Standard

| INVESTMENT PRINCIPLES |

Why invest?

Tools to make compound interest work

MARKETS ARE FALLING and shareholders worldwide have seen a significant amount of the value of their investments in shares evaporate over the past few weeks. Against that background the man in the street will be wondering why they should bother with investing in shares on the stock exchange.

In a nutshell, the simple answer is that investing in shares is a good way to create long-term wealth for any individual. Simon Pateman Brown, MD of SAWarrants, says that the stock market outperforms any other asset class over the long term. As the graph shows, equities (or shares) produced an average 19,3% return after tax each year between 1985 and 2005. That compares favourably to the average annual returns of other asset classes over the same timeframe, such as own mortgages (16,6%), 20-year bonds (13,6%), property unit trusts (12,7%), participation bonds (7,8%), one-year fixed deposits (6,8%) and Krugerrands (5,2%).

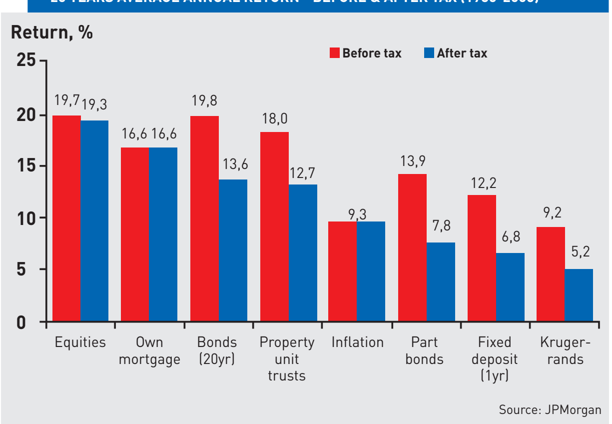
It's important to note that investing in shares has also resulted in creating real wealth, as inflation has averaged 9,3% over the same period.

Wealth creation occurs when a shareholder buys shares at a low price and sells them at a higher price in the future. The "magic" behind shares' superior wealth creation is making the money do the work. That's called "compound interest". *Investopedia* defines compound interest as: "The ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings. In other words, compound interest refers to generating earnings from previous earnings." Though it may not sound like much, over time the "interest on interest" adds up to a significant amount of money.

Investors need four tools to make compound interest work for them: perseverance, intelligence, knowledge and time.

Investors need perseverance to stick to their investing plan even when the markets are a little bit rocky, as compound interest works over the long term. Second, investors need intelligence, as they must know what they're doing and why. Over the next 12 weeks this series will give readers some of the tools they need in that regard, as well as pointing them to other sources of knowledge.

20 YEARS AVERAGE ANNUAL RETURN - BEFORE & AFTER TAX (1985-2005)



Source: JPMorgan

The knowledge that investors need to make wise investment decisions comes from understanding how the mathematics works. The table illustrates the difference between two investors who begin saving at different ages.

Investor A starts saving R2 000/year from the age of 26 until retirement at 65. Over his lifetime he'll invest R80 000. Assuming interest at 10%/year his nest egg will be worth R973 704.

INVESTOR A (VD) AT 10% INTEREST + GROWTH			INVESTOR B (VD) AT 10% INTEREST + GROWTH		
Age	Contribution	Year-end value	Age	Contribution	Year-end value
19	R0,00		19	R2 000,00	R2 200,00
20	R0,00		20	R2 000,00	R4 620,00
26	R2 000,00	R2 200,00	26	R2 000,00	
27	R2 000,00	R4 620,00			
28	R2 000,00			R0,00	
65	R2 000,00	R973 704,00	65	R0,00	R944 641,00
	Total Contribution	(R80 000,00)		Total Contribution	(R14 000,00)
	Return	**R893 704,00**		Return	**R930 640,00**

Investor B invests R2 000/year each year from age 19 to 26. He then stops investing but leaves his R14 000 nest egg, earning 10%/year interest until he retires at 65. At that point his nest egg will be worth R944 641.

Though the total is slightly less than that of Investor A's savings, it's clear that Investor B has actually made more money from a far smaller investment. The six years' head start in investing more than offsets the bigger contribution (in rand terms) made by Investor A. That's the power of compound interest and shows why investors need time.

While many individuals are already tapping into the stockmarket's wealth creation potential through products such as unit trusts, they can maximise the value they receive by reducing costs.

In week three of this series we'll show how just a small upfront saving of a few percent makes a real difference to the long-term result due to compound interest.

Richard Seddon, head of Online Share Trading at the Standard, says that the potential for returns through direct investment in shares is greater than that in a simple savings account or a unit trust.

That's because direct investment cuts out the costs associated with products such as unit trusts.

However, wealth creation (or capital growth) isn't the only reason to invest in shares.

Shares can also be bought to generate income. Shareholders earn income from their share investment, as they receive dividends. Dividends are payments (either half-yearly or annual) that companies make from the profits they declare.

Whatever your reasons for investing it's never too early to start. Over the next 12 weeks this series will give the novice investor some tools to take charge of his or her own financial destiny. ¤

| SUPPLY & DEMAND |

What drives share prices?

"Quality companies always rise to the top."

"INVESTING ISN'T GAMBLING," says Simon Pateman Brown, MD of SAWarrants. He notes that gambling is putting money at risk in the hope that you'll make more money than you lose. By contrast, investing is more than simply hoping that luck's on your side. That's because share prices are not random outcomes but rather reflect all information that investors have about a company and its earnings prospects.

Prices are set at the level where buyers and sellers agree on a value. **Richard Seddon, head of Online Share Trading at the Standard**

Richard Seddon, head of Online Share Trading, says that the economic forces of supply and demand are the most important drivers of a share price. Like any other goods or services, prices for shares are set at the level where buyers and sellers agree on a value.

In times when more people want the shares, demand is high and supply is likely to be limited, as existing shareholders will want to hold onto their investments. That will result in an increased share price. Conversely, the share price will drop when fewer people want to own the share (which equals lower demand) and there are more sellers (higher supply).

In turn, supply and demand will – ultimately – be driven by other factors, including the outlook for general economic growth, the investor's opinion of a sector and prospects for an individual company. All are important, as they – in one way or another – affect a company's earnings potential.

Earnings growth is a key signal that the market watches to determine whether it wants to buy or sell any particular share. In general terms, share prices rise where investors anticipate earnings will increase in future and fall when shareholders expect a decline.

Under normal circumstances the market anticipates earnings about 18 months in advance. Consequently, it's important for investors to remember to try and project the future and not make investment decisions based on a recent set of financial results, which show what's happened in the past.

Clearly, the overall state of the economy will, at least partly, determine a company's growth prospects. South African investors must remember that it's not only the state of the domestic economy that matters but that the international situation is also important. The current situation – where concerns about emerging markets in general led to a markdown of SA share prices – is a case in point.

Investors should also develop a view of an entire sector's prospects, as the market tends to tar companies operating in the same industry with the same brush. A well-run company in a sector with a dismal outlook is unlikely to outperform the market as a whole. By contrast, it's not unusual for less admired companies in growth sectors to see their share prices run ahead, at least in the short term.

Over the long term each individual company's share price is set by its own performance and the market's assessment of its management. Brown says that quality is all-important for investors and that will determine whether a company's share price outperforms the market as a whole over time. "Quality companies always rise to the top."

Ideally, people want to invest in good companies that are doing something well. In addition it's useful if they can grow earnings without making acquisitions. ¤

What are shares?

Prudence requires that companies be capitalised with a mixture of debt and equity

AT SOME POINT every company needs to raise money to expand or grow its business. At that point it has two options: debt or equity finance. In debt financing the company will borrow the necessary capital from either a bank or debt investors by issuing a bond. The alternative is to sell a part of the company in a process known as issuing shares or equity financing. That means shareholders are actually the owners of a company. Each share represents a tiny claim on a company's assets and earnings. As a shareholder buys more shares, the percentage of the company that they own increases.

Both debt and equity have a number of advantages.

The big advantage in issuing shares (or equity) is that the company's not required to either pay back the capital amount or make interest payments. Instead shareholders may receive dividends and invest in the hope of making future capital gains. The first sale of shares by a public company – and its listing on a stock exchange – is called an initial public offering (IPO).

The downside of equity finance, compared to debt, is that debt is cheaper than equity as it doesn't have to compensate shareholders for their higher risk. That has to be balanced against cash flow constraints,

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and prudence requires that companies be capitalised with a mixture of debt and equity.

A company can choose to issue two classes of shares: ordinary shares and preference 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 board members. The board's job is to "manage the managers" of the business.

There are three key terms that investors need to know when looking at ordinary shares. First, "authorised shares": the total number of ordinary shares that can be issued. Management can ask shareholders to increase the authorised share capital at the company's annual general meeting.

The second concept is "issued shares" – shares that the company has issued and less than or equal to the number of authorised shares.

Third, investors speak of "outstanding shares": the issued shares that are available in the market place.

Companies can also issue preference shares.

They differ from ordinary shares in that they have preference over ordinary shares for dividend payments and for assets if the company is liquidated.

But the downside is that preference shareholders give up the gains that ordinary shareholders make if the company performs well, as their dividend payment is usually fixed. In addition, preference shares don't have voting rights. ¤

Taking stock of exchanges

A super market

A stock exchange is nothing more than a super sophisticated farmers' market. **Simon Pateman Brown, MD of SAWarrants**

"A STOCK EXCHANGE IS nothing more than a super sophisticated farmers' market linking buyers and sellers," says Simon Pateman Brown, MD of SAWarrants. The difference, of course, is that this market buys and sells shares instead of fresh produce.

Many countries have these markets. Some of the best known are the New York Stock Exchange (NYSE) and Nasdaq, the London Stock Exchange (LSE) and the Tokyo Stock Exchange. In South Africa, the JSE and its subsidiary AltX are the only markets on which public companies can list their shares.

Share exchanges operate under strict regulations. Some exchanges, such as the NYSE, have a physical location where transactions take place on a trading floor. Others – like the JSE – use a network of computers that trade electronically.

A stock exchange has two key purposes. First, it's a place where companies can raise capital to finance expansion. Unlisted companies can sell shares to the public through an initial public offering (IPO) and then list on the stock exchange. Companies that are already listed can sell more shares to the public through a rights issue. Second, it's a place where buyers and sellers meet to exchange shares for cash.

The performance of share or equity markets is tracked by share indices. An index is basically defined as "a statistical measure of the changes in a portfolio of shares representing a portion of the overall market". That means that when an index is up on balance most share prices have increased.

Most indices weight companies based on market capitalisation (the share price multiplied by the number of shares in issue). That means price movements of the index's largest capitalisation companies will have a much larger effect on the overall change in the index than a similar increase or decrease in a small capitalisation stock. The JSE's indices all work on that basis.

The JSE/FTSE all-share index is SA's main equity index and is made up of just 160 shares representing more than 80% of the exchange's total market capitalisation.

The JSE/FTSE actuaries all-share 40 top companies (Alsi 40 index) contains the JSE's largest 40 shares on the JSE by market cap. The JSE also provides a number of indices that track performance of the different sectors, including the JSE/FTSE all-gold index, the JSE/FTSE financial index and the JSE/FTSE industrial index. ¤

QUIZ

EACH WEEK WE'LL PUBLISH three questions related to that week's content.

At the end of the 12 weeks Online Share Trading will give R10 000,00 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 (011) 884-0851.

Questions:

1. Which asset class has historically outperformed all others over time?
2. What tracks the performance of shares over time?
3. What is investing not? ¤

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