an investment portfolio.
- Basic terms associated with collective investments including but not limited to *interest, income, equity, capital growth, yield and unit price* are understood and explained with reference to a selected collective investment scheme fund.
- The inherent advantages and disadvantages of collective investments as an investment are listed from the point of view of a small investor/new investor.



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## What is a Collective investment scheme?

### Overview

The potential of collective investment schemes is enormous. Collective investments provide a means for ordinary people to invest in the stock exchange and to beat inflation by getting good returns. Many people do not have the vaguest idea of what collective investments are. In a way they can be described as a group of people investing for a common interest. The world of collective investments is so vast that it can be overwhelming as there are many types of funds. The purpose of this chapter is not to tell you precisely when and in what to invest, but to help you become aware.

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### Definition

A collective investment scheme (previously known as a collective investment scheme) is a trust based scheme that comprises a pool of assets that is managed by a collective investment scheme manager (previously known as the collective investment scheme management company) and is governed by the Collective Investment Schemes Control Act no 45 of 2002. Collective Investment Schemes (CIS) are a popular form of investment, and they are accessible to all. Each investor has a proportional stake in the CIS portfolio based on how much money he or she contributed. The word "unit" refers to the portion or part of the CIS portfolio that is owned by the investor. The "trust" is the financial instrument that is created in order to manage the investment. The trust enables financial experts to invest the money on behalf of the CIS investor. Collective Investment Schemes provide a relatively secure means of investing on the Stock Exchange, and other financial instruments. The sums of money that are exchanged on the Stock Exchange and in the Money Markets make them too pricey for most people. With a CIS, the money or funds from a group of investors are pooled or collected together to form a CIS portfolio.



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## Pooling / Collective Investments

The act makes provision for five different types of collective investment schemes:

- CIS in securities (the portfolio consists mainly of securities and includes all local and foreign funds registered with the FSB. Most collective investment schemes fall in this category.)
- CIS in properties (The portfolio consists mostly of property shares. It is different to a PUT)
- CIS in participation bonds (The portfolio consist mainly of participation bonds.)
- Declared CIS (Any scheme the minister declares a CIS)
- Foreign CIS (Foreign schemes that solicit investments from South Africans and not registered with the FSB)

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### Units

The investment portfolio is divided into equal parts. These are referred to as "units". Each unit represents a direct proportionate interest in every asset in the portfolio. The investor will purchase units in the relevant fund and the amounts he or she will receive depend on the amount invested and the ruling NAV price (net asset value). The price of the units will reflect the value of the underlying investments. That sounds more complicated than it is. What it means is that the price of the unit will reflect the price of the share, bond or other investment in which the investor's money has been invested. The price of the units varies according to the market value of the investments in its portfolio. Since the introduction of the Collective Investment Schemes act in 2003 a net asset value, or "nav" price is quoted. This price reflects only the value of the underlying assets and accrued income. Fees are quoted separately. The value of these units is subject to the rises and declines in the stock market. With the new CISCA legislation the term "unit" was replaced by "participatory interest in a collective investment scheme" but for all purposes the industry still prefers to units.



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**Pooling  
/Collective  
Investments**

Pooling is the basic concept behind collective investments. The money of thousands of individual investors, who share a common investment objective, is pooled together to form a CIS portfolio. The CIS portfolio manager uses this pool to buy a diversified portfolio of investments on stock exchanges for example the Johannesburg Stock Exchange (known as the FTSE/JSE), international equities, bonds, derivatives, and other financial instruments. You will be learning about these investment products later in this course. The portfolio manager's decision will be based on the mandate of the portfolio and the economic house view of the asset manager.

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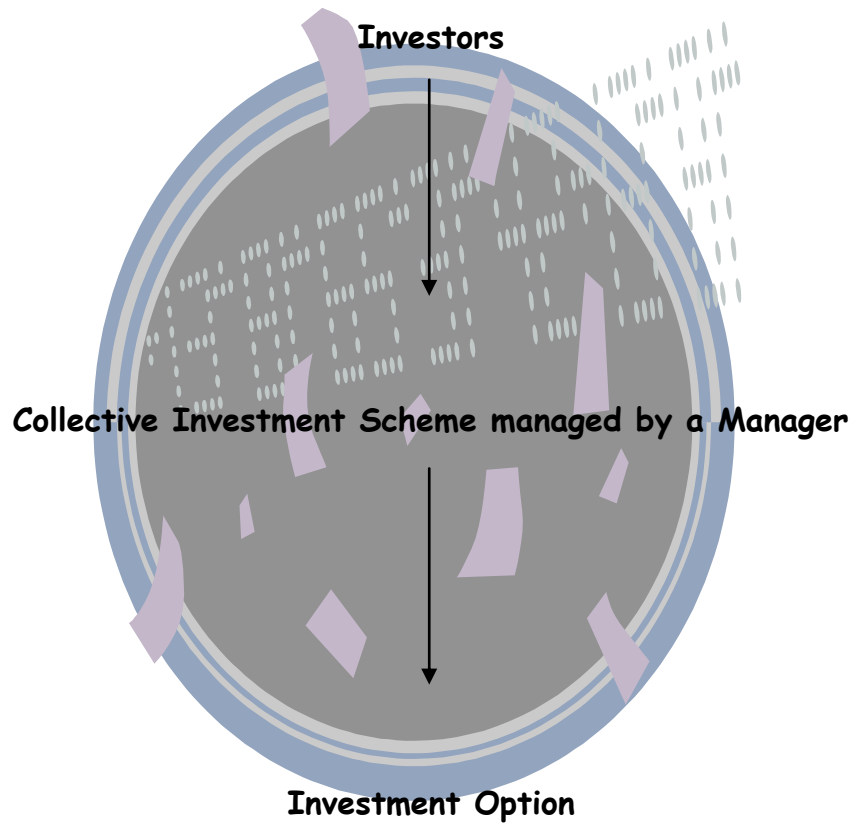
**Investment  
portfolio**

An investment portfolio is a collection of securities owned by an individual or institution (such as a collective investment scheme). A funds' portfolio may include a combination of financial instruments such as bonds, equities, money market securities, etc. The theory is that the investments should be spread over a range of options in order to diversify and spread risk. Each of the clients of the CIS manager will own a portion of the investment portfolio of the fund of their choice, indicating where his/her shares have been invested.



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Illustration of Pooling:





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**The Manager** The Manager is the bridge between the various investors and the portfolio or asset manager. A Manager usually handles the administration, marketing and sales of collective investments. To be able to fulfill these functions collective investments companies charge fees on every investment made in the fund. The structure of a Manager will differ depending on the size of the company and the type of core business that it is affiliated to.

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**Trustee** The trustee or custodian acts as the caretaker of all cash and securities in a scheme, holding these on behalf of investors. Another function is to ensure that the CIS is run in accordance with the deed of the scheme and the requirements of the act. For this reason the trustee must be independent, and cannot be a subsidiary or holding company of the CIS manager.

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**Portfolio manager** The portfolio or investment manager acts as the channel through which the investors invest their money. The portfolio manager is therefore responsible for investing the pool of investors' money. He or she will decide which securities to hold, when to buy or when to sell.

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**Diversification** Collective investment schemes work on the principle that spreading your investments over a range of products will protect the investors' money better than placing it all in one area of the financial market. Whereas this would cost a great deal of money if one were investing as an individual, the CIS is able to spread the investments by pooling investors' money. The level of diversification may vary between fund investment objectives.



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## Basic terms of a collective investment scheme

### Overview

The following definitions of some of the financial terms may help you understand the working of a collective investment scheme better.

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Term	Description
Assets	The investment holdings and cash owned by a collective investment scheme.
Bond	An IOU note issued by the Government, municipalities, or large organisation for money borrowed.
NAV price	Price at which a collective investment scheme's units are bought or sold by the fund.
Dividend	Dividends received by a cis from an asset in its portfolio are distributed to its investors (also called income dividend).
Equity	Shares in a company that represents part of the equity or ownership of the company.
Fund	Pool of cash from shareholders and invested in a variety of securities, including stocks, bonds and money market instruments.
Income	Payments to mutual fund shareholders of dividends, interest, and/or short term capital gains earned on the fund's portfolio securities after deducting operating expenses.
Capital growth	An increase in market value of a cis fund's securities, as reflected in the NAV of fund shares. This is a specific long-term objective of many cis funds. Also known as capital appreciation.
Trustee	Acts as custodian of funds.
Risk/Award	Investment principle that holds that an investment must offer the potential for increasing returns in order to compensate for increasing levels of risk.



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## Basic terms of a collective investment scheme

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Term	Description
Trust	Legal entity within which funds are administered.
Yield	<p>The income per share paid to a shareholder over a specified period of time. Yield is expressed as a percent of the fund's current price per share. For example, if your fund distributed R1 per share over a year and, at the end of the year, its price was R20 per share, its yield would be 5 percent:</p> $R1 / R20 = 5\%$
Interest	The price paid for borrowing money. It is expressed as a percentage rate over a period of time.
Securities	Certificate of stock, document detailing a loan or bond, or a form of promise or pledge to pay money.
Stock exchange	The generally accepted definition of a stock exchange is an institution that operates a market for the orderly buying and selling of financial products.



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**Advantages  
of collective  
investment  
schemes**

- They allow ordinary people to invest in shares that would normally be out of their financial reach if their money had not been pooled with that of other investors in the fund.
- They provide a means to beat inflation, as returns are normally higher than the inflation rate.
- CIS are a flexible form of investment, as you can either invest a lump sum or you can make a regular investment each month.
- CIS offers liquidity. In other words, the unit holder may choose to cash in a portion of the CIS or all of it. This means that your money is always accessible, which is not the case with all long-term investments.
- They can also be transferred to another party, and you can even invest on somebody else's behalf.
- You can monitor the performance of your CIS on a daily basis as it appears in the newspapers' business reports.
- Experts in the field of managing money, invest your money on your behalf.
- You can choose a CIS to meet your needs.
- You may invest in markets all over the world, and reap the benefits of rand hedging.
- Capital gains are taxed in the hands of the individual investor in respect of CGT.



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**Disadvantages  
of collective  
investment  
schemes**

- CIS are seen as medium to long-term investments, so investors should not expect to make a profit in the short term.
- All investments in securities, including CIS, run the risk that the markets may collapse and that investors may lose money.
- The CIS investor is dependent on the expert judgement of the portfolio manager, and there may be cases where the fund manager does not live up to expectations.
- Due to volatile market circumstances over the past decade the performance of many CIS has been disappointing, particularly in the equity sectors. In some cases there has been no capital growth at all, in other words, the CIS has not made a profit, which means that the investors have lost money.
- A CIS that is heavily slanted towards one sector may be negatively affected by economic changes in that sector.
- CIS charges have been deregulated and costs may differ from one scheme or manager to another.
- Schemes have become increasingly specialized in terms of their mandates and sophisticated in respect of the investment instruments used. Investors should therefore take great care that the profile of the CIS meets their needs and risk profile.



## ACTIVITY SHEET 1



Match the words in the first column to the best available answer in the second column.

- |                       |   |
|-----------------------|---|
| _____ CIS             | 1) Funds from group of investors are pooled.  |
| _____ Manager         | 2) Bridge between investor and asset manager. |
| _____ Trustee         | 3) Spread of investments                      |
| _____ Diversification | 4) Custodian of funds.                        |

## Answer Key:

- 1 CIS
- 2 Manager
- 3 Diversification
- 4 Trustee



## ACTIVITY SHEET 2



1. Explain what a *collective investment* is.

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2. Describe the function of the *portfolio manager*.

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3. Name 4 advantages and 4 disadvantages of a collective investment scheme in the table below.

Advantages	Disadvantages



## ACTIVITY SHEET 2



4. What does the term *diversification* mean?

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5. Use the information below to compile a diversified investment portfolio for a conservative client.

Gold shares   Financial shares   Bonds  
Money Market   Technology shares  
Empowerment shares



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## 1.2 Different investment instruments

### Learning outcomes

By the end of this section, the learner must be able to: -

- Identify different investment products.
- Compare the different products based on their potential.
- Investigate the risk attached to each product based on growth and income.

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The different investment products such as equities, shares, gilts, money market instruments, futures derivatives, and interest-bearing deposits are named with examples of each.
- The investment potential of the different products is compared based, on the investment characteristics of the product.
- The risk attached to each investment product is indicated, based on the growth and income.



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### Overview

There are a great number of different collective investment schemes. These schemes invest in a variety of investment instruments. In this part of the course we shall be examining the various investment instruments and comparing them in terms of their characteristics and in terms of the risk attached to them. You are not expected to know these instruments in detail, but you will be expected to be able to differentiate between them. Beginning to decipher this complex mass of information and concepts will help you make better choices.

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## Equities

### Definition

Companies issue shares, otherwise referred to as equities, in order to raise money. Equities are shares in a company that represent part of the equity or ownership of the company. The number of equity shares owned by an individual or a collective investment scheme reflects his/her ownership of the company. The risk attached to the equities can vary from low risk for blue chip companies, too high risk for others. The individuals, who invest their capital in the company, are known as shareholders. These shareholders are entitled to the following privileges within the company:

- Share in the profits of the company, which is referred to as dividends.
- Stand a chance to make a capital gain.
- Attend annual general meetings.
- Have voting rights depending on the specific type of shares.



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**Equities** Various types of shares are issued, such as Ordinary shares, Preference shares and N-shares.

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**Structure of  
FTSE/JSE  
Stock  
Exchange**



## Money Market

**Definition** Banks, corporate and large financial institutions issue instruments for borrowing and lending purposes in this specific market, known as the money market. These instruments offer a low level of risk and are highly liquid. The interest rate on these investments varies daily and they are regarded as a safe haven for investment. The effective rate is the annual rate at which an investment grows in value when interest is credited over a year. The nominal rate is often referred to as the daily interest rate.



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**Examples of  
Money  
Market  
instruments**

- **Banker's Acceptance (BA's)** is loan certificates issued by borrowers. The repayment of the initial loan amount is guaranteed by a bank, which stamps the document as proof of acceptance.
- **Treasury Bills** are short-term loan certificates issued by the SARB on behalf of government.
- **Promissory Notes and Commercial Paper** are unconditional loan certificates normally issued by large companies, and are not usually guaranteed by a bank.
- **Negotiable Certificate of Deposits** are tradable deposits issued by banks for a specific period and at a fixed interest rate, which is paid six monthly in arrears if the term exceeds one year, and on maturity if less than one year. NCD's can be sold prior to maturity and the ultimate holder of the deposit certificate will receive the interest.
- **Call, Notice and Fixed Deposits** are bank deposits with different liquidity constraints and offering differing rates of interest.

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## **Bonds**

### **Definition**

An IOU note issued by the Government, municipalities, or large organisation for money borrowed. The organisation that issues the bond pays interest to the holder of the bond and promises to repay the money at a later stage. They are regarded as a sound and safe investment.

There is a range of different types of bonds issued by various institutions. These bonds have different maturity and different coupon rates.



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### Types of Bonds

**Government stock:** Also known as RSA stock. These bonds constitute the long-term debt obligations of the government. These are the safest type of bonds as the government backs them. Therefore, they have lower risk of default (i.e. that the debt will not be paid).

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### Types of Bonds

**Semi-Government stock (semi-gilts):** Issued by semi-government institutions to finance capital projects and assets such as power stations, new railway lines, for example Eskom and Transnet.

**Corporate bonds:** Bonds, which are issued by companies.

**Zero Coupon Bonds:** This type of bond pays no interest, but instead is issued at a substantial discount to the redemption value.

**Inflation Linked Bonds:** The value of the bond is adjusted according to changes in inflation.

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## Derivatives

### Definition

This is a collective term used for financial instruments such as futures and options. Derivatives DERIVE their value from another security. Derivatives are risk-shifting devices, assisting those with certain risk to relocate them to others willing to carry the risks. They are usually based on a contract to buy or sell something in the future. This is why you often hear the term "future derivatives".



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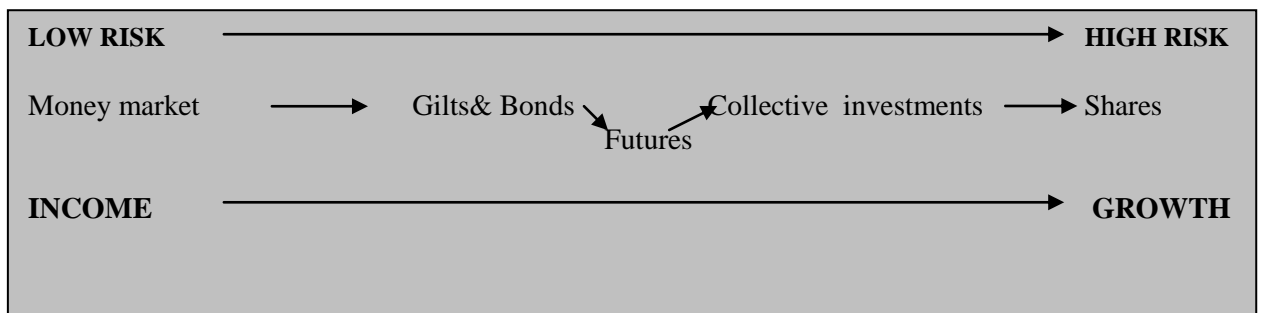
**Types of derivative instruments**

**Futures:** This is an abbreviation for futures contracts. It consists of an agreement between a buyer and a seller for the sale and purchase of a commodity (product), security or currency in a specified quantity at a fixed price on a certain date in the future. Derivatives i.e. futures are medium to high-risk investments.

**Options:** Gives the buyer the right, but not the obligation, to buy or sell an asset at a set price on or before a given date. Investors, not companies, issue options.

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## Risk profile of financial instruments





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**Growth  
rewards**

The primary goal of a collective investment scheme is to generate growth for the investor. In other words people want to see an increase in the value of their investment. They can do so by buying units at a low price per unit and sells it at a higher price. Example: Investor A bought units in the Sanlam Value Fund at R3.79 on 14.01.2001 and sells it on 14.01.2005 at R8.80. Investor A has made a profit of R5.01 per unit. We must also realize that there is a close relationship between risk and growth or return. The higher the risk of an investment the higher the returns as well as the potential for a loss. Capital growth is not the only aim of investors, as many investors are looking for a steady income, in which case the objectives will be different.

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**Income  
rewards**

Investors can receive an income from his or her collective investment scheme during the time that he/she owns them. Income funds are fixed interest investments aimed at providing a reasonable, steady income stream and generating total returns in excess of the returns of money market funds. With income funds, capital preservation is important and emphasis is therefore placed on investing in short-term money market and capital market instruments. If the collective investment scheme has invested in equities or shares, investors can receive dividends and/or interest from those shares, provided that the company in which the fund has invested made sufficient profit to declare dividends. Generally dividends and interest are paid to the client after the deduction of operating expenses. The investor can choose to have these payments made to him/her in cash or to re-invest it and buy more units.



## Investment Characteristics

Element	Money Market	Bonds	Equities
<b>Term</b>	Short term	Medium term	Medium to long term
<b>Investment Return</b>	Relatively low	Should outperform cash in a low interest environment and under perform equities or shares over the long term.	Should provide the greatest potential for capital gains over cash and bonds.
<b>Income or Capital Growth</b>	Provides income in the form of interest. The interest can be reinvested which will result in the increase of capital value.	Provides both interest income and potential for capital growth if the price of the bond strengthens.	Potential income will be provided in the form of dividends. This is, however, not guaranteed and the investment return is more in the form of capital growth if the share price rises.
<b>Risk</b>	Low	Medium	Medium to High
<b>Tax</b>	Interest income will incur an income tax event	Both the coupons and increase in the capital value are considered to be income, which will result in an income tax event.	Dividends are not taxable in the hands of the investor. Any capital growth made since October 2001 will incur a Capital Gains Tax event.



## ACTIVITY SHEET 3



The table below contains words that have been chopped in half. Find the pieces that fit together and write them in the answer area below.



deriv	market	res	money
rence	ures	gover	ions
prefe	equi	ri	ital
ome	nment	cap	nary
sk	gi	inc	atives
ties	opt	ordi	fut
sha	lts		

Place your answers here:

Gilts, money market, futures, equities, risk, shares,  
Preference, ordinary,  
Government, derivatives, options, capital, income





## ACTIVITY SHEET 4



1. List in the table below the four different forms of investment instruments and examples of each.

Investment instruments	Example

2. Investors need to know and understand the investment characteristics of the different instruments, before they can decide on the ideal instrument, which will suit them best. Why, do you think this is so important? Discuss in your groups and write down your answers.

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## 1.3 Classification of Collective investment schemes

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain the different geographical classes of collective investments
- Explain the basis for the classification of a collective investment.
- Name the geographical classes of collective investments with examples of each.
- Apply the broad asset classes to collective investment funds.
- List two specialist categories of collective investment funds

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### Assessment criteria

The learner will be assessed on the following criteria:

- **Geographical classes are explained with reference to the split between domestic and offshore exposure.**
- **The basis for the classification of a collective investment is indicated according to its investment portfolio-2<sup>nd</sup> tier of asset classes.**
- **The geographical classes of collective investment schemes are named with examples of collective investment funds in each class.**
- **The broad asset classes applied to collective investment funds are named with an example of a fund in each category.**
- **Two examples of specialist categories of collective investment funds are listed with examples of each type of specialist fund.**



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## Basis for classification

**Overview** Collective Investment Schemes are grouped into sectors to enable investors to compare the performance of portfolios with similar objectives and benchmarks.

The first step in the classification process is where Collective Investment Schemes in Securities are categorised according to where they geographically invest. This could be in **domestic** markets, **worldwide** or **foreign**.

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## Geographical Categories

**Domestic Collective investment schemes** These invest in the local markets and are the most widely available of the schemes. Minimum investment in SA should be 70% of the portfolio's assets. There are numerous examples of these in the CIS index in the business section of the newspaper, and we can take Investec Equity R Fund as an example.

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**Worldwide Collective investment schemes** Worldwide CIS invest in various markets around the world. There is no minimum set of exposure limits for either domestic or foreign assets.



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**Foreign Collective investment schemes** CIS in this category have a minimum of 85% of their investments outside of South Africa. An example of this type of CIS is STANLIB Global Equity Portfolio. These funds must not be confused with pure offshore funds in which investors can only invest their R4 million pa allowance. Offshore funds do not form part of the classification model.



## Asset Classes

### Overview

We have now looked at the various categories of schemes and classified them according to where they invest. Now we shall categorise the funds according to HOW and WHERE they invest money. In this context the "where" does not refer to the geographical area, but to the financial tools or instruments in which they invest.

Each of the geographic categories is subcategorised into the second tier of asset classes. They are named according to the type of investment that such a fund would make.



The categories are:

- Equities
- Asset Allocation
- Fixed Interest



<b>Equity</b>	A minimum of 75% of the fund must be invested in equities at all times. At least 80% of this equity portion must be invested in the JSE and a maximum of 20% may be invested outside the JSE sectors provided they comply with the category definition.
<b>Asset Allocation</b>	Invest in a wide spread of investments in the equity, bond, money and property markets.
<b>Fixed Interest</b>	Invest in bond, money market instruments and other income earning securities.



## Equity Funds

**Overview** Equity funds achieve their objectives by investing mainly in the equity or share market.

EQUITY	ASSET ALLOCATION	FIXED INTEREST	READ ESTATE
General funds	Prudential Low Equity funds	Bond funds	General funds
Growth funds	Prudential Medium Equity funds	Income funds	
Value funds	Prudential High Equity funds	Money market funds	
Large cap funds	Prudential Variable Equity funds	Varied Specialist funds	
Smaller companies funds	Flexible funds		
Mining & resources sector funds.	Targeted Absolute and Real Return funds		
Financial sector funds			
Industrial funds			
Varied Specialist funds			

**Equity General funds** - These funds invest in selected shares across all economic groups and industry sectors of the JSE Securities Exchange South Africa as well as across the range of large, mid and smaller cap shares. These funds do not subscribe to a particular theme or investment style. The funds in this category offer medium to long-term capital growth as their primary investment objective.

**Benchmark:** FTSE/JSE All Share Index (J203T)



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### **Equity- Growth Funds**

These funds seek maximum capital appreciation as their primary objective through investment in growth companies. Growth companies can be defined as those whose earnings are on or are anticipated to enter a strong and sustainable upward trend and typically trade on high price to earnings ratios (PE ratios).

These funds are invested in growth companies across all economic groups of the JSE Securities Exchange South Africa. Determination of a company as "growth share" takes into consideration the company's sustainable earnings growth on the basis of a combination of:

- The 2 year historical earnings growth and
- 1-year consensus I-net forecasts.

**Benchmark:** FTSE/JSE All Share Index (J203T)

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### **Value Fund**

These are funds seek medium to long-term capital appreciation as their primary investment objective. The funds seek out "value" situations typically investing in shares with low relative PE ratios as well as shares that is trading at a discount to their net asset value. These funds frequently offer a higher than FTSE/JSE All Share Index average level of income. These funds are invested in selected "value" shares across all economic groups of the JSE Securities Exchange South Africa.

Determination of a share as "value share" takes into consideration:

- The current PE trading at a discount to the average PE of the market.
- The dividend yield of the company significantly exceeding the dividend yield of the market.

**Benchmark:** FTSE/JSE All Share Index (J203T)



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**Equity -  
Large cap  
funds**

These funds seek long-term growth as their primary objective through investment in large market capitalisation shares which fall within the top 40 JSE Securities Exchange South Africa listed shares ranked by market capitalisation, *i.e.* included in the FTSE/JSE Top 40 Index.

**Benchmark:** FTSE/JSE Top 40 Index (J200T)

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**Equity -  
Smaller  
companies  
funds**

These funds invest in established smaller companies as well as in emerging companies that are in the initial phase of their life. New investment by the funds are restricted to fledgling, small and mid-cap shares only, and at least 75% of the fund will be invested in these shares at all times. Due to both the nature and focus of these funds, they may be more volatile than funds that are diversified across the broader market.

**Benchmark:** FTSE/JSE Mid Cap Index (J201T)



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**Equity -  
Resource and  
basic  
industries  
fund**

These funds invest in industries whose principal business operations involve the exploration, mining, distribution and processing of metals, minerals, energy, chemicals, forestry and other agricultural and natural resources or where at least 50% of their earnings are derived from such business activities and excludes service providers to these companies

These funds invest primarily in securities listed in the FTSE/JSE Resources and Basic Industries economic groups and may be more volatile than funds that are diversified across a wider range of FTSE/JSE economic groups.

**Benchmark:** FTSE/JSE Mining Index (J177T)

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**Equity -  
Financial  
funds**

These funds invest in shares of financial services companies including banks, insurance companies, brokerage firms and other companies whose principal business operations involve the provision of various financial service or where at least 50% of their earnings are derived from the provision of such financial services. The funds invest primarily in companies listed in the FTSE/JSE Financials Economic Group. These funds may be more volatile than funds that are diversified across a wider range of FTSE / JSE economic groups.

**Benchmark:** FTSE/JSE Financials Index (J580T)

**Equity -  
Industrial  
funds**

These funds invest in selected industrial companies listed on the JSE Securities Exchange South Africa but excludes all companies listed in the FTSE / JSE Resources and Financial Economic Groups.

**Benchmark:** FTSE/JSE Industrial (J257T)



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**Equity -  
Varied  
specialist  
funds**

These funds invest in a single economic group or industrial sector or in companies that share a common theme or activity, as defined in their respective mandates. However, due to the unique nature of their mandates they cannot be categorised into any of the aforementioned categories. The performance of these funds cannot be compared to others in this category. Due to both the nature and focus of these funds, they may be more volatile than funds that are diversified across the broader market.

Should it be considered appropriate, where five or more funds share a common focus or theme as defined in their mandates, a new category will be created and the funds reclassified, provided that a suitable benchmark can be established.



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## Asset Allocation Funds

**Overview** Asset Allocation funds are funds that invests in a wide spread of investments in the equity, bond, money and property markets. These funds are also known as "balanced" funds or "managed" funds. Managed funds aim to achieve medium to long-term performance by investing in a combination of markets. This is a way of decreasing the risk associated with investing in a single market.

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**Asset Allocation- Prudential Low equity funds** These funds invest in a spectrum of investments in the equity, bond, money, or property markets. These funds tend to display reduced short term volatility, aim for long term capital growth and typically would have an actual equity exposure below 40%. These funds generally conform to legislation governing retirement funds, (Regulation 28 of the Pension Fund Act) and are thus suitable as investment vehicles for retirement funds. The underlying risk and return objectives of individual funds may vary, as dictated by each fund's mandate and investment objective strategy.

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**Asset Allocation - Prudential Medium Equity funds** These funds invest in a spectrum of investments in the equity, bond, money, or property markets. These funds tend to display average volatility, aim for medium to long-term capital growth and typically would have an actual equity exposure between 40% and 65%. These funds generally conform to legislation governing retirement funds, (Regulation 28 of the Pension Funds Act) and are thus suitable as investment vehicles for retirement funds. The underlying risk and return objectives of individual funds may vary as dictated by each fund's mandate and stated investment objective and strategy.



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**Asset  
Allocation -  
Prudential  
High Equity  
funds**

These funds invest in a spectrum of investments in the equity, bond, money, or property markets. These funds tend to have an increased probability of short term volatility, aim to maximise long term capital growth and typically would have an equity exposure above 65%. These funds generally conform to legislation governing retirement funds, (Regulation 28 of the Pension Funds Act) and are thus suitable as investment vehicles for retirement funds. The underlying risk and return objectives of individual funds may vary, as dictated by each fund's mandate and investment objective and strategy.

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**Asset  
Allocation -  
Prudential  
Variable  
Equity funds**

These portfolios invest in a spectrum of investments in the equity, bond, money, or property markets. These portfolios tend to have an increased probability of short-term volatility, aim to maximise long-term capital growth and would have an effective equity exposure (including international equity) between 0% and 75% at all times. These portfolios conform to legislation governing retirement portfolios, (Regulation 28 of the Pension Funds Act) and are thus suitable as investment vehicles for retirement portfolios. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolios mandate and stated investment objective and strategy.

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**Domestic -  
Asset  
Allocation -  
Flexible  
property  
funds**

These funds invest at least 50% in securities listed in the Real Estate industrial sector of the JSE Securities Exchange South Africa and liquid assets. The objective of these funds is to provide high levels of income and long-term capital appreciation.



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<b>Domestic Asset Allocation - Targeted Absolute and Return Funds</b>	These funds invest in a combination of equity, bond, money market, Property or derivative instruments. The underlying risk and return objectives of the individual funds may vary, as dictated by each fund's mandate and investment objective and strategy. These funds tend to display below average short-term growth volatility and are mandated to manage towards a predetermined, explicit benchmark. These funds may not conform to legislation governing retirement funds, and do not necessarily offer capital or performance guarantees.
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## Domestic Real Estate General Funds

**Real Estate - General funds** - These funds invest in listed property shares, collective investment scheme in property and property loan stock. The objective of these portfolios is to provide high levels of income and long-term capital appreciation. Due to liquidity constraints in the Real Estate sector on the exchange these portfolios must maintain a minimum effective exposure to real estate securities of 50% and may include other high yielding fixed interest and other securities from time to time.

**Benchmark:** FTSA/JSE SA Listed Property Index (J253T)



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## Fixed Interest Funds

**Overview** These funds invest only in interest bearing assets. The level of risk for these funds is relatively low, but so is the likelihood of enormous growth. The sub sectors of this category are:

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**Fixed Interest - Bond funds** These funds invest in bonds, fixed deposits and other interest-bearing securities. These funds may invest in short; intermediate and long-dated securities. The composition of the underlying investments is actively managed and will change over time to reflect the manager's assessment of interest rate trends. These funds offer the potential for capital growth, together with a regular and high level of income.  
**Benchmark:** BEASSA All Bond Index

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**Fixed Interest - Income funds** These funds invest in bonds, fixed deposits and other interest earning securities which have a fixed maturity date and either have a predetermined cash flow profile or are linked to benchmark yields, but excluding any equities. To provide relative capital stability, the average modified duration of the underlying assets is limited to a maximum of two years. These funds are less volatile and are characterised by a regular and high level of income.  
**Benchmark:** BEASSA All Bond 1 to 3 year split Index



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**Fixed  
Interest -  
Money market  
funds**

These funds seek to maximise interest income, preserve the fund's capital and provide immediate liquidity. This is achieved by investing in money market instruments with a maturity of less than one year while the average maturity of the underlying assets may not exceed 90 days. The funds are typically characterised as short-term, highly liquid vehicles.

**Benchmark:** Alexander Forbes Money Market Index

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**Fixed  
Interest -  
Varied  
Specialist**

These funds invest in bonds, fixed deposits, structured money market instruments, listed debentures and other high yielding securities. They seek to maximise income with either preservation and stability of capital, or an offer of potential growth of capital. The underlying risk and return objectives of individual funds may vary as dictated by each fund's mandate and investment objective and strategy. However, in terms of the investment mandates of these funds, they fall outside the existing sub-categories of the Fixed Interest sector. Should it be considered appropriate, where five or more funds have a similar focus, a new category will be created and the funds reclassified.



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## Index, Property and Balanced Funds

**Overview** Index Funds and Fund of Funds are found within the various sectors we have discussed, but no longer have their own respective categories, as they did prior to the reclassification.

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**Index Funds** These funds are designed to replicate the performance of a specific benchmark. As Index Funds are passively managed, they have a substantial reduced initial and annual management fee. These funds do not have their own category, but instead are classified into a category based on the index/benchmark that the fund is tracking. The best index fund will be the one that tracks its chosen index the closest.

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**Property Collective investments (PUTS)** A property collective investments is a portfolio of investment properties, which is divided into units. The objective of these funds are to provide high levels of income and long-term capital growth. It can be used as a higher risk alternative to bonds or income funds. Property collective investments differ from other collective investments in that they are listed on the JSE and are closed - ended funds, with a limited number of units in issue. The value of these units are linked to supply and demand forces on the JSE, and not on the underlying properties.



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## Specialised Funds

### Overview

In addition to these collective investments funds, there are specialised funds regarded as packaged products that include a number of collective investment schemes or investment portfolios in one "bundle". Do not confuse them with Specialist Equity Funds, which are funds that invest in one specialised area of the JSE.

They enable the investor to spread his/her investment through a range of collective investments, and are also known as split investments. These packaged products include:

- ◆ Funds of funds,
- ◆ Wrap funds and
- ◆ Multi-manager funds

Multi-manager funds differ from the two given above, because multi manager funds do not invest in collective investment schemes as such, but in specific investment portfolios. It may sound somewhat confusing so we will explore the funds in more detail.



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**Fund of Funds** These funds made their entry to the CIS industry in June 1998. It was introduced as an alternative to collective investment scheme link products. A fund of funds product is a collective investment fund that invests in a range of other collective investments. When an investor purchases units in a fund of funds, the investor only owns the units in the fund and not in the underlying collective investments, which make up the fund. The collective investments chosen may originate from the same Manager (in which case they would be called an internal fund of funds), or they may be those of a different Manager. Every fund of funds has to invest in more than two underlying collective investments. The portfolio manager chooses the underlying funds and his choice is based on the fund's mandate and risk profile. Investors can choose between a fund of fund investment locally or offshore.

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**Wrap Funds** A wrap fund is a portfolio or collection of investment products "wrapped" into a single product. The investments made by the fund are not necessarily in collective investments; although many wrap funds include both collective investments and other money market accounts. The combination used in the wrap fund will depend on the needs of the investor, in terms of the risk the investor is prepared to take, and the returns he/she expects to get.

Wrap funds are not controlled by the same legislation as collective investments, and can be managed by anyone who has registered with the Financial Services Board as a portfolio manager. They are not considered to be suitable investments for the small investor.



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**Multi-  
manager or  
Combination  
funds**

A multi-manager collective investments fund invests in a combination of specialist equity and fixed interest portfolios, by bringing together a number of different fund managers into one investment product.

Each of the managers is responsible for his/her portion of the entire portfolio. The portfolio managers are chosen for their expertise in a particular area, and the combination of the managers will be tailored to suit the client's needs. Multi-manager funds are controlled by the same legislation as collective investments, and therefore offer a high level of protection to the investor.

These specialised funds charge higher management fees than regular collective investment schemes, but they may bring higher returns to the investor if he/she chooses the fund carefully.



## ACTIVITY SHEET 5



### CLASSIFICATION OF CIS

Unscramble the following words:

- 1) itcdoems \_\_\_\_\_
- 2) girnfeo \_\_\_\_\_
- 3) bnlre  
arueuttos \_\_\_\_\_
- 4) deancalb \_\_\_\_\_
- 5) wdrioeldw \_\_\_\_\_
- 6) ilfananci \_\_\_\_\_
- 7) wrhtgo \_\_\_\_\_
- 8) leauv \_\_\_\_\_
- 9) at rlgmnimeua \_\_\_\_\_

#### Answers:

1. domestic
2. foreign
3. absolute  
return
4. balanced
5. worldwide
6. financial
7. growth
8. value
9. multi  
manager



10) nfun  
dfsfd u o \_\_\_\_\_

11) lrngaoei \_\_\_\_\_

12) asept \_\_\_\_\_

13) ft  
erdeixtsni \_\_\_\_\_

14) osdnb \_\_\_\_\_

15) sueresroc \_\_\_\_\_

16) niliasutrd \_\_\_\_\_

17) asgec ralp \_\_\_\_\_

18) spaalmlsc \_\_\_\_\_

19) alirntudep \_\_\_\_\_

20) coinme \_\_\_\_\_



Answers:

- 10. fund of funds
- 11. regional
- 12. asset
- 13. fixed interest
- 14. bonds
- 15. resources
- 16. industrial
- 17. large cap
- 18. small caps
- 19. prudential
- 20. income







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## 1.4 CIS as a Long Term Investment

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain the term fluctuation.
- Explain the term volatility.
- Illustrate the concept of Rand cost averaging.

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The impact of market trends of the stock exchange on the fluctuation of collective investment schemes' prices is explained with reference to examples.
- Volatility is explained in terms of market fluctuation.
- The concept of Rand cost averaging is explained using a graph to illustrate the underlying principles.



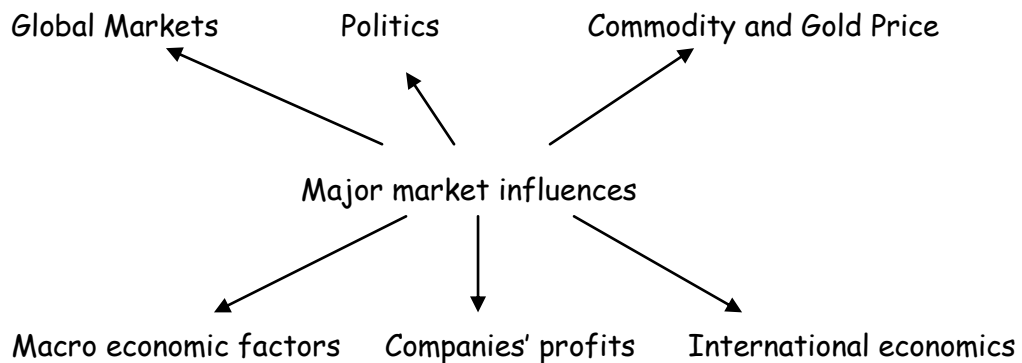
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**Overview**

If you are looking for an investment vehicle that will give you a quick return on your investment, collective investments are not for you. A collective investments scheme in securities should be regarded as a medium to long term investment. Since the underlying securities are investments on a stock exchange, market trends will have a direct impact on the performance of your investment. In this chapter we are going to examine the basic economic and socio economic factors that influence market trends and conditions.

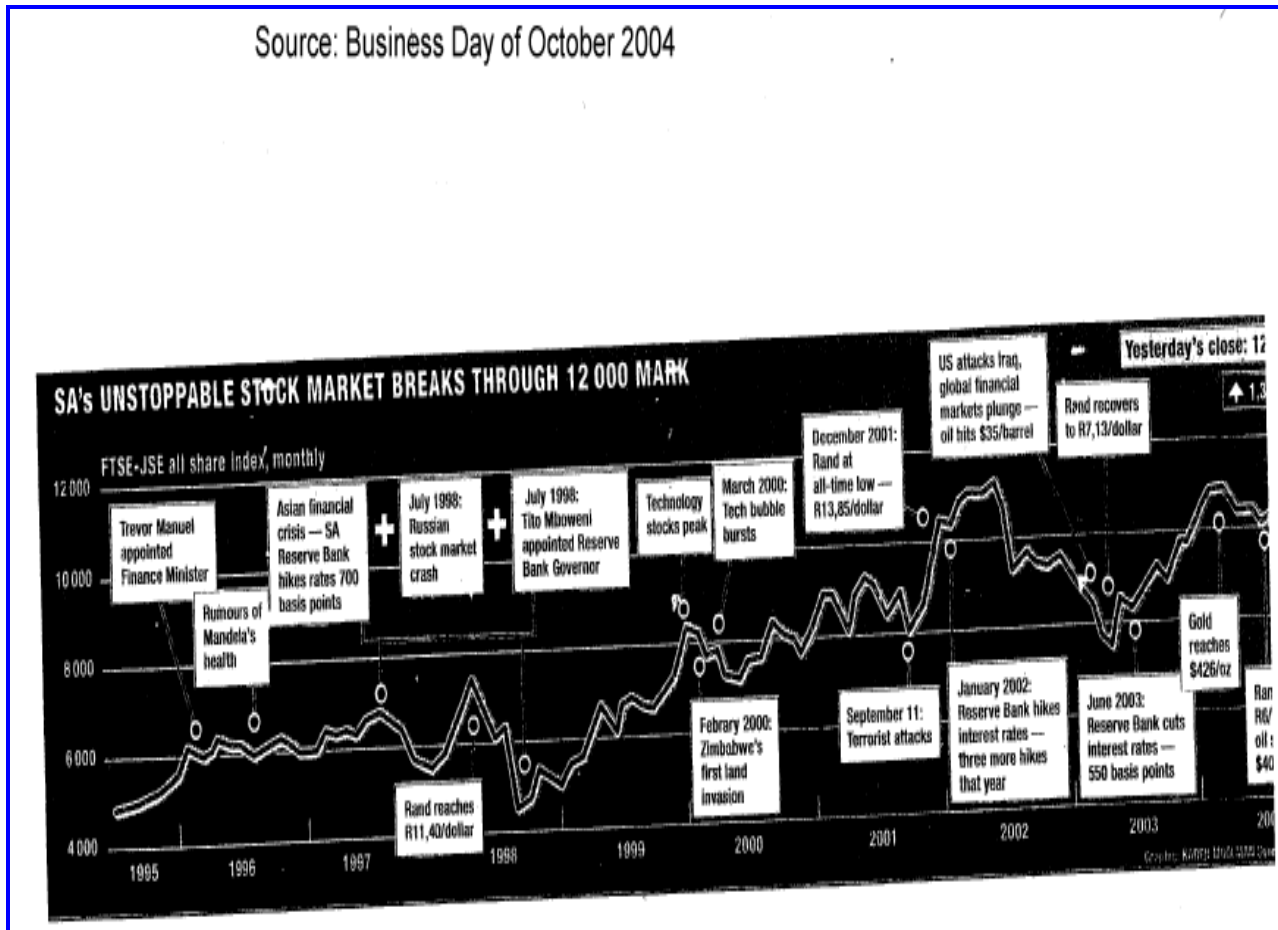
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**Economic and Socio-economic factors that have an impact on stock market trends:**





The graph below stipulates the impact of various economic and socio-economic factors on the South African stock market.





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## Fluctuation and Volatility

**Fluctuation** If you pay any attention to the JSE and follow the price of certain shares, you will see that they go up and down regularly. This is known as fluctuations in the share price. Of course, fluctuations in the prices of the shares lead to fluctuations in the value of the collective investment schemes that have bought shares. However, collective investment schemes work on the assumption that the price of the shares may be very volatile or changeable in the short term, but in the long run the value of the shares will increase.

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**Volatility** Volatility is the word used to describe the fluctuations or changes in share prices, and a share that is volatile is one that is susceptible to changes in the market. The fact that a share is volatile does not necessarily make it a risky investment either, as some shares are more vulnerable to trends than others. Gold shares are considered to be volatile, as the price of gold fluctuates frequently. However, investing in gold shares may be less risky than investing in Information Technology shares, for example, as there is a constant demand for gold.



## Rand Cost Averaging

### Rand Cost Averaging

Rand cost averaging is based on the principle that if one invests small amounts of money at regular intervals for example monthly installments, the overall cost of units will be cheaper over the longer term than a lump sum investment. As you know, the price of collective investment schemes fluctuates on a daily basis. By investing on a monthly basis you will buy more units when the price is low and less units when the price is high. The table below shows that the unit price has dropped from Day One to Day Three. If Investor IOU invested R5000 in a collective investment scheme on Day One, he would have paid 105 cents for each unit in the fund at that price, Investor IOU would have ended up with 4 761.9 units ( $5000,00/105c \times 100 = 4761.9$ ) However, if the same investor had waited until Day Four he would have found that the price had dropped and he would have paid only 80 cents for them. This would have given him more shares for the same price, and he would have ended up with 5 thousand units @ 80 cents a unit.

If Investor IOU had chosen to use rand cost averaging as a payment option, he could divide the R5000 capital amount into 5 daily payments of R1000 each. If you look at the table below, you will see that rand cost averaging would have enabled him to buy more units than the lump sum payment would have done.

Look at the table below to see how rand cost averaging would work for the investor over a period of 5 days.

DAY	PRICE IN CENTS	PAYMENT IN RAND	UNITS BOUGHT
Day 1	105	1000	952
Day 2	101	1000	990
Day 3	100	1000	1000
Day 4	080	1000	1250
Day 5	104	1000	961



## ACTIVITY SHEET 7



1. Research reasons for the two declines in the local market in August 1998 and Feb 2000.

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2. Research reasons for the two declines in international markets in March 2000 and September 2001.

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3. What is volatility?

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5. What is Rand Cost Averaging?

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6. How can an investor use Rand Cost Averaging to his/her advantage? Use an example to illustrate your point.

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## 1.5 Collective investment schemes and Interest

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain what the term interest means.
- Know and calculate the principles of compound interest.
- Explain what the term repo rate means
- Explain what the term prime rate means

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The concept of the term interest is explained using a practical example of the flow of money.
- The principles of compound interest are understood and illustrated by performing simple calculations.
- Researching the rates over a period and comparing past and present rates using examples from a resource explain the term repo rate.
- Researching the rates over a period and comparing past and present rates using examples from a resource explain the term prime rate.



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## Collective investment schemes and Interest

### Overview

Unit holders do not only create more money for themselves by buying and selling collective investment schemes for profit. As mentioned earlier, collective investments also provide income for investors through dividends paid on shares in the portfolio and on the interest paid out on the liquid assets. For the benefit of those of you who have forgotten what we mean when we talk about interest in connection with financial matters:

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### Interest

Interest is "money paid for the use of money that has been lent, or the charge made for borrowing a sum of money".

So, most of us receive interest payments from our bank or building society for the money that we have deposited in the bank in the form of a savings or current account. That interest is a payment from the bank for the use of the money that we have deposited with them. On the other hand, if you have borrowed money from the bank in the form of a home loan or a credit card, then you will pay interest to the bank for the use of the money that the bank has lent to you.



**Simple Interest**

The investor receives interest on the investment he/she has made in the collective investments fund. This takes the form of compound interest. Financiers talk about two types of interest, simple interest and compound interest.

Simple interest is interest that is earned or paid on a fixed amount. It is calculated only once and is on the principal or main amount of money only.

**Example:  
Simple Interest**

Now you can work out the simple interest on the amount of R5000, 00. The interest rate in this example is 10%. Follow the steps given below to find out what the simple interest on that amount would be;

**Steps:**



1. Take the amount of R5 000.00 and enter it into your calculator.
2. Press the Multiply sign on the calculator.
3. Take the simple interest rate of 10% and enter it into your calculator as 10. Then press the percentage (%) button on your calculator.



**Steps:**

3. Write down the amount that appears on your calculator after you have pressed the percentage button.
4. Take the amount that appears in your calculator and add it to the principal amount of R5 000.00. Press the equals sign (=) on the calculator to get the principal amount plus the interest that the person who is lending the money will earn.

**The Answer**

**Month 1: R5000, 00 x10%= R5 500,00**

**Month 2: R5000, 00 x10%= R5 500,00**

**Month 3: R5000, 00 x10%= R5 500,00.**



You can see that the principal amount of R5000, 00 gives a regular simple interest payment of R500, 00 every month. Therefore the person who lent the money earned R1 500,00 in three months of having the interest paid to him.



**Compound interest**

You will see that calculating the compound interest on a sum of money is a little more complicated, and it is used more frequently in financial institutions. With compound interest, the money a person earns in interest becomes part of the principal amount and **ALSO EARNS INTEREST.**

**Compound interest is calculated on both the principal amount and the interest earned.**

**Example:  
Compound Interest**

We shall calculate the compound interest on the same amount as we did for simple interest, which is R5000, 00, again using the calculator.

**Steps:**



1. Take the principle amount of R5 000.00 and enter it into the calculator.  
Press the Multiply sign on the calculator (x).
2. Take the compound interest rate of 10% and enter it into the calculator



### Steps



3. Note down the amount that appears on your calculator after you have pressed the percentage button.

4. Take the amount that you got in the 3<sup>rd</sup> step and add it to the principal amount of R5 000.00. When you press the equals sign (=) you will have the sum of the principal amount and the interest, which is R5 500.00.

5. Enter the total that you obtained in the 4<sup>th</sup> step and enter it into the calculator.

6. Press the Multiply sign (x) on the calculator.

7. Take the compound interest rate of 10% and enter into your calculator as 10, then press the % button on your calculator.

8. Write down the amount that you found in step 7, and add it to the principal amount and press the equal sign (=) on the calculator, to get the principal amount plus the interest that will be earned for the first month.

The answer at this stage will be  $R5\ 500.00 \times 10\% = R6\ 050.00$ .

9. Take the answer from step 8 and enter it into your calculator.

10. Press the Multiply sign (x) on the calculator.

11. Take the compound interest rate of 10% and enter it into your calculator as 10. Now press the % button on your calculator. Write down the amount that appears after you have done this.

12. Now take the amount that you wrote down in step 11 and add it to the principal amount, to get the principal amount plus the interest that will be earned for the 1<sup>st</sup> month.

ANSWER:  $R6\ 050.00 \times 10\% = R6\ 655.00$



### Simple and Compound Interest



The difference between simple and compound interest becomes very clear when one compares the interest calculations over a number of months:

$$\text{Month 1: } R5\ 000,00 \times 10\% = R5\ 500,00$$

$$\text{Month 2: } R5\ 500,00 \times 10\% = R6050,00$$

$$\text{Month 3: } R6\ 050,00 \times 10\% = R6655,00.$$

The amount of money with which we started was R5 000,00. If we compare the amount of interest earned on that capital amount over the period of 3 months by subtracting R5 000,00 from the amount at the end of the 3-month period, we can see that the type of interest paid has a major effect on the amount that is earning interest.

If simple interest is charged, the interest earned is R1 500,00, whereas the compound interest gives an interest payment of R1 655,00.

Most unit holders prefer to earn compound interest on their investment, as it pays them more money that way. The unit holder can choose whether to have the interest paid out or distributed to him or her (simple interest), or to have the interest re-invested in the collective investments (compound interest).

### Repo rate

The repurchase rate, which is commonly referred to as the Repo rate is the interest rate at which the South African Reserve Bank lends money to commercial banks such as Standard Bank, Nedbank, ABSA, First National etc. The South African Reserve Bank is the bank for banks and it only lends money to commercial banks. It acts as the banker for the government. Generally, if the repo rate decreases, the interest rates are likely to decrease as well. If the repo rate increases, the interest rate will eventually increase.

### Prime rate

The prime rate is the interest rate commercial banks offer their preferred customers.



## ACTIVITY SHEET 8



1. What is the difference between what an investor will earn on an investment of R5 000, earning 10% interest per year over a 2 year period:
  - a) in the case of Simple interest
  - b) in the case of Compound interest, where it is compounded annually.

Simple interest	Compound interest

2. What is the current prime rate? \_\_\_\_\_%

3. What is the current repo rate? \_\_\_\_\_%



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## 1.6 Customer profiles and Risk

### Learning outcomes

By the end of this section, the learner must be able to: -

- Explain what the term risk means.
- Design a risk profile

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### Assessment criteria

The learner will be assessed on the following criteria: -

- The concept of the term risk is explained with reference to a person's age and investment horizon.
- A person is interviewed and on the basis of this a risk profile is designed and the appropriate CIS funds that fits this profile is named.



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**Overview** Risk is one of those terms that are often associated with investments. Not only is this one of the hardest terms to define, but also to measure. Risk means different things to different people and will change during your lifetime as your personal and financial needs change. Every investment holds some degree of risk. We are going to discuss some risk considerations you should review when planning your investments.

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**Design of a Risk Profile** Factors that need to be considered:

**The investor's current situation**

- **Age**- Younger people tend to absorb more risk as they have longer working careers in which to recover any financial losses.
- **Net worth**- People with more additional funds tend to be less afraid to take on more risk as they have sufficient funds to endure potential losses.
- **Income**- The higher the investor's income, the more he/she can invest.
- **Expenses**- The more one's expenses, the less money one has to invest.
- **Amount**- What is the amount I can invest?
- **Tax**- What is my tax rate?
- **Health**- Am I a healthy person?
- **Dependants**- Do I have any dependants and what is the number of dependants?

**Financial goals**

- The return one needs to make.
- The reason for investing.
- The effects of inflation.



## ACTIVITY SHEET 9



1. Discuss in your groups and write down which questions you feel are more appropriate when determining a customer's risk profile.

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2. Interview a person with your list of questions and depending on the outcome, which risk profile and investment options will suit this person best?

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## CRITICAL CROSS FIELD AND DEVELOPMENTAL OUTCOMES

1. **Identify and solve problems** - learners can analyse investment instruments and compile an investment portfolio
2. **Organise and manage oneself and one's activities responsibly and effectively** - learners can use the time allocated for projects and learning, effectively and productively
3. **Collect, organise and critically evaluate information** - learners can do research for projects and organise this information in an understandable and chronological order
4. **Communicate effectively using mathematical and language skills in modes of written presentations** - learners can explain concepts and calculations (in class and assessments - Rand cost averaging) to trainer in an understandable manner
5. **Used science and technology effectively and critically** - learners can use the computer and internet effectively for research and typing of report
6. **Demonstrate an understanding of the world as a set of related systems by recognising that problem-solving contexts do not exist in isolation** - learners can interpret information about volatility and market fluctuations, and the effects it has on investments and subsequently the income or profits of investors.