| RISK OPTIONS |

Investment risk

But some tips to help minimise potential pitfalls

INVESTING IN SHARES for the long term is a solid way to create wealth. However, it does have risks, which all investors should realise. That isn't necessarily a bad thing. For with higher risk comes the potential for higher reward. Richard Seddon, head of Online Share Trading at the Standard, has some tips to manage that to your own advantage.

Seddon says there are a number of risks in investing. First, the share price of a company can fall as well as rise. He advises that investors should use stop losses to protect themselves from falling markets.

Second, if a company is liquidated, shareholders in possession of ordinary shares are the last in line and will only receive a payout of the residue left after all the company's creditors – including suppliers, the SA Revenue Service and preference shareholders – have been paid in full. Seddon advises that investors should buy blue chip shares, keep an eye on a company's financial health by reading its annual reports and relevant Sens announcements, and ensure that it's managed well.

However, shareholders won't be held liable for a company's debts. That's known as "limited liability". It means that individual shareholders aren't personally liable if the company doesn't pay its debts. As a shareowner, the maximum amount that you can lose is the value of your investment.

The third risk is that an illiquid share can be difficult to sell. A share is illiquid if there's very little trade in it and, as a result, the spread – the difference between the buying and selling prices – is large. Typically, that occurs in smaller companies that have a controlling shareholder.

That means that the free float (or number of shares available to the public to buy) is small. Seddon advises investors to buy shares with high liquidity. That can be ascertained by checking that there are many buyers and sellers on the market and that the spread between the buying and selling prices is not too large.

Fourth, Seddon says that a company isn't compelled to pay dividends, as its directors may choose to keep all available cash in order to finance its growth. Hopefully in that case future share price appreciation will more than make it up. He advises to check the dividend yield before buying the share, as companies rarely change their dividend policy significantly.

Lastly, things can go wrong in companies – and that will affect the share price. Earnings can disappoint the market, there can be instances of poor corporate governance, companies can become overzealous in making acquisitions and then find that there are difficulties in bedding those down, or they can be the victims of fraud. Seddon says investors should check annual financial statements and attend AGMs. "If you're unhappy sell before it becomes an issue."

Overall, investors need to balance these potential pitfalls by equipping themselves with as much knowledge as possible about their investment. ¤

Asset classes

Providing structure to vast array of financial instruments

INVESTORS HAVE A NUMBER of options in terms of investment destinations. These options are usually called "asset classes". Investopedia.com defines asset classes as: "A specific category of assets or investments, such as stocks, bonds, cash, international securities and real estate. Assets within the same class generally exhibit similar characteristics, behave similarly in the marketplace and are subject to the same laws and regulations. Asset classes exist to provide structure to the vast array of financial instruments available in today's market."

Asset classes are important to investors, as each different asset class has a different risk profile. Cash is generally regarded as being low risk and therefore shareholders are unlikely to lose their capital. (In South Africa, depositors have been protected from losing their deposits owing to banks closing. That's not always the case in other countries.)

Bonds are generally regarded as being more risky than cash. These are effectively loans to a government, municipality or corporate that will pay an attractive interest rate (called a coupon) and repay the capital at the end of the investment period.

Bonds can also be traded on an exchange, so investors aren't locked in for the long term if they don't want to be and have the potential for capital appreciation if interest rates fall. The risk of country or sovereign bonds is generally regarded as low. Corporate bonds are riskier than sovereign bonds but are also regarded as being lower risk than shares.

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The different risk characteristics of each asset class means that investors can structure a portfolio with a percentage of assets in each asset class to diversify risk. Simply, that's not "putting all your eggs in one basket" and is the most effective way to reduce risk because there's no such thing as a completely safe investment. (Even putting your hard-earned cash under the literal mattress carries the risk of theft.)

It also means that investors can structure a portfolio to carry higher risk (and, hopefully, higher reward) when they're young by investing a higher proportion of their portfolio in growth assets, such as shares and property. Closer to retirement it's prudent to increase the weighting of less risky assets, such as cash and bonds.

Richard Seddon, head of Online Share Trading at the Standard, says that investors can access the different asset classes through the JSE. Investors can buy property shares, gold, bonds, preference shares, exchange-traded funds as well as foreign exposure through Itrix and rand hedges. In addition, Online Share Trading pays money market linked interest rates on cash balances. ¤

ASSET CLASSES

TYPES	DESCRIPTION	REASONS TO CHOOSE	MAJOR RISK
Shares	• Common, preferred • Large cap, mid cap, small cap • Growth, value • International/domestic	• High return potential • May provide income • Long-term horizon	• High
Bonds	• Government, agency • Municipal • Corporate • Mortgage-backed, asset-backed • International/domestic	• Regular income • Potential for price appreciation • Possible tax advantages • Lower risk	• Medium
Cash equivalents	• Treasury bills • Commercial paper • CDs and banker's acceptances • Money markets	• Regular income • Relative price stability • Liquidity • Lower risk	• Low
Property	• Real estate • Property unit trusts • Listed property funds • International/domestic	• High return potential • May provide income • Long-term horizon	

Source: Evergreen Investments, Standard

Shareholders' rights and responsibilities

TECHNICALLY, shareholders own a tiny slice of a company's assets and earnings that's equal to their percentage shareholding in the business. As owners, shareholders have certain rights and responsibilities.

In broad terms, shareholders' rights include the right to request and convene general meetings, to attend, appoint a proxy or speak at general meetings and to vote at general meetings.

There are two different types of general meetings: annual general meetings (AGMs) and extraordinary general meetings (EGMs). A general meeting is only valid if it has been properly convened with enough shareholders present to form a quorum, if the chairperson is present and if nobody has been excluded who is entitled to attend.

All companies must hold an AGM. The first should occur within 18 months of its incorporation. After that an AGM should be held every calendar year and not more than six months after the company's financial year-end. The AGM provides a forum for shareholders to receive important information about the company and to question directors. It's usually used for shareholders to pass resolutions contained in the annual report and to consider the annual financial statements, to approve a dividend, to elect directors and to appoint auditors.

EGMs are general meetings held to consider business that's considered "too urgent" to wait for the next AGM, such as a merger or acquisition. Where someone (or another company) owns more than 10% of a company's shares such person or company will generally be invited to sit on the board – though that isn't a hard and fast rule and is often ruthlessly ignored where there's hostile corporate activity.

Management also has to ask shareholders for approval of certain actions, such as share buybacks, sizeable acquisitions or increasing the company's authorised share capital. In addition, shareholder approval is now increasingly been sought for management incentive schemes, whether cash- or share-based.

In addition, shareholders have the right to acquire the tools necessary to exercise their key rights, including receiving copies of the annual financial statements, to communicate directly with directors, the right to expect all directors to act on their behalf and the right to information.

The JSE has adopted the principle of "simultaneous dissemination". That means all shareholders should receive important news – including the publication of financial results and corporate actions, such as mergers and acquisitions – at the same time. Consequently, companies are required to publish all news on the Stock Exchange News Service before speaking to selected fund managers, journalists or analysts. That ensures all investors are treated equally.

South African investors have traditionally been horribly apathetic.

Even now directors often outnumber the investors present at AGMs. That's in stark contrast to Britain, where AGMs tend to go on for hours and directors often have to answer a number of tough, incisive questions from shareholders.

Institutional shareholders have a fiduciary duty to exercise their proxy votes at general meetings in the best interests of their clients. Over the past few years SA has seen a handful of institutions standing up to – and even replacing – dishonest management. In the past year the most high profile example has been the Allan Gray-led ousting of Brett Kebble as CEO of JCI and Western Areas.

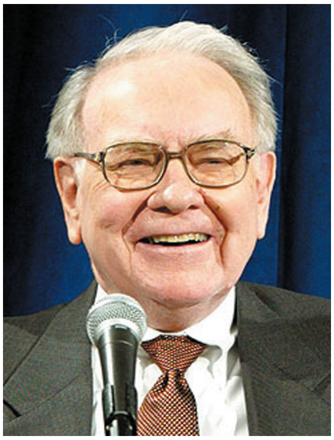
Since 2002 the US Securities and Exchange Commission has required all asset managers to disclose their proxy votes to their clients to ensure that those votes were cast in their clients' – and not the fund managers' – best interests. ¤

| DEFINITIONS |

What's in a name?

Defining shares and how to choose them

LAST WEEK WE DISCUSSED what ordinary shares are. We'll now flesh that out and outline definitions for 10 commonly used words that describe different types of shares:



There's a fair price for everything.
Warren Buffett, investment guru

blue chip, growth, value, income, cyclical, small capitalisation, mid capitalisation, large capitalisation, penny and rand hedge shares.

Ordinary shares make up the majority of listed shares and are issued by companies to raise capital. These shares represent ownership by the shareholders of the company and each shareholder is usually given one vote per share to elect the board members.

However, some companies – such as Naspers – issue shares (usually called "N" or "A" shares) that have fewer voting rights than one vote per share. Such structures are usually put in place to entrench control. They've fallen out of favour, though some black economic empowerment groups are likely to continue to use them in constructing business empires.

- Blue chips – such as Standard Bank and Pick 'n Pay – are usually large, financially solid companies with long-term track records. They tend to be well-known corporate names or have strong brands and both institutional and individual shareholders hold their shares.

  The perceived wisdom is that blue chip shares can be bought and held for the long term. Their performance is unlikely to be spectacular, but there's – theoretically – also less risk. In SA emerging empowerment conglomerates – such as Mvelaphanda – have been tagged "black chips".
- Growth shares – such as Grindrod – are issued by companies that have produced consistent above-average revenue and earnings growth in the recent past. More importantly, they're likely to continue to do so over the medium term.
- Value shares – such as Hudaco – are usually viewed as the direct opposite of growth shares. They tend to be profitable companies in "sunset" industries with lacklustre growth prospects. But one truism in investment is that there's a fair price for everything and the market always overshoots in its optimism or pessimism. Consequently, a value company is one where the share price is too cheap and doesn't reflect a company's value, despite its muted growth prospects. That's the investment approach used by investment guru Warren Buffett.
- Income shares have a high dividend yield that compares favourably on an after-tax basis with interest rates on bank deposit accounts. (Property companies have traditionally been bought for income.) The shareholder also has the possible future benefit of any capital gain. Income shares are usually highly cash generative companies in mature industries that have a limited need to invest capital for expansion.
- Cyclical shares, as their name suggests, are companies whose operating – and earnings – performance are closely linked to the economic cycle. Consequently, their share prices track the vagaries of the economic cycle and can be very volatile. The market prices them accordingly. Mining and retail shares tend to be cyclical.
- Small capitalisation, mid capitalisation (or medium capitalisation) and large capitalisation stocks are ranked according to their market capitalisations, or total value on the stock market. In common usage, capitalisation is usually abbreviated to "cap" – as in small-cap, mid-cap and large-cap stocks.
- Penny stocks – such as Sekunjalo – are the smallest of small-cap stocks, with prices at less than R1/share. These low share prices (in absolute terms) can reflect investor concerns regarding the company's viability, low profit levels or even just that it's no longer in favour with investors. By and large, institutions avoid penny stocks, as they're usually illiquid. But investors punt them because the initial capital requirement to buy 100 shares is low and a 1c move in the share price can translate into a big percentage change.
- Rand hedge shares – such as Richemont – are those companies that have revenues denominated in offshore currencies and rand costs. They've fallen out of favour as the rand has strengthened over the past three years. ¤

QUIZ

EACH WEEK we will publish three questions related to that week's content.

At the end of the 12 weeks, Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To participate in the draw just answer the following three questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

Questions:

1. What is the legal term that means that shareholders are not responsible for the debts of a company?
2. What is the term that describes low-voting shares?
3. What are the two types of general shareholders' meetings? ¤