Chapter 9

Investment Planning

Chapter Objectives

Students must be able to:

- Explain the Various Ways Money Can Be Used
- Explain the Rewards for Investing
- Compute the Real Rate of Return
- Explain the Impact of Inflation on Investment Returns
- Explain the Role of Time in Investment Decisions
- Explain the Simple Ways to Grow Your Money
- Discuss Some Established Investment Strategies
- Demonstrate the Principle of Dollar Cost Averaging
- Explain the Importance of Diversification
- Briefly Explain the Risk and Return Profile of The Different Markets
- Identify the Different Characteristics of Stocks and Bonds
- Explain the Benefits of Mutual Fund Investment
- What are Some Myths Behind Unit Trust Investments
- Construct a Plan to Meet Investment Objectives
- Know How to Compute Basic Returns on Investments

Chapter 9

Investment Planning

Introduction

The topic of investment captures every essence of our imagination. I believe this component of financial planning to be the principal focus of most financial planners. That seems a very logical conclusion when almost all objectives require a high performance in this area. Even if we talk about insurance we will realize that the insurance companies need to invest the insurance premiums well to give as high a pay-off as possible to the affected policy holders. Variable insurance policies evolved to provide a higher return to policy holders. The good investment performance of insurance companies will also keep the cost of insurance down and provide a higher and better cover to policy holders.

Even in tax planning the cash that is saved needs to be invested so that the tax savings earn a good return to add value to a person's net worth. Most goals and objectives are about accumulation of funds for future consumption. The better the investment performance the better is the chance of reaching these goals. Therefore it is by all measures a very important topic for financial planners.

Investments can generally be distinguished from savings. Savings are funds set aside for the ultimate purpose of investments. But many individuals who are risk averse will consider their savings in banks or other savings institutions as investments. It is always recommended that a fund be set up as an emergency fund which is liquid. By liquid we mean the savings are able to be withdrawn in a day's notice or so. Therefore the use of the words savings or investments depends on the individual concerned. For the purpose of our discussion, cash or cash equivalents i.e. savings in banks and financial institutions will be considered savings and investments will generally be in the main categories like stocks, bonds, unit trusts, properties, real estate investment trusts, money market instruments, investment-linked insurance, options, futures, derivatives and collectibles like art, ceramics, precious stones, stamp and coin collections.

Insurance will be argued as a savings vehicle as well as a protection device. Many insurance policies have a cash value build up which can be drawn upon during emergency. There is very little merit in arguing if cash value insurance is a savings or investment vehicle. Regular savings with little variation in market value can be considered savings.

There is a whole plethora of new structured financial products created on a daily basis in the global investment market. The investment domain has gone international and today in the 21st century capital flows to where the action is. A financial planner needs to know what is available in the local and global markets.

But the basics of investing remains the same – risk versus return. The whole subject of investments is centered on this central concept; the higher the return expected the higher the risk assumed. Every investor is placed on this lever and classified as a high risk taker, risk neutral or risk averse. Consequently the return expectations will have to follow these three categorizations, high, medium and low return expectations. The financial planner's role is to match the investment products to the client's risk profile. A mismatch will lead to subsequent argument and possibly litigation. Therefore the discussion in topic 7 of risk tolerance is very important to get the matching right.

There is a special module assigned for Investments and Retirement. This module will present a cursory view of investments just to whet the student's appetite for more knowledge in this area.

Investment Basics

You are in control of your money

How strange this sounds. That statement merits another look. Are you in control of your money? What do you do when you come to hold some money? **How are you going to use it?**

a. **Spend it on yourself and family. What else?**

b. **Keep it at home**. You are not aware of the numerous break-ins taking place in your neighborhood. You have a favorite stashing place. There is nothing wrong in keeping money at home after all safety box costs money and getting in and out of the bank is a real headache with public transport the way it is and of course the massive traffic jams. The harmful effect is if nobody gets to use the money there is no income earned. You just learned in chapter 6 that time has a value and there is an opportunity cost. If you left the money idle inflation will erode its purchasing power and you find you can't buy the same basket of goods.

c. **Store in a bank**

This is a good choice. The banks want your money. They are the financial intermediaries who will channel the savings of the community to businessmen who will borrow this money to expand the production of goods and services. They will allow you to open either a current account or savings account. If you do not need the money in a hurry you might open a fixed deposit account or even a money market account. Immediately there is a decision to be made. Current accounts hardly earn any interest. Savings accounts generate some interest but they are very low. But if most of your transactions are in cash you might keep a savings account. You have been having trouble issuing checks. The law does not enforce everyone to accept your checks. Current accounts have lost their popularity with the presence of ATMs everywhere. Cash is easy to get to. And let us not forget the invasion of credit cards.

d. **Buy shares in a public listed company**. Your neighbor is a stock remisier.

As a stock owner you own part of the company. Of course you are a very small part owner. You wonder if anybody in the company knows you are a shareholder. Of course

you observe very carefully at what price you got in. Your remisier says you bought it at the lowest price for the day and you are happy. You look at the newspapers everyday to see if your share price has gone up or down. You are also expecting some good dividends along the way although that was not why you bought the share. The main reason was your remisier told you there is some buying activity and therefore the share is expected to increase in price. Who do you know who can tell you otherwise?

e. Lend your money to businessmen and or even the government

You have heard that by buying bonds you are effectively lending your money to companies or even the government. You also have heard that bonds have been doing well the last couple of years and further you want something better than the interest on your fixed deposits with the banks. The idea of fixed income appeals to you when you compare it to shares. The coupon on the bond is 5% a year and you bought the bond at a discount from its face value. The yield to maturity they say is higher than the fixed deposit rate you are currently getting on your bank deposit.

f. Buy into a mutual fund

Somehow this unit trust agent heard you had just received your bonus. He promptly invites to invest in his mutual fund that has done very well in the past year. You are asked to state your investment objective. You are quite blur about it and the agent shows you several options. He asks you whether you are interested in income or capital growth or a balanced fund. You are 40 years old and wonder how to choose between these 'investment' objectives. You are persuaded to put the whole bonus to kick start your retirement plan. You are told the risk is yours and there is no guarantee and very conveniently the agent reminds you that past performance is no guarantee of future performance. Since it is only RM 10,000 you decide to give this agent a try.

g. Buy real estate

You just heard Azizi Ali talk about becoming a millionaire through property investments in the Money Matters program. You examine if you have enough funds available to put a down payment in a sub-urban housing development. You were successful in getting a loan as you have always been prompt in your other loan payments and you have a good credit history. You are hoping for property appreciation as you do not think you will stay there as it is still too far away from your place of work. You are still struggling to find a tenant who will stay long enough. The last tenant damaged your property and owes you two months rent.

h. Speculate or gamble the money

You can get greedy and try to multiply your money many folds the easy way. Buy lottery or visit Genting Highlands. Your friend seems to always tell you that his friend, whom you never seem to meet, has an incredible formula that cannot lose at the Black Jack table in Genting. You go there and there is no Black Jack table but a game close to it called Pontoon. You have a hard time figuring it and before you know it you are down a thousand ringgit. You still have RM 9,000 and you are planning on another assault on the highlands casino.

What is the Reward for Investing?

Having gone through all the options of where to put your money you now give a serious thought to how does each option reward you. This necessitates you asking how comfortable you are with the risk associated with each investment option. Then again you want to explore the rewards first.

i. **Protect your wealth objective**

If you feel more comfortable with keeping the money in the bank you know you will earn the stated interest rate 3.7% per annum. It is quite safe and in case of emergency you know you can break the deposit and use the money. Safety is your primary objective. You want to keep your money in liquid investments like money market instruments and government securities. Even the bonds you choose are of prominent companies that have a small chance of default. The rating on the bonds say A or triple AAA. But you are aware that the reward for choosing safety is a low return. You wonder if inflation will exceed the return earned and therefore there is effectively no growth.

j. **Earn income objective**

Being afraid of low return you are told that if you lend your money for a longer period you will earn a higher income. Since regular income is your objective you look at some good corporate bonds that give you a yield of 5 to 6 percent at least. Some long term bonds if held to maturity will give even 7 or 8 percent. Your unit trust agent will recommend you a mutual fund that invests in bonds which gives regular income.

You also are considering buying some stocks that give regular dividends. You want only the ‘blue chip’ stocks that have never failed to pay dividends in the last five years. You also feel utility companies like the telecoms and tenagas are good bets for long term income. Capital appreciation is not your main concern but if they keep their price and move with the market you consider it a bonus. All you hope is for at least a 5% dividend yield, with price appreciation a bonus.

k. **Growth objective**

You have time in your hand. Your goals are large. You need to grow your money. With this objective you look for stocks and real estate. You are even willing to look at start up companies which have just been listed or technology stocks that have limited track record. You want price appreciation. Newly listed stocks are in growth industries and given time will yield good returns in terms of price appreciation. So you hope. But you can rest assured you will have an exciting journey. In some years you can make 20 to 30 percent and in some years you can be in negative territory. Faint heart never won fair returns, you say.

Properties are somewhere in between bonds and stocks. They have a long term yield of 7 to 8 percent. But a good location may guarantee you double or triple your money after several years. But you must get the real estate cycle right. If you missed it you may have to wait a long time for the next upturn in property prices. But property prices generally hold

and then explode at certain times. But it is determined by the choice of location. You are wondering if you have a good real estate agent to help you.

What is the Risk Involved?

l. You can't avoid risk

Investment risk is defined as the uncertainty surrounding the expected return. There might be a variation or deviation from the expected return. This is especially true of more risky assets like stocks. Last year the stock returned 12% but this year it nose dived to 0%, a variation of 12%. This uncertainty is sometimes too much for some people and they rather put their money in the bank.

The bank gives you a steady return of 3.7% per annum. However you read in the newspapers that inflation is 4%. There is therefore a loss in purchasing power. This is called inflation risk when you put money in safe places like banks. Using the rule of 72 with 3.7% return you will double your RM 10,000 to RM 20,000 in 19.46 years. You know that waiting 20 years for your money to double is not going to get your targets and goals reached.

So if you need to raise funds for college education in ten years and you need RM 100,000 and if you put the money in the bank you will risk not sending your daughter to college. At 3.7% and ten years you will need to have 69,536 today to reach the 100,000. Or you will need to save every year 8,445. If you took the long term view of stocks and they returned 8% per annum on average then your initial investment would have been 46,319 and the annual payment need only be 6,902. Obviously risk is a function of goals.

To reach certain goals it is even more risky not to place your money in more aggressive vehicles. Therefore, risk is not in the investment vehicle per se, it has got to do with what your goals are.

There is clearly a good alternative not discussed in general by financial planners. Most goals are possible only when you generate high income. Investments are very helpful but it is the ability to generate income from gainful occupation that enables people to generally achieve their goals. So if I want to reach targets I have to find economic activity that can generate the income. After good income is generated we can then invest the money efficiently to fulfill your objectives.

m. You can Control risk

There are many strategies developed today to control risk. One key strategy is asset allocation and diversification. These strategies will be explored later. By finding investments that perform differently from each other, called low or negative correlation you can reduce the overall risk of the portfolio without harming the expected returns of each asset class in the portfolio. The famous saying is "Do not put all your eggs in the same basket".

n. Use risk to your advantage

When your goals are urgent and you need growth, risky assets are your alternative. However, your risk profile must accept it. More understanding and knowledge may open the doors to more risk taking. After all not reaching your goals may be the bigger risk.

Inflation and the Real Rate of Return.

In financial planning we have to be very aware of inflation. As explained earlier inflation erodes the purchasing power of your ringgit. Since most goals are accumulation goals for some future consumption, like education and retirement, the impact of inflation must be taken into consideration. Money does not keep its value. Neither does cost of things remain the same. Financial planners must do time value of money calculations using real, inflation adjusted, rate of return.

Finding the rate of inflation

The Consumer Price Index is usually the proxy for inflation. However this rate is for a standard basket of goods and services used by the Statistics department. This may not be reflective of your client's consumption basket. CPI in Malaysia is about 3% or even less. Many have been uncomfortable with this official rate as they personally experience higher cost of things than this rate suggests. Education and medical costs are certainly galloping at their own merry rate. The statistics department's basket has a certain allocated percentage of the various items. Your client's basket may contain different percentages of consumption items.

The government also has enforced price controls on many food items. The CPI is heavily loaded with food items. Therefore the suspicion is that with controlled prices we have an artificially low CPI. Of course the statistics department can argue that the controlled prices are the real prices that people have to pay. The debate still continues. But with the price of oil skyrocketing and with food prices at an all time high we are certainly going to face some adverse conditions. Even the government cannot keep the food prices down for too long. There are talks that much of the current subsidies will be removed in the near future. Investors must factor in these new developments in their return expectations.

How to calculate the real rate of return?

If the rate of return offered on an investment is 8% and inflation is 3%, the real rate of return is 5%. Your money in real terms has only grown by 5%. Please refer to chapter 6 for a discussion on computing real rates of return for time value of money calculations. The formula adopted was: rate of investment – inflation rate / (1 + the rate of inflation)

In the above example the rate is 8%-3%/1.03 = 4.8544%.

Investment Returns and Inflation

Investment books and Research houses have compared the returns on various investments and the average inflation rate over long periods of time. In a study by Ibbotsons Associates, the top earner over the period of 60 years was small company stocks with 340 times inflation. In second place were large company stocks 97 times the inflation rate. Bonds came a distant third with only 3 times the inflation rate. Treasury bills only performed 1 ½ times better than inflation.

The moral of this story is that to combat inflation you need to invest in stocks.

What Causes Inflation?

It is difficult to say but there are generally two theories. One is the theory of demand pull inflation. There is too much money in circulation that drives the prices of goods up. The government may have printed too much money or there is a general increase in incomes that has pushed demand up.

The other reason is when costs go up pushing prices up. The biggest contributors to cost increase are wage increases through collective agreements and union actions and the increasing costs of raw materials and intermediate goods pushing the cost of production.

When it is demand pull inflation the usual monetary policy action by the central bank is to increase interest rate. This will dampen demand for borrowing and reduce the money in circulation.

If it is cost push the increase in interest rate is only going to make it worse. Other structural methods have to be used.

The best remedy for inflation is to increase production and productivity. When the supply of goods and services increases especially those that are in hot demand the general price level is stabilized. The increase in money supply is matched by increased production. Malaysia at this moment is facing a food crisis. The only option is to increase food production. It is interesting to explore all the reasons for the fall in food production. I believe Malaysians have adopted a lifestyle that abhors working in the fields and plantations.

The Role of Time

Time is a physical dimension that affects our life. The physical dimension has matter, energy, space and time as its components. We saw in an earlier chapter the time value of money. Our life has a limited time. Time solves human issues but also creates more risks.

If your retirement fund is fast evaporating and you are hale and hearty you are likely to wonder how long will I survive. How are you going to support the remaining years in retirement? You are on the wrong side of time on this score.

Most decisions have a time element. Time changes a lot of things. How does time affect your money handling? Time will allow you to make more money. Time will allow you to recover from losses. Time will allow you to take more risk. Time will allow you to have more control over your investment. Time will allow you to learn more about investments. It all depends on how you use TIME.

Short-Term versus Long Term Use of Money

If you place deposits for a short term like in the money market or lend for the short term you incur less risk. But the holder of your money will have less time to turnover that money and so will pay you less for the use of the money. On the other hand if you lend for a longer term the borrower can use the money more effectively and therefore is prepared to pay more for the use of the money. However, allowing more time to the borrower will also incur more risk. The money has been put into new uses and you hope it has been turned over profitably. For this extra risk you undertake you hope to be compensated more. That is why bonds have a slightly higher return than bank deposits. Holding bonds to maturity will give you that little extra.

Your Investment Perspective

It is very interesting to see the graphic presentation of investment returns on the various markets. If you view the short run you will see a very volatile picture. Our Malaysian stock market is a great example. The KLCI was at 1,200 in 1996. It dropped to less than 600 in 1998. It went up again to 1,400 in 2007. It is now back at 1200 levels. What would you predict for the year 2010 or 2015? If you take a long term perspective the short run fluctuations will seem small and you will see a general up trend. In the long term stocks move up. Time is therefore an essential element in stock market investment. Obviously longer term graphs using a scale will naturally shrink the volatile short term trends. That being so, it is the long term trend that is important for long term goals.

Stock market can be very safe if you have a 20 year term. In the short term there will be volatility. I urge students to take this challenge and survey past returns to derive a long term trend in the stock market especially 15 to 20 years. This time period will be the usual time period available for funding education and retirement goals.

Simple Ways to Grow Your Money

Keeping your hands off the till is a very important principle. In chapter 6 the discussion on simple and compound interest stated why re-investing your interest or dividends is important. Compounding refers to re-investing the interest earned in the earlier periods so that you earn interest on interest. With simple interest you only earn on the original principal deposited. This means to grow your money you have to keep your hands off the income. It takes discipline to do this. In Malaysia we have a variety of festivals with our different cultures and so there are plenty of reasons to take out the interest and dividends to spend on these festivities. This is critical for people to realize. Compounding gives you financial independence and consuming the annual income keeps your goals underachieved.

Keeping the government's hands off

Taxes are a necessary burden to support the government's expenditures. Today we are on pay-as-you-earn regime. But there are several opportunities to minimize or even avoid paying taxes under the existing legislation. The government allows certain lee ways to plan your tax affairs to minimize your tax burden. Knowledge of our tax system is necessary to maximize the tax situation a person faces.

There is a big difference between taxable income and not taxable income. A good example is EPF contributions. They accumulate tax free. More importantly the employer's contributions are tax free. This is a huge boost to your retirement savings. In Malaysia we are fortunate that the government does not tax capital gains. Therefore capital acquisition is necessary to become financially independent. The tax treatment of the various investment incomes is also important to understand.

Interest income on bank deposits is generally exempt. If your deposit is less than RM 100,000 there is no tax. If you deposit for a longer term like 12 months or more the interest is exempted. When interest becomes taxable it is taxed at source at only 5%. The government encourages depositing with banks and other savings institutions like Lembaga Tabung Haji, Bank Simpanan Malaysia, and Malaysia Building Society Berhad.

Bond interest for the most part is tax exempt. Only interest earned on convertible bonds are taxable. Therefore the government also encourages bond investments.

Investing in stocks has taken a turn for the worst. Shareholders who are the owners of companies will have the company profits taxed at the corporate tax rate. In 2008 the corporate tax rate is 26%. Dividends from profits are already taxed at 26%. There will be no more tax credit given to shareholders when they declare their dividends in their personal tax returns. Dividends are no longer taxable in the individual's hands. They suffer tax at source at the 26% corporate tax rate. This has made the return from share investment less attractive. You will experience a lower return from investing in shares.

Keeping your hands and the government's hands off capital and income is a major financial planning exercise that is worth every effort put in.

Investment Strategies – Buying and Selling Investments

Timing the market and trading in the market

Assets are accumulated for both income needs and capital gains. The timing of purchase and disposal of assets may need some fine tuning to produce greater returns. The general rule is "buy low and sell high". However, most people seem to do the opposite. They buy when it is high and sell it after it has become low. This sounds like a loser. Yes it is difficult to time the market.

Active trading

People who are more knowledgeable and understand investments may trade in the market hoping to make gains. Technically any adventure in the nature of trade is taxable. However, buying assets

and realizing that investment in due course is capital gains. That aside, it is one of those rumors you keep hearing, how one made a fortune in two weeks trading on the stock market not just in the local bourse but in the US market through the internet. Worse still are the stories associated with trading commodity futures. Anyway active trading is not for the uninitiated. Successful short term trading requires concentration, focus, courage to act based on convictions and the proverbial “luck’. Hopefully a trader is making a sufficiently large margin to cover his transaction costs. This is clearly an activity for the high risk taker.

Buy and hold strategy

This is the strategy most financial planners hitherto believe. Most financial intermediaries are asking their unit holders to stay invested in the market and not to buy and sell for profit from short term market movements. Having established a goal your choice of strategy is based on buy and hold until the time for realizing the investment is up. Most people who want to save for education will buy bonds that will mature at the time the child goes to college. Each year the bonds will mature to give the appropriate amount of money. For long term goals like retirement the plan is to buy stocks or units along the way and keep it in hand until you need to dispose enough for your funding requirements.

One of biggest obstacle to buying and selling is the transaction cost or commissions payable to middlemen. The terms bid and ask or offer is familiar to unit trust investors. The difference called the ‘spread’ is the salesmen’s commission. Not only must you get the timing right you must bear the transaction costs.

Dollar Cost Averaging

When timing the market is very challenging a better option is to use dollar cost averaging. It has its merits and most financial planners advise its use. It removes the uncertainty and guesswork over when to buy. How does it work?

o. You choose your investment type be it stocks, bonds or units in an appropriate unit trust scheme.

p. Select your timing schedule and keep to it strictly, monthly seems most appropriate

q. Select a constant amount to invest each time. This will depend on surplus cash flow he can assign to that goal or investment type.

r. Allow time to work its magic

Using dollar cost averaging you invest a little at a time. It is a methodical process. You only invest that constant amount regularly. The price you pay will fluctuate and so there will be times you will buy less units and times where you will buy more units. When you total up the units you have purchased and the total investment so far you will get an average price. You compare this average price to the current market price. If the current market price is low you can immediately see the gain. If it is higher you are at least closer to that price. But this is a long term strategy. You keep doing it until your target or goal is reached. The markets fluctuate enough for this strategy to work in the long run.

Using a Consistent Pattern of Investing

There are many examples of how keeping to a constant schedule of buying has resulted in great gains. Some investment advisers in the United States have followed this method and have derived great benefits. One example is buying stocks at exactly the same day or week in the year and then leaving the market for the rest of the year. If it is the 5th of January then you keep at it on the 5th of January each year. Of course you must have a selection process. Stock pickers have various strategies. One that makes sense is to choose stocks based on dividend yield. Pick the highest five or ten of the stocks that gave the best dividend yield. You sell those in your portfolio which are not on the list and acquire the ones that qualify. You do this every year. Most investors who followed this method were close to those who could time the market perfectly, buy at the lowest and sell at the highest. Investors using a consistent pattern of investing using some sensible selection process will have a better chance of succeeding.

Diversification

Diversification is an investment strategy that overcomes the uncertainty of choosing what to invest in. You place your investment ringgit in a mixed bag of investments. You diversify by selecting different stocks, different bonds and different markets and even different fund managers. There is no one investment for all seasons. Stocks do well at a certain time and bonds in another time. Properties do well following their own cycle. Different markets do well at different times. There are plenty of examples of this up and downs in the different markets. The most important reason you do this is to reduce your overall risk. It has been found that you can get a positive average return but with half the risk by diversifying.

A simple example

You are selling ice creams. And another is selling umbrellas. When it is raining the umbrella man is doing well. When it is hot and humid the ice cream man is doing well. To reduce the risk you divide the capital between ice cream and umbrella business. Whether it rains or shines you are earning a profit. You average your return but you avoid the risk that you were bearing earlier.

How do you diversify with stocks?

s. Mixing large capitalization stocks with small and medium sized stocks
t. By mixing companies in matured industries that offer regular dividends with smaller companies in new growth areas
u. In different markets, global market environment
v. By industries

How do you diversify with bonds?

- ✓ different issuers with different ratings
- ✓ Government securities
- ✓ Different maturity periods –long medium and short term bonds

The key ingredient to diversification is to find investments that have low correlation or low covariance. You will study later that market risk affects different investments differently and so low correlation will keep you floating against any weather like the ice cream and umbrella story. You will have to sacrifice some potential gain to have less risk. Risk tolerance study suggests that people are more averse to losses than to partial gains. It is the 'keep winning' psychology.

Understanding the Different Markets

Students of investment must become familiar with the different markets. A market is a place where you buy and sell a certain product. Malaysians are familiar with Pasar Malam the night market which has a unique acceptance in the community. A stock market is the place to buy and sell stocks. You buy bonds in the bond market and short term securities in the Money market. However various dynamics affect these markets differently. In financial planning we must become conversant with financial market economics. Macro economic variables are followed daily to see where each market is heading. Views of economists are continuously elicited for a better understanding of market economics. Active traders follow CNN, CNBC and Bloomberg to get in the know of what is happening in the world economic environment.

Bursa Malaysia is the body that runs the Malaysian stock market. The supervising authority is the Securities Commission. The stock market acts as both the secondary market for the buying and selling of existing shares and as a primary market where new shares are issued. To list a company in the Bursa Malaysia is an expensive and long drawn affair usually done with the assistance of a merchant bank. By listing a company the original owners are able to raise more capital for expansion and also perhaps find a cash return for their own shares. The original owners need not own more than 50% to retain control of their company. The ownership is spread out and therefore a significant holding is sufficient to keep control of the company.

There are various trading rules to follow. A visit to their website will provide a lot of information. Stock markets are well regulated so that investors can have confidence in their dealings.

The bond market does not have a physical presence. Transactions are conducted over the phone with authorized dealers. It is usually referred to as over –the-counter (OTC) market. Banks especially merchant banks conduct most of the trades.

Property markets are not standardized. They are fragmented. Although all transactions are recorded they are not published in the media. The efficiency of the various markets differs. Some even say that it is in the inefficient markets that profit potential exists. With the organized and regulated markets information is quickly and readily disseminated to all or at least the newspapers. So it is difficult to profit from an efficient market. But George Soros and Warren Buffet still find a way.

These and other issues need to be studied later by students of investment markets.

Is it the Market Economy or the Market Index?

A common misconception is to equate what happens to the market index as happening to the real market. Is the market down, is a common question. But it is not the market we are talking about but the market index. The stock market index measured by a certain formula is a leading index. In other words it reflects the future view of how the economy will perform. It is not the economy itself. Traders and investors will take a forward view of the market. The companies listed in the stock market will continue to produce the same output as they did before the index went down. The companies are not folding up. But one would think that when the market index is down the companies are closing down. The market only thinks the profits will go down or sales will be affected in the future. The world is not coming to an end. People tend to over react. They react too quickly and often with disastrous consequences. That is why fear keeps them selling when they should hold and buy when greed makes them jump into the band wagon when caution should have prevailed.

In Malaysia the popular index is the Kuala Lumpur Composite Index (KLCI) of 100 Malaysian stocks. In the United States the popular index is the Dow Jones. The media shows the performance of all the major stock markets to keep the viewers and readers informed. But the buy and hold or dollar cost averaging investor just gives a cursory glance to all these reports. He has got his game plan.

Being a Stock Owner – Riding the Fortunes of a Company

Being a stock owner gives you a share in the profits of the company. You derive your return from the dividends distributed or from the increase in the share price when you decide to sell.

In the past it was very profitable to participate in new public offerings. The government regulated capital issues and the offer price had to be accepted by the regulatory authorities. During the hey-days of pre -1997, the stock price will rise much higher than the issue price upon listing. Today we hardly hear of new issues and the attention of the regulators and the public seems to have waned. The market index at that time was only 1200. The fervor and excitement of those days are not present today in April 2008 but the market index is around the old 1200 levels. Clearly if we take an objective view we can conclude that is something is amiss in the stock market at the present time. If we can bring back the exuberance of the pre-1997 era we may be in for a more exciting market performance.

In the secondary market there is no new capital being raised. However, a good showing of share prices will reflect well on the company management and will also keep the company creditors happy as often the company's principal owners would have pledged their shares as collateral for loans.

Dividend policy

It is often misunderstood if dividend paying stocks are better than non dividend paying stocks. A classic example would be Berkshire Hathaway shares managed by Warren Buffet. Each share is about RM 83,000. The company does not declare dividends. All profits are re-invested back into the

company. But shareholders are happy as the share continues to do well. Anyone wanting a cash return only needs to sell a portion of his share holdings.

When a company declares dividends it is tantamount to saying the management has no real reason to keep the profits. Distributing the dividends takes cash out of the company and places it in the shareholders hands. This will appropriately bring down the market value of the share in the same ratio as dividends are paid out. But Malaysian companies compete on dividend payouts. The public quite mistakenly goes for dividend distribution as an indication of how well the company is doing. Corporate finance policy says that dividend distribution should make little difference to the value of a company.

Being a Bond Owner – The Journey of a Lender

Buying bonds both conventional and Islamic has become more common. It is important to understand the various bond categories. There are government securities, corporate bonds, Islamic bonds, Khazanah or Treasury bonds and savings bonds. Although bonds are issued in large denominations they are available as an investment with investment linked insurance and mutual funds. It has become relevant to the investment community as they are tax efficient investments.

Being lenders instead of owners they will be paid first. Ordinary share holders are paid last. This aspect makes bonds less risky. However, long term lending involves the risk of default by the issuing company not being able to pay back the money borrowed. That is why the lender must check the official rating of each bond issue. The lower the rating the higher must the interest be to compensate for the greater risk. We have heard of the junk bond era in the United States and how it all collapsed. In Malaysia the Rating Agency of Malaysia (RAM) and another agency called MRCB offer public ratings on bond issuers and issues.

Capital gains

It is possible to earn capital gains from bond transactions. Bonds are issued with a stated coupon or interest rate. This interest is fixed and the owner earns them usually on a semi-annual basis. The bonds are also sold at a discount or premium depending on the market interest rate. If the coupon rate is high issued at a time when interest rates were high, will now increase in value when the interest rates fall. The bonds can therefore be sold in the market at a capital profit. It is therefore expedient to look at bonds near the peak of interest rates. When interest rates slide, the existing bonds will do well.

The investor must match his goals to this investment. It is often bought for education funding because of its maturity at the right time. Upon maturity the full face value is given which will fund the objective. It is liquid and there is no fear of loss of value as it might be with stocks and real estate.

Mutual Funds and/or Unit Trusts

Mutual funds are appropriate for those who do not have the time nor the penchant for investment, and can only come up with small but regular capital. They can invest with professional fund

managers who will do all the work for them. There is no free lunch and therefore these services come with a price.

Each fund has a dominant objective be it income, growth or balanced. It may also mirror a stock market index. Real Estate Investment Trusts have also begun to spring and are making an impact. Choosing your objective is very important to select the appropriate fund. An agent is advised to fact find a client to determine his risk profile so that a proper matching of investor and fund is achieved.

The common objectives are income and growth. The stage in the lifecycle of an investor will tell the preference for either. However, growth is still important to hedge against inflation. A common composition is 60 percent in stocks or equity and 40 percent in bonds or fixed income securities. Income can be derived from both bonds and dividend stocks.

There is a regulated mechanism for the buying and selling of units in a unit trust. Today the prices are quoted in the newspapers at the Net Asset Value (NAV). The net asset value is the total value of the assets of the fund less liabilities, divided by the number of units. Fund managers are allowed to charge a commission or loads that are reflected separately. Different funds use different rates and competition is definitely welcome. The difference is also due to the amount of trade and research needed for each fund category.

The funds are required to stay with the stated objective of the fund. The Securities Commission regulates the unit trust industry quite closely as the investors are generally from the lower income group and they need to be protected from unscrupulous fund managers.

The unit trust industry has exploded and there are few hundred funds in the market and increasing on a regular basis. Today the problem may be in selecting the right fund manager for you. Numerous private rating agencies have cropped up offering their ratings of the different funds segregated according to type, asset classification and duration. The public are also flushed with advertisements boasting the performance of fund managers who have won various awards.

The Federation of Malaysian Unit Trust Managers (FMUTM) is a self regulatory body that monitors and supervises its industry.

Unit trusts are the in thing and as an investor we have to increase our reality on investing in this very popular investment vehicle.

Understanding the Motives of Product Vendors/Manufacturers

It is very important as investors to understand the interest and motives of the product manufacturers. Time and again we hear that there is no such thing as a free lunch. The products offered by the companies serves some better than others. We have to find the appropriate match.

In Malaysia we have both unit trust companies and Insurance companies offering retail fund management. There is a saying that, it is better to buy the cheaper term policy and invest the difference in unit trusts or other investment assets. There are many who are opposed to this

viewpoint. An investor must study the details of any investment product and look at the small print and make an informed decision. Sensitivities are high especially between these two industries which are regulated by different financial regulators. The financial planner who should mostly be independent should falter on the side of the client and not his principal. But if the manufacturer's product is the best the market can offer there is no conflict of interest. The planner can confidently offer the product to the client.

The risk profile and what the product can do must be understood by all concerned. But more importantly all products must address the specific goal it is addressing. The attainment of the specific goal or objective is the main point. A planner should also monitor the investment to see if the objective is being achieved.

Creating a Plan

In the final analysis all investments are for achieving goals. It is investments that will grow your money and contribute to the fulfillment of goals and objectives. The six step financial planning procedure will ensure that all the goals are addressed at the same time so that no important objective is left unattended.

A written plan is necessary to monitor the results of your investments and its assumptions. The economics of the situation will change and even your personal circumstances will change. Therefore all investments must have a purpose. They are there to satisfy a goal. If the products are well matched to the temperament of the client everyone will stay the course. If not the plan will go awry and we will have another disillusioned client submitting himself to the ill-will of the market and poor products.

Computing Investment Returns

We have explored the power of compounding and its difference with simple interest. One of the requirements in investment planning is to compute historical returns of assets and if possible their standard deviation.

There are two measures of investment return. One is called the arithmetic mean and the other is called the geometric mean.

Arithmetic mean is computed by adding the annual returns and dividing it by the number of observations. The geometric mean is the product of the annual returns and finding the ^{n} th root of the product.

An example demonstrating the computation of geometric and arithmetic mean.

Worksheet for computing average total annual return on stock or unit trust investment

Year	Market Price	Annual Dividends	Return on Investment (%)	Return Relative
1987	0.7	0.04	NA	
1988	1.2	0.04	77.1429	1.7714
1989	1.47	0.058	27.3333	1.2733
1990	4.54	0.078	214.1497	3.1415
1991	5.49	0.138	23.9648	1.2396
1992	3.97	0.1	-25.8652	0.7413
1993	4.95	0.11	27.4559	1.2746
1994	4.74	0.119	-1.8384	0.9816
1995	3.4	0.117	-25.8017	0.7420
1996	3.44	0.094	3.9412	1.0394
1997	4.79	0.1	42.1512	1.4215

Computation of 5-year total return

Product of annual return relative 1993 to 1997	1.3716
Geometric mean of return relative	1.0652
Average annual total ROI (%)	6.5238

Computation of 10-year total return

Product of annual return relative 1988 to 1997	8.932159
Geometric mean of return relative	1.244789
Average annual total ROI (%)	24.47887

Workings

The return relative is obtained by the formula: **Ending value/beginning value**. Because annual figures are used in the above example the return relatives are annual rates. If not the holding period return is adjusted for annual holding period return. The annual holding period return is derived by finding the nth root of the holding period return, n, being the number of years. To find the annual yield, you minus 1, from the annual holding period return.

To calculate the arithmetic mean you add the annual yields and divide the total by the number of observations.

The geometric mean = nth root of the product of annual holding period returns.

Returns should be calculated using after tax cash flows. This has become significant as share dividends are taxed at the corporate tax rate instead of the individual tax rate.

Self Assessment

1. “Well managed companies that have had a long and uninterrupted story of high earnings and good dividends” are usually described as being shares that are.

   a. growth
   b. green chip
   c. income
   d. blue chip

2. Bursa Malaysia is considered as:

   a. Capital Market
   b. Primary Market
   c. Secondary Market
   d. a and c

3. Auraxia Company has declared a rights to “two for three” existing shares. This entitles shareholders to acquire:

   a. five new shares for every three rights
   b. three new shares for every two rights
   c. three new shares for every five rights
   d. two new shares for every three rights

4. Factors to consider in investing directly in primary instruments:

   a. Expected return of investment and volatility of return
   b. Asset liquidity
   c. Industry transparency
   d. All of the above

5. Unit trust which retains and keeps a certain portion of annual return as reserve is called:

    a. Equity Fund
    b. Balance Fund
    c. Index Fund
    d. Capital Guaranteed Fund

6. A feature, which distinguishes a warrant from common stock, is:

    i. The possible Ringgit loss on a warrant is less than that on the common stock which the warrant can be used to purchase
    ii. Warrants do not carry the rights accorded to stockholders, especially dividends and voting rights
    iii. The Ringgit investment in a warrant is less that in a share

    a. i
    b. i and ii
    c. i and iii
    d. i, ii and iii

7. The short-term debt securities issued by Bank Negara Malaysia on behalf of the Federal Treasury is known as:

    a. Bank Negara Bills
    b. Negotiable Certificates of Deposit (NCD)
    c. Floating Rate Negotiable Certificates of Deposit (FNCD)
    d. Malaysian Treasury bills

8. Types of fixed income securities in Malaysia are:

    a. Malaysian Government Securities (MGS)
    b. CAGAMAS Bonds
    c. Corporate Bonds
    e. All of the above

9. A party's failure to meet contractual obligation of debt servicing is considered as:

   a. Liquidity risk

   b. Market risk

   c. Credit risk

   d. Management performance risk

10. When the value of bond falls, the bond holder will face capital losses if:

   a. market interest rate is equal with the coupon rate

   b. coupon rate is higher than the market interest rate

   c. market interest rate is higher than the coupon rate

   d. none of the above

Answers: 1-D, 2-D, 3-D, 4-D, 5-D, 6-D, 7-D, 8-D, 9-C, 10-C.