**Financial Investment Advisor**

**SAQA ID: 105026**

**Module 1**

**Overview of the Financial Advice Process**

**NQF Level 5**

**40 credits**

**LEARNER GUIDE**

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**1. HOW TO USE THIS GUIDE**

This guide belongs to you. It is designed to serve as a guide for the duration of your training programme and as a resource for after the time. It contains readings, activities, and application aides that will assist you in developing the knowledge and skills stipulated in the specific outcomes and assessment criteria. Follow in the guide as the facilitator takes you through the material, and feel free to make notes and diagrams that will help you to clarify or retain information. Jot down things that work well or ideas that come from the group. Also, note any points you would like to explore further. Participate actively in the skills practice activities, as they will give you an opportunity to gain insights from other people’s experiences and to practice the skills. Do not forget to share your own experiences so that others can learn from you too.

**2. ICONS**



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**3. HOW YOU WILL LEARN**

The programme methodology includes facilitator presentations, readings, individual activities, group discussions, and skill application exercises.

**4. OVERVIEW OF THE MODULE**

This Module is at NQF level 05 and successful completion of the module will earn you 40 credits towards Occupational Certificate: Financial Investment Advisor. The material will enable you to understand the fundamentals of short-term insurance.

The time you will spend on this module will be a combination of classroom training, self-study and workplace learning. It involves learning, practising, completing activities of a formative nature, doing self-evaluation and putting into practice, in your workplace, what you have learnt.

The approach of classroom contact session-based training is that an adult learning situation is created (through stimulation) by the facilitator to get as much participation as possible from the course participants.

This module will introduce the learner to some of the most important principles of:

* Economics;
* Application of Economic Principles to the Financial Services Sector;
* Current affairs in the Financial Services Sector.

This module has 3 learning units which cover both knowledge and practical components. Guidance is provided in a separate guide, of how to perform some of the practical activities required.

Someone who has competence in at least an NQF Level 4 qualification with English Communication is eligible to study this course.

**GLOSSARY OF TERMS**

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| --- | --- |
| **Advice** | Advice is terms of the FAIS Act is defined as any recommendation, guidance or a proposal of a financial nature, furnished by any means or medium to any Client Group of groups of Clients in respect of the following:   * The purchase or investment in any financial product, * The conclusion of any other transaction aimed at incurring any right or benefit or liability in respect of any financial product (this includes loan or cession); and   The variation, replacement or termination of any financial product |
| **Annuitize** | This is the exchanging of a lump sum at retirement for a series of periodic payments by an insurance company. The reason for doing this is to ensure that the retiree has an income during retirement years |
| **Bankers’ Acceptances (Bas)** | * A Bankers’ acceptance is a bill of exchange that entitles the holder of the instrument to a payment of the face value at maturity day by a Bank. The maturity period varies between 30 to 180 days. |
| **Bond Market** | A Bond market is a market for fixed income securities that consist of a series of fixed payments to the investor on specified dates and repayment of the principal at maturity date. Bonds have maturities ranging from 2 to 20 years and trade in the Capital market |
| **Bond with a put option** | A Bond with a put option gives the bondholder the right to sell the bond to the issuer at a special put price |
| **Bond Yield** | The yield of a Bond is the interest rate that would make all future cash flows of the Bond equal to the present value of the Bond |
| **Bulking** | The practice by an FSP of pooling together money from different Clients in order to benefit from economies of scale for example higher interest rates |
| **Business Cycle** | Fluctuations around the long-term GDP Growth. The Phases of the Business cycle are Trough (the lowest point of a contraction), Expansion, peak and contraction |
| **Business Risk** | This is the risk that a business that an investor has invested funds in ceases to be a going concern due to a collapse in its operating model and goes bankrupt |
| **Call Deposits** | Call deposits are interest bearing accounts with banks that can be called at any time by the depositor. The interest rate earned is a function of the amount invested and is paid monthly but calculated on a daily basis. |
| **Call Risk** | This risk pertains to Bonds that have call options. When interest rates fall, there is increased risk that the issuer may recall the Bond in order to take advantage of lower interest rates |
| **Callable Bond** | A callable Bond gives the issuer the right to buy the Bond from the bondholder (the investor) |
| **Capital Gain/Loss** | Capital gain is the gain realized from an appreciation of an asset price relative to the purchase price. Capital loss is the loss realized from a depreciation of an asset price relative to the purchase price |
| **Car and Household Insurance** | A contract between a natural person or legal entity and an insurance company that obligates the insurance company to pay a stated sum of money in exchange for premiums that are paid on a regular basis in the event of a risk event pertaining to car and household contents |
| **Cash Reserve requirement/structural liquidity requirement** | A tool that the reserve bank uses to influence the supply of money in the economy by requiring all commercial banks to keep a prescribed percentage of their total liabilities as cash |
| **Circular flow of income** | Economic model that illustrates the equilibrium between income that is earned from production and the value of goods and services produced in an economy |
| **Composite Coincident Business cycle indicator** | An index that is made up of economic indicators that occur at the same time as the current stage of the business cycle |
| **Composite lagging business cycle indicator** | A composite economic indicator that confirms what has already happened in an economy |
| **Composite Leading Business Cycle indicator** | A composite piece of economic data that is used to predict future economic activity |
| **Consumer Price Index (CPI)** | A measure of the general increase in the Price Level in the Economy measured through a representative Basket of goods and services in the Economy. This also known as Headline inflation |
| **Consumer Price index excluding interest rates on mortgage Bonds (CPIX)** | A measure of the general increase in the price level in the Economy measured through a representative basket of goods and services after removing repayments on mortgage Bonds. This is in order to only have components that fluctuate due to market forces and not due to policy decisions by the SARB |
| **Continuous Professional Development (CPD)** | Ongoing activities that an FSP, KI, Representative should engage in order to maintain the required competence to render or manage or oversee the Financial services that they are authorised to render advice for |
| **Contractionary fiscal policy** | The use of the government’s budget to reduce aggregate demand in the economy and thereby reducing inflation through raising taxes and/or reducing government expenditure |
| **Contractionary phase of the business Cycle** | Phase of Business cycle where GDP Growth rate declines and is characterized by falling GDP output, increasing unemployment, high interest rate, depreciating currency and low Business confidence and profitability |
| **Convertible Bond** | A Bond that gives the Bondholder (the investor) the right to convert the Bond into shares of the company that issued the Bond. These types of Bonds are issued by corporates as it is not possible to own the shares of the government |
| **Core inflation** | A measure of the general increase in the price level in the Economy after removing from the representative basket goods whose prices are considered volatile that is food, non-alcoholic beverages, fuel and electricity |
| **Cost Push inflation** | The rise in the general price levels in an economy caused by an increase in the cost of production. The increased cost of production is passed on to the final consumer |
| **Coupon Bonds (vanilla or straight Bonds)** | Coupon Bonds pay periodic interest payments (known as coupons) at agreed dates for example after every 6 months. The initial amount invested is paid on maturity date |
| **Credit risk** | This is the risk of default by the issuer of a Bond. |
| **Crowding in effect** | The effect of increased government spending which induces a participation by business as they respond by increasing production |
| **Crowding out effect** | Occurs as a result of increased government expenditure which is funded by debt. Government borrowing increases interest rates which makes it difficult for private sector to borrow to finance business activity |
| **Deficit financing** | Fiscal policy that entails the government spending more than the income it is receiving from taxes |
| **Deflation** | It is the general decline in price goods and services in an economy |
| **Demand – Pull inflation** | An increase in the demand of a product thereby outstripping supply and accompanied by an increase in the price of that product |
| **Demand Curve** | The relationship between price and quantity demanded holding other factors constant |
| **Demand relationship** | The relationship between price and quantity demanded holding other factors constant |
| **Depression** | Long term sustained contraction of GDP in an economy often spanning several years |
| **Disability insurance** | A contract between a natural person or legal entity and an insurance company that obligates the insurance company to pay a stated sum of money in exchange for premiums that are paid on a regular basis in the event of a disability event as defined in the policy document |
| **Disinflation** | A drop in the rate at which inflation is going up |
| **Disposable income** | Income that can be spent at an individual’s discretion after removing taxes |
| **Earnings per share** | The earnings per share is calculated as the net profit after tax divided by the total number of ordinary shares. All things being equal, a higher earnings per share is desirable for investors. |
| **Earnings Yield** | The earnings yield is the inverse of P/E and is calculated as (Headline earnings per share/Price of a share). A higher earnings yield indicates that the share is delivering higher earnings given its price and vice versa |
| **Economic indicator** | A piece of economic data that can be used to analyse historical, current and future state of the economy |
| **Estate planning** | A plan that guides how an individual’s assets will be managed or distributed in the event of Death |
| **Ethics** | The moral principles that govern a person’s behaviour or the conducting of an activity |
| **Expansionary fiscal policy** | The use of the government’s budget to increase aggregate demand resulting in an increase in GDP in an economy |
| **Expansionary phase of the Business cycle** | Phase of Business cycle characterized by increased business profitability, high money supply and low interest rates, inflation, low unemployment, high consumer and business spending and high GDP Growth |
| **Expected Return** | The probability weighted average of return distribution |
| **Factors of production** | Inputs into the production process that are supplied by Households (labour, capital, entrepreneurship etc.) |
| **Financial Life cycle** | A model that shows the changes in the needs of an individual caused by trigger events during their lifetime |
| **Financial Service** | A financial service is defined as the furnishing of advice or the furnishing of advice and an intermediary service or the rendering of an intermediary service |
| **Financial Services Conduct Authority (FSCA)** | The FSCA is the market conduct regulator of financial institutions that provide financial products and financial services, financial institutions that are licensed in terms of a financial sector law, including banks, insurers, retirement funds and administrators, and market infrastructures. This role was implemented on 1 April 2018, taking over from the Financial Services Board as part of the initiative in implementing the Twin Peaks model of Regulation |
| **Financial Services provider (FSP)** | A Financial services provider (FSP) is any person other than a person who furnishes advice, furnishes advice and an intermediary service or renders an intermediary service as a regular feature of their business |
| **Financial Services Regulation Act** | Legislation signed into law on 21 August 2017 to give into effect the twin peaks model of financial regulation |
| **Fiscal policy** | The use of the government’s budget to influence economic variables |
| **Fundamental Analysis** | A method of determining a security’s intrinsic value by analysing economic and financial factors in relation to the security |
| **GDP Deflator** | A measure of inflation component in the calculation of GDP. It is the denominator in the calculation of real GDP that is used to convert nominal GDP to Real GDP |
| **Gross Domestic Product (GDP)** | Measure of production in an economy. It is made up of Consumption(C), Investment (I), Government expenditure (G) and net exports(X-M) |
| **Holding period return** | Measures the return from holding a share over a period and is calculated as the capital gain/loss plus the dividend yield |
| **Inflation** | Inflation is the ***sustained*** and ***continuous*** rise in the general price Level of an Economy |
| **Inflation linked Bond** | The inflation linked Bond adjusts the initially invested amount that is the coupon rate is calculated on a fluctuating par value that is adjusted for inflation |
| **Inflation risk** | In relation to Bonds, this is the risk that inflation could go up and erode the value of fixed coupon payments for Bonds that are not inflation linked |
| **Inflation targeting** | The SARB’s target inflation range in order to achieve and maintain price stability in the interest of sustainable and balanced economic development and growth |
| **Interest rate risk** | The risk that Bond prices may fall due to a rise in interest rates |
| **Intermediary service** | An intermediary service is any act other than the furnishing of advice, performed by a person for, or on behalf of, a client or product supplier,  As a result of which the Client may, or does, enter into a financial product transaction with a particular product supplier |
| **Investment Horizon** | This is the length of time that the investor expects to be invested in an investment |
| **JSE** | The Johannesburg stock exchange. Its function is to facilitate the raising of primary capital by business. It also functions as a price determination and trading platform for listed securities |
| **Juristic Representative** | A Company or Close corporation as defined in section 1 of the companies Act 2008 that is appointed as representative of only one FSP and has a written mandate from the FSP to render a service for a particular financial product and has entered into and maintains a guarantee policy or a contract as contemplated in part 4 of the short term insurance regulations |
| **Key individual (KI)** | An appointee by an FSP who oversees the operations and activities of the FSP. |
| **Life insurance** | A contract between a natural person or legal entity and an insurance company that obligates the insurance company to pay beneficiaries a stated sum of money in exchange for premiums that are paid on a regular basis in the event of death of the Life insured. |
| **Liquidity Risk** | The risk that the bondholder may find it difficult to sell a bond in the market due to the deterioration the creditworthiness of the issuer |
| **Market disequilibrium** | Inefficient allocation of resources where supply is not equal to demand resulting in either a shortage or surplus in the market |
| **Market equilibrium** | The most efficient allocation of resources point when supply and demand are equal |
| **Medical aid/Health insurance** | A contract between a natural person or legal entity and a medical aid or insurance company that obligates the medical aid/insurance company to pay a stated sum of money in exchange for premiums that are paid on a regular basis in the event of a health event as per the rules of the scheme or policy document |
| **Monetary policy** | The framework that the SARB uses to manage the supply of money and interest rates in the economy |
| **Monetary policy committee (MPC)** | The committee within the SARB which makes decisions on the appropriate monetary policy stance. It has seven members and is chaired by the SARB Governor |
| **Money market** | The money market is a broad definition of liquid investments with maturities that are less than 12 months |
| **Negotiable certificates of deposits (NCD)** | An NCD is a receipt issued by a bank as acknowledgement that an investor has deposited funds with the bank. It offers a market related rate of return. Instead of holding the NCD to maturity, the holder or bearer of the NCD can sell the NCD in the secondary market |
| **Nominal GDP** | GDP measured at current prices that is without taking into account the effect of inflation in the computation of GDP |
| **Nominal interest rate** | The cost of borrowing money without taking into account the effect of inflation |
| **Notice Deposits** | A notice deposit is an interest-bearing investment that requires the investor needs to give notice of withdrawal in advance. The deposited funds earn interest based on the amount invested. |
| **Peak phase of a Business Cycle** | The peak of a Business cycle is the highest point of the expansionary phase of the business cycle and it is at this point that the GDP growth, low unemployment and high business earnings level off |
| **Price to earnings Ratio** | The P/E ratio is the price of a share divided by its headline earnings per share |
| **Primary market** | The primary market is the market for new securities. |
| **Prime rate** | Is the lowest rate at which commercial banks lend money to the public after adding a profit margin to the repo rate |
| **Promissory Notes** | A promissory note is a written promise by the issuer to pay another party a specified sum of money at an agreed date or on demand.  The promissory note will contain the principal amount, interest rate, maturity date, date and place of issuance and the issuer’s signature |
| **Protection of Information Act (POPI)** | The Protection of information Act has been enacted in order to protect consumers’ right to privacy which is enshrined in the Section 14 of the South African constitution. POPI regulates the protection of personal information without hampering the legitimate use of information to execute business |
| **Prudential Authority** | An arm within the South African Reserve Bank (SARB) responsible for regulation and monitoring of the financial soundness and safety of Banks, insurers, cooperative financial institutions, financial conglomerates and certain financial infrastructures. |
| **Quantitative easing** | A deliberate central Bank strategy to increase the money supply in order to increase Business activity and GDP growth |
| **Real GDP** | GDP at constant prices that is GDP adjusted for inflation |
| **Real interest rate** | The cost of borrowing money after adjustment for inflation |
| **Recession** | A prolonged decrease in GDP Growth. A technical recession occurs when two GDP Quarters record negative Growth |
| **Regulatory Arbitrage** | The process of identifying loopholes in regulation and in the process avoiding compliance with regulation for the benefit of the consumers of financial products |
| **Reinvestment Risk** | This is the risk that interest rates may be lower at the time that the Bond is called by its issuer or at the time that a coupon is reinvested. If prevailing interest rates are lower, the proceeds from the callable bond are reinvested at a lower interest rate. |
| **Repo rate** | The repurchase rate better known as the repo rate is the rate at which the SARB lends money to commercial banks |
| **Representative** | A person or legal entity who has a contract with an FSP and who renders advice on behalf of an FSP in accordance to a contract entered into by the FSP and the representative |
| **Required rate of return** | The minimum return that investors in the share require given the risk of the share |
| **Retail Distribution Review (RDR)** | A current initiative by the FSCA (formerly FSB) to revamp the types of services provided by intermediaries, the relationship between product suppliers and the remuneration structure of intermediaries in order to support the outcomes of TCF |
| **Retirement planning** | The determination of one’s income goals after retirement and establishing and implementing a plan to meet those retirement income goals |
| **SARB** | The South African Reserve Bank is the central bank of the Republic of South Africa. The primary purpose of the Bank is to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa. Together with other institutions, it also plays a pivotal role in ensuring financial stability |
| **SARB Open market transactions** | This is a range of transactions that the SARB undertakes in the money market in order to influence the money supply and interest rates in the economy. Example of such transactions are the issuance of SARB debentures, movement of public funds between the market and the SARB and the conduction of foreign market swaps in the foreign market |
| **Secondary market** | The secondary market is the market where existing securities are traded |
| **Sovereign Risk** | Sovereign risk is the risk posed by the deterioration of a government’s ability to repay its debt obligations. |
| **Standard Deviation** | A measure of the magnitude of the deviation from expected returns of an investment |
| **Supply curve** | The relationship between price and quantity supplied holding other factors constant |
| **Supply relationship** | The slope of the supply curve depicting the relationship between price and quantity with other factors held constant |
| **The Law of Demand** | The Law of Demand states that the higher the price of a good (other factors remaining constant), the lower the quantity of a good or service that is demanded. |
| **The Law of Supply** | The Law of supply states that the higher the price of a good (other factors remaining constant), the higher the quantity of a good or service that is supplied. |
| **Treasury Bills** | Treasury Bills are government issued money market instruments in order to raise money for government programmes or as a way of implementing monetary policy. They have a maturity of either 91 days or 182 days. |
| **Treating Customers Fairly (TCF)** | An objective of the twin peaks model that focusses on Treating customers fairly in order to ensure better financial outcomes for Financial Services Clients |
| **Trough** | Is the bottom (lowest point) of the contraction phase of the Business cycle where GDP Growth is at its lowest point in a Business cycle |
| **Twin Peaks model of regulation** | A two-pronged regulatory approach that focuses on two broad objectives that is market conduct supervision through the FSCA and prudential supervision through the Prudential Authority which is an arm of the SARB |
| **Volatility Risk** | This is the risk of an asset price going up and down in response to supply and demand which are determined by company specific and market wide forces |
| **Yield curve risk** | The risk of a change that could affect the yields of bonds of particular maturities and not all Bonds. |
| **Zero Coupon Bond** | Zero coupon Bonds are sold at a discount and do not pay regular coupons. At maturity, the issuer pays the par value to the investor |

# LEARNING UNIT 1: BASIC ECONOMICS



**Learning Outcomes**

By the end of this learning unit and having completed all the formative assessment activities, you will be able to:

* Define the Laws of Demand and Supply and discuss how equilibrium shortages and surplus occur in a free market economy.
* Distinguish movements along the supply and demand curves from shifts in supply and demand curves and what the implications are.
* Discuss the circular flow of economic activity and the determination of Gross Domestic Product in an economy
* Outline the difference between nominal and real GDP and convert nominal GDP to real GDP using the GDP Deflator.
* Clearly discuss the movement of economic variables in each phase of the Business cycle.
* Discuss the concept and causes of inflation, deflation, disinflation as well as the negative effects of inflation.
* Describe the types of economic indicators and their relevance in economic analyses.
* Explain how the government influences the economy through monetary and fiscal policy and the implications of the policies on the economy.
* Discuss the risk/return profile of major asset classes in the investment universe, their valuation and the impact of economic outcomes on the value of the asset classes.

# THE LAWS OF DEMAND AND SUPPLY AND THE BUSINESS CYCLE

**INTRODUCTION**

*“Petrol affects everything”: SA Braces for long lasting effects of price hike.” (Source City press article by Palesa Dlamini 3 July 2018.”*

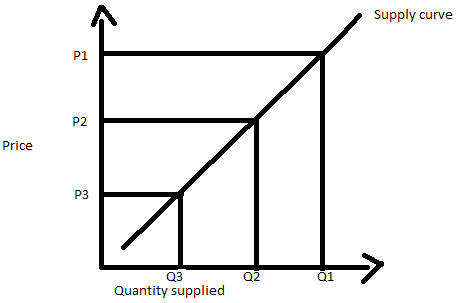
To the motorist, the above article is a reminder to fill up the petrol tank before the latest price increase. To the user of public transport, this may be a signal to an increase in taxi fares and a strain on an already stretched budget. Similarly, a taxi operator anxiously anticipates a drop in the number of people using his service. All this captures the dynamics of supply and demand in an economy. Why do the prices of goods and services go up after a fuel hike? A study of the laws of demand and supply will help us to answer some of these questions. We look at the Law of Supply first and the Law of Demand and then merge the two concepts to see how equilibrium in the market is reached.

## 1.1. The Law of Supply



*The Law of supply states that the higher the price of goods (other factors remaining constant), the higher the quantity of goods or service that are supplied.*

The relationship between price and quantity supplied produces what is called a supply curve. This is depicted in Fig 1 below.



At a low price of P3, the Quantity supplied is Q3 (assuming that the only change in the market is the price). At a higher Price of P2, the quantity supplied is higher at Q2. At an even higher price P1, the quantity supplied is higher at Q1.

In a nutshell, the supply curve is upward sloping. The main dependents of supply are:

* Price of the product.
* Input costs.
* Technological improvements.
* Regulation that is taxes and subsidies.
* Size of the market.
* Future Expectations.

We will discuss these factors in detail when we look at the concept of a shift in the supply curve.



In the establishing the law of supply, all the determinants of supply are held constant except the price.



Let us suppose that you are a proud owner of an Uber taxi. Uber is a company that has revolutionised the taxi industry by using a model where software identifies the nearest cab in proximity to a Client. This model facilitates the most efficient and cost-effective way of a Client to get to their destination. The owner of an Uber taxi provides their vehicle and in return for using Uber software pays a commission to Uber. In November 2018, the cost of a trip for an Uber vehicle in Cape Town was R7.00 per kilometre. In an announcement in December, the Company announced that the fares would change by 5% to R7.50 per kilometre (the actual increase was in fact 7%) (Source IOL Business report: Uber SA announces increase by 5% - 7 December 2018). As an Uber Car owner, would you be willing to supply more cars for your service?

In our Uber example, let us suppose that the price is at P2 (R7.00 in November 2018). An increase of 7% would result in the price moving up to P1 and the quantity of uber taxis supplied would increase to Q1 in Fig 1.

This is the Law of supply. Each point reflects a correlation between Price (P) and the Quantity supplied (Q). The slope of the supply curve is known as the supply relationship. The combination of price and quantity along the supply curve is a movement along the supply curve (other factors have been held constant).

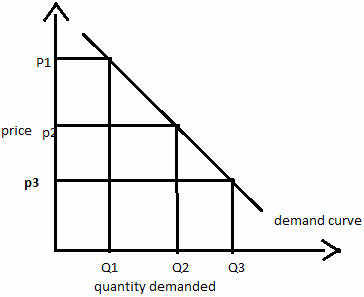
## 1.2 The Law of Demand



*The Law of Demand states that the higher the price of goods (other factors remaining constant), the lower the quantity of goods or service that are demanded.*

The relationship between price and quantity demanded produces what is called a Demand curve.

This is depicted in Fig 2 below:



The Demand relationship is the relationship between price and quantity demanded holding other factors constant. In the Graph above, at a high price P1, the quantity demanded is at Q1. As the price drops to P2, the quantity demanded increases to Q2. At even lower prices that is P3, the quantity demanded increases to Q3. Any price, quantity combination along this downward sloping curve is known as a movement along the demand curve. The elasticity of demand measures the change in quantity demanded given a change in the price of a product. Holding other factors constant, elasticity of demand is high when there is an availability of substitutes and vice versa.



If you were the fee-paying passenger in the Uber example, would you be willing to continue using the Uber service given the 7% increase? A look at the comments section of the stated article would provide that answer! In a free market economy and holding other factors constant, the higher the price of a product, the lesser the quantity of that product demanded. Why is this so? What determines demand?

* One of the main factors affecting demand is the availability of substitutes. When buyers are “spoilt for choice” the elasticity of demand (this is the percentage change in the quantity demanded given a change in price) is very high. In our example, services like Taxify, Gautrain, Metrobuses, public taxis and Metro rail would be substitutes to the Uber service.
* Another important determinant of demand is a complement of a product. A complement is a product or service that is used in conjunction with the product in question. For example, bread and butter are complements. A rise in the price of bread will affect the quantity of butter that consumers demand. In our uber example, a compliment to the service is a smartphone. If there is a steep rise in the price of smartphones which an uber user would need to use to “hail a taxi”, the less would be the quantity of uber taxis demanded. The lower the price of compliments, the higher the quantity of the product (holding other factors constant).

In a nutshell, the demand curve is downward sloping. The main determinants of demand are:

* The price of the product,
* Price of substitutes or compliments,
* The purchasing power of potential customers and their personal preferences.
* Changes in consumer income.
* Complimentary goods and substitutes.
* Future Price expectations.

We will discuss these factors in detail when we look at the concept of a shift in the demand curve.

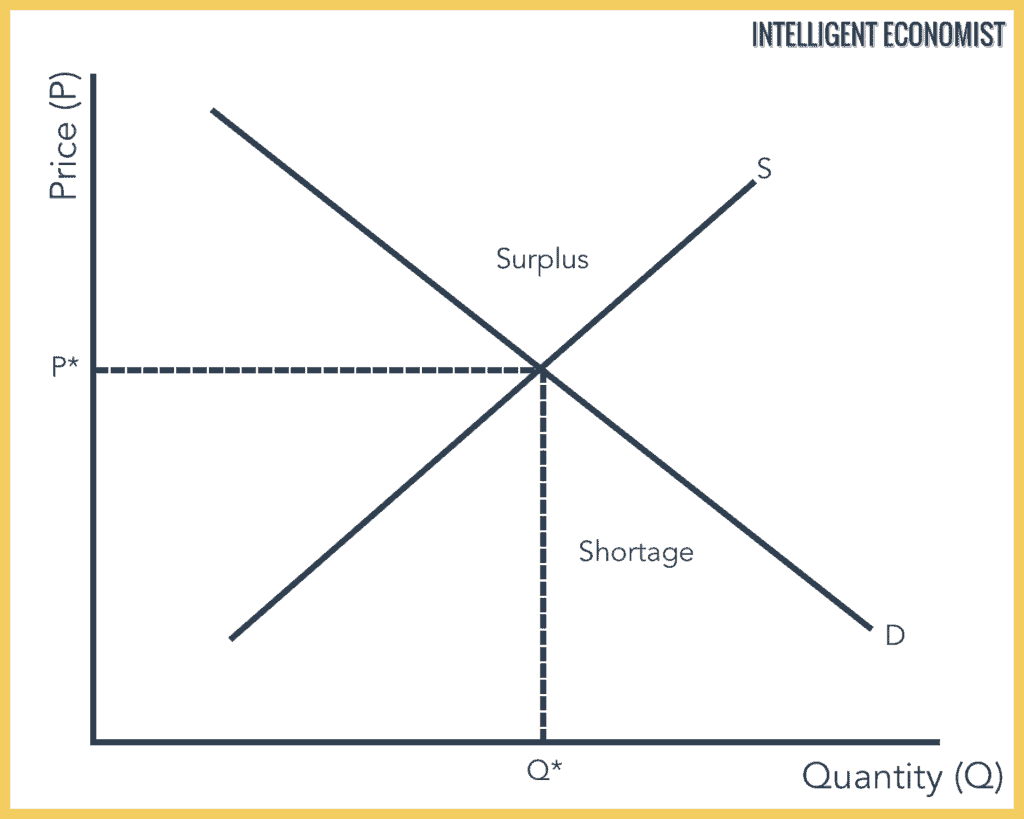


In the establishing the law of demand, all the determinants of demand are held constant except the price.

## 1.3 Determination of Equilibrium in a free market economy:

Market equilibrium occurs when supply and demand are equal. This is the point when the allocation of a good or service is at its most efficient that is there is no surplus or shortage. In our Uber example, the number of uber taxis demanded is exactly the same number supplied and everyone is satisfied.

Equilibrium is depicted in Fig 3 Below:



*Source: Intelligent Economist*

When plotted on a graph, the downward sloping curve is the demand curve and the upward sloping curve is the supply curve. Equilibrium occurs at the intersection of the supply and demand curves. In other words, the interests of suppliers and consumers meet. The price (P\*) is a price consumers will buy at and suppliers will sell their goods for. The corresponding quantity demanded Q\* is the quantity that sellers will supply and consumers are buying. There is harmony at this price and both parties are content. All Prices above P\* will result in a disequilibrium. At any price higher than P\*, suppliers will supply more goods than what consumers will buy (surplus). Any point below the Price P\* will also result in a disequilibrium. Consumers will demand more than suppliers resulting in shortages.

## Shifts in the Demand curve

In our example on the supply and demand of Uber Vehicles, we looked at the relationship between price and quantity whilst holding other factors that might affect demand constant. In summary, the factors affecting the quantity of a good (called the determinants of demand) are as follows:

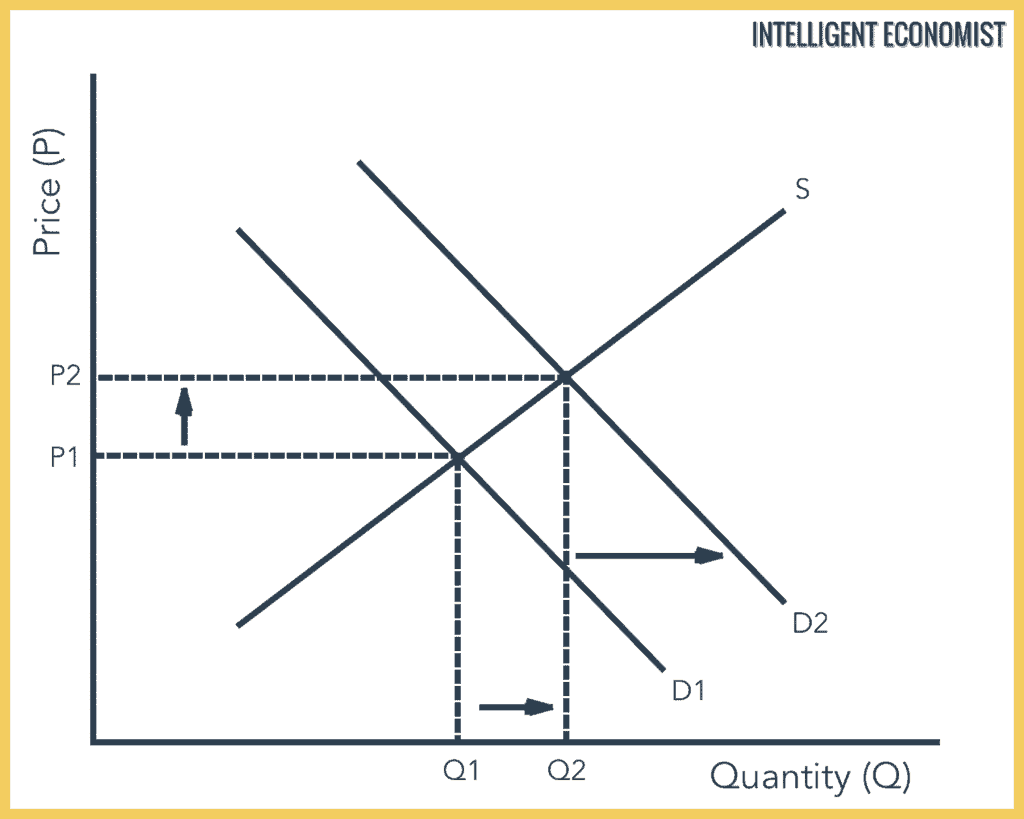
* **Consumers’ income**: For a normal product, an increase in the income of consumers will result in a higher quantity demanded for that good. In other words, the restraint of affordability is lessened with an increase in income.
* **Changes in preferences:** A change in the preference of a product will affect its demand. For example, the introduction of Uber drove traditional metered taxis out of business as commuters preferred more modern vehicles with better comfort compared to the former.
* **Complementary products:** As already explained, a rise in the price of a complementary good results in a drop in the demand for the other good for example smart phones and uber.
* **Substitutes:** An increase in the price of a substitute will increase the demand for a product that could serve the same purpose to increase.
* **Market size:** An increase in the market size for a product will increase its demand. For example, an increase in the overall population will increase the demand for a particular product.
* **Future price expectations**: Future expectations play a big role in determining demand for a particular product. If for example there is an option to pre book future trips, an expected increase in fares for Uber would result in many consumers pre booking their trips immediately before the anticipated increase. This leads to a sudden rise in demand.



Recall that the demand curve shows the price, quantity relationship holding other factors constant. This is a movement along the demand curve. A change in any of the determinants of demand mentioned above causes a shift in the demand curve.

This is depicted below:

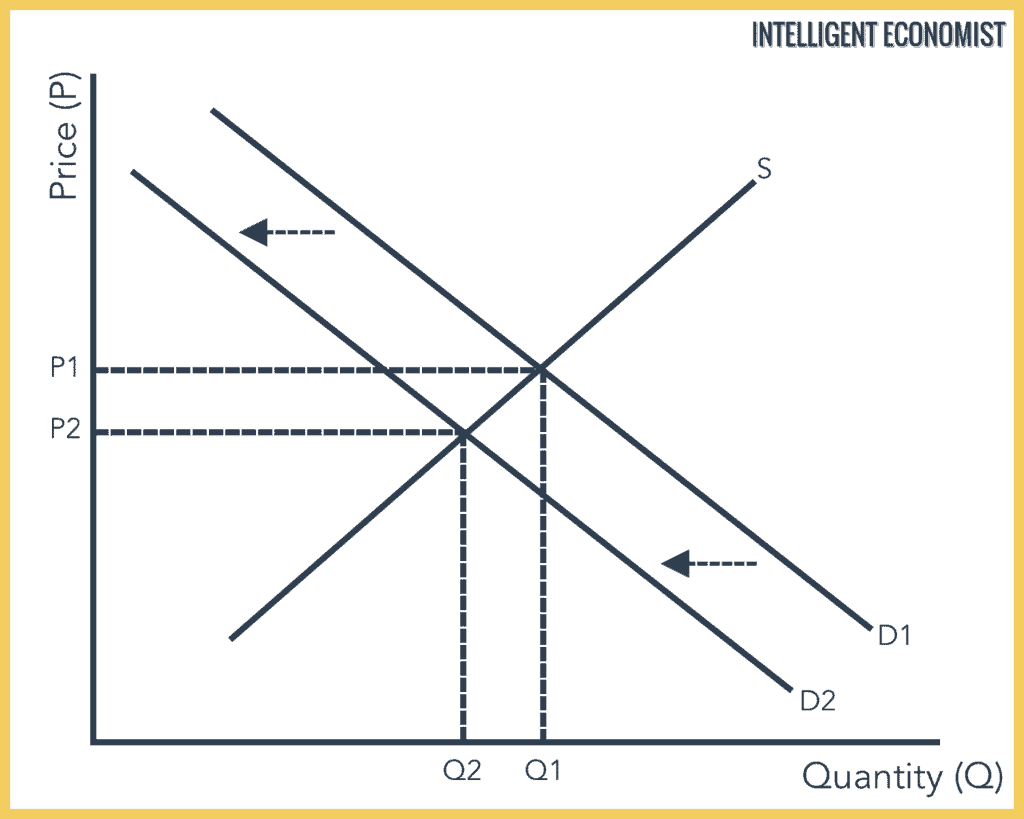
Fig 4



Let us suppose that Uber’s main rival in SA (another internet-based taxi system called Taxify) goes out of business. This a substitute for travellers who prefer using a cellphone application to request for service. The demand for Uber would go up and this would cause a shift of the demand curve to the right (from D1 to D2) as depicted in Fig 4. What this means is that there has been a permanent shift in the relationship between price and quantity. Commuters are now prepared to pay more given the lack of alternatives. An example of this demand relationship at a higher price of P2, commuters are now using more Uber services (Q2). A shift in the demand curve occurs when any of the determinants of demand listed above changes. If the supply remains the same, a new equilibrium is reached at P2 and Q2.

Let us suppose that Taxify reduces its price per kilometre by 5% and all other factors remain constant. Because it now makes sense to use an alternative service for a lower cost, the demand for the Uber service goes down. This results in a permanent shift of the demand curve to D2 as depicted below:

Fig 5



Commuters now demand less quantity at the prevailing prices. The corresponding Price, quantity relationship is now at P2 and Q2. If the supply does not change, the new equilibrium is now a price of P2 and a Quantity of Q2.

## Shifts in the Supply Curve



Remember the definition of a supply curve: A movement along the supply curve that occurs only if there is a change in quantity supplied caused by a change in the price of that product. What other factors can cause the quantity supplied to change (the determinants of supply)? We answer this question using our Uber example:

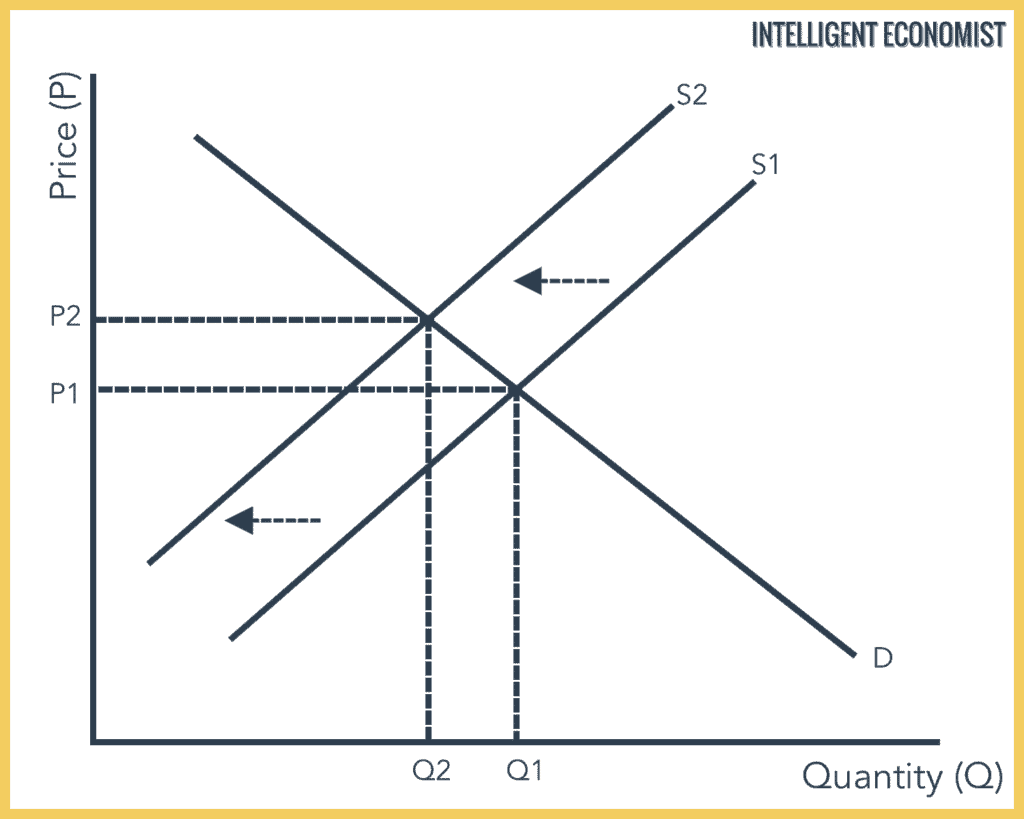
* **A rise in input costs**: Results in lesser of product supplied for example a steep rise in the price of fuel with the price remaining constant would result in a drop in Uber services supplied as profit margins drop.
* **Technological improvements**: Result in higher efficiencies and lower the cost of production. This leads to increase in profit margins and higher quantity supplied. The traditional meter taxi industry which thrived before the advent of uber has borne the brunt of technological changes. The app based uber system which reduces the distance travelled to fetch a customer enabled uber to cut on travel costs and charge lower prices. This has led to a decrease in the number of traditional meter taxis.
* **Regulation**: Subsidies and taxes impact the supply of a product. For example, a rise in the fuel levy increases the price of petrol which squeezes the margins of the taxi industry. This would cause the supply to decrease.
* **Size of the market**: Generally, supply increases as the size of the market grows.
* **Future expectations**: Anticipation of a high demand for example could cause an increase in the supply of the product.



A change in any of the factors can cause a permanent shift in the supply curve.

This is depicted below:

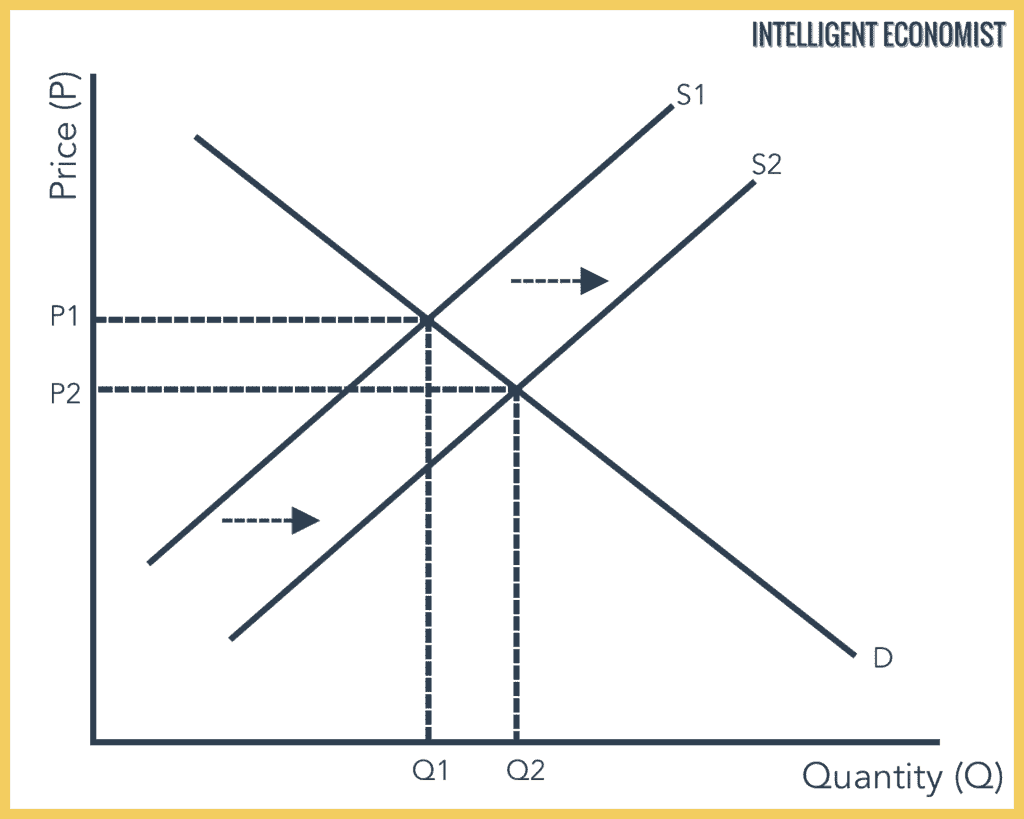
Fig 6



An increase in input costs for example can cause a decline in the quantity supplied as profitability is squeezed. Let us suppose in our example that the cost of fuel went up by 20%. With high input costs and lower profitability, the number of suppliers of Uber cars would drop. This causes a shift in the supply curve from S1 to S2. If demand remains the same, the new equilibrium is now at a higher price P2 and quantity supplied less at Q2. This would make sense as we see this as we go about our business on a daily basis. A good that is in high demand but in short supply would fetch a higher price.

What would be the effect of a 20% drop in the cost of fuel? The possibility of higher profits would trigger more supply of Uber vehicles.

This would cause a shift in the supply curve to the right as depicted in Fig 7:

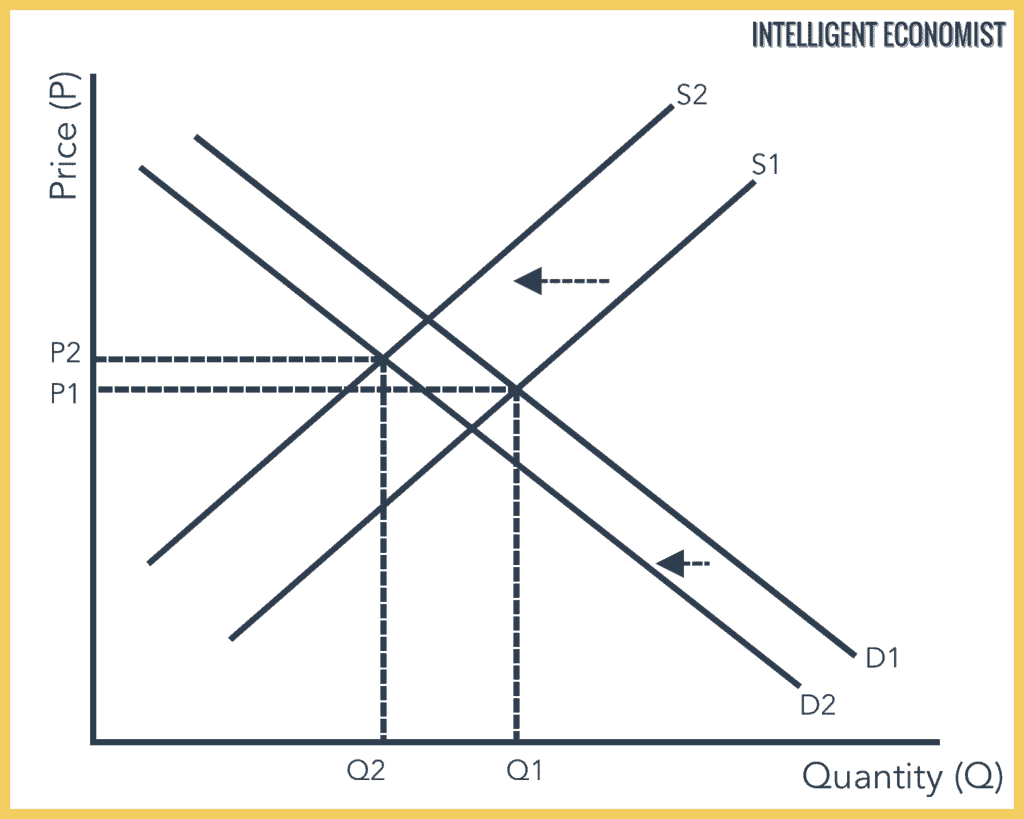


A shift in the supply curve to the right with demand remaining constant would result in a new equilibrium at a higher Quantity Q2 and lower price P2. We also see this on a daily basis isn’t it? An increase in the supply of a product results in a higher quantity in the market and a lower price as buyers have more bargaining power.



What would happen in the event of a shift in both the demand and supply curves? Let us assume that there has been a steep rise in the cost of fuel causing a decline in supply of Uber cars and a simultaneous decrease in demand as commuters now prefer to use Metro bus (perhaps because of a government subsidy that cushions Metro bus from the fuel price increase). This is depicted in the below graph:

Fig 8



A decrease in supply would shift the supply curve to the left so S2 and a decrease in demand will also cause a leftward shift in the demand curve to D2. The new equilibrium is now P2 price and Q2 Quantity.



Note that the increase in the Price from P1 to P2 is not as great a magnitude as in Fig 6. In Fig 6, the increase in the price is greater because the demand remained constant. In Fig 8, suppliers cannot increase their prices as much as the prices as much as there has been a corresponding decrease in demand. The change in the price is determined by the magnitude of the change in supply compared to the change in demand. Where change in demand is higher than the change in supply, the result would be a much lower price at a lower quantity supplied.

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Look again at Fig 8 and see if you can apply this logic. The same logic applies if supply and demand increase simultaneously. Learners should depict the following on a graph such as Fig 8:

* A shift in demand to the left that is more than a shift to the left of the supply curve. In this case both demand and supply curves are shifting to the left but the shift in the demand curve should be higher.
* Learners should plot the corresponding new equilibrium price and quantity and then conclude that the change in price when shift in demand curve is higher than the shift in supply, the change in price is not significant.

## 1.6 The Gross Domestic Product concept and the Business Cycle

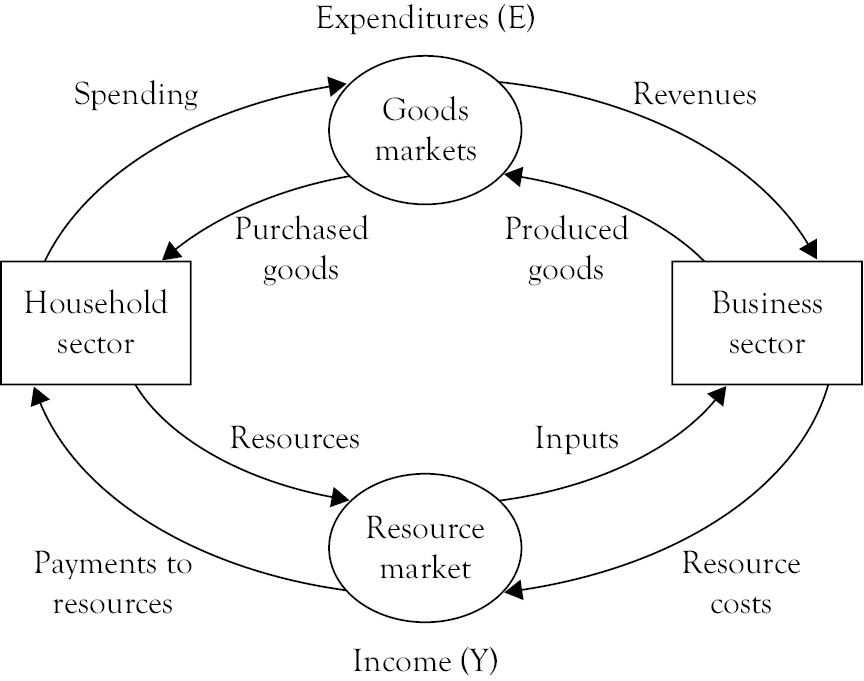
The circular flow of income illustrates the equilibrium between income that is earned from production and the value of goods and services produced in an economy. In an Economy, Households provide factors of production which businesses use to produce goods and services. These goods and services are in turn sold to households. Households pay for the Goods and services supplied by businesses using the income that businesses pay them for providing factors of production (labour, capital, entrepreneurship etc.). The Gross Domestic Expenditure (GDP) is a measure of production in an economy. It is made up of Consumption(C), Investment (I), Government expenditure (G) and net exports(X-M). GDP measured at current prices is known as nominal GDP and GDP at constant prices is known as Real GDP. GDP grows in the long term but in an uneven manner. Fluctuations around the long-term GDP Growth form the Business cycle. The Phases of the Business cycle are Trough (the lowest point of a contraction), Expansion Peak and Contraction. Two consecutive quarters of contraction create a recession and a [prolonged period of recession is a depression. These concepts are discussed in detail in this section.



In our definition of the circular flow of income, we have kept the model simple by assuming that there are no “leakages” that is money is not diverted from spending through savings, taxes and imports meaning that all the income received by households is spent on goods and services provided by the Business Sector. We have also assumed that there are no injections that is there are no exports, Investments and government spending. We will relax this assumption when we look at how Gross Domestic Product is calculated.

The circular flow is depicted in the chart below:

Fig 9



Households supply resources (factors of production that is labour, capital, entrepreneurship) to the resource market (factor market). Business Sector acquires these resources to be used as the input into the Business. It does not stop here. The output from the business sector (produced goods) is sold by businesses to Households in the Goods market. Follow the anticlockwise flow in the chart to understand this. How do households pay for these goods and services? There is a flow of income and expenditure in the opposite direction. Business sector pays for the resources acquired in the resource (factor) market and this equates to income for households. The income households receive is spent on goods and services in the goods market. This is the clockwise flow depicted in the Chart. It therefore follows that Expenditure (E) is equal to Income(Y).

## 1.7 Measuring Gross Domestic Product (GDP)

The Gross Domestic Product is a measure of the economic activity that has been described above. A way of measuring the GDP is to sum the total value of expenditure in an economy over the period.



But surely a Huawei Cellphone produced in China and purchased in South Africa cannot be counted as constituting South Africa’s GDP! How do we account for this? Let us look at the formula for calculating GDP in order to answer this question. Remember that we established that Income(Y) = Expenditure (E) in our study of the Economic model. Here we substitute Income for GDP in the following formula:

GDP=C+I+G+(X-M),

Where,

C = consumption by Households,

I = Consumption by Business on Capital goods (that is goods used in the production of goods and services).

G= Consumption by the government of Goods and services.

X = Exports (This measures spending of South African Goods by foreigners outside the Republic of South Africa). As this is expenditure on South African produced Goods, we add it.

M = Imports (This measures the consumption by South Africans of non-South African produced goods, The Huawei example that we gave earlier).

This in a nutshell is how the size or performance of the Economy is measured.

## 1.8 Accounting for the Effect of inflation on GDP

According to a respected statistical source, the United States of America’s nominal GDP is projected to be about US$21 482 Billion in 2019. China is second at US$14 172.20 Billion. South Africa lies at number 31 with a projection of US$385.53 Billion. What is GDP and how is it measured? Of what significance is it to policymakers and to the University Graduate entering the job market? Further, what is nominal GDP and how is it different form Real GDP? How is it measured? Let us explore this topic and answer these questions.

### 1.8.1 Nominal Versus Real Gross Domestic Product (GDP)

In the above model, we have not taken into account the effect of price changes on calculation of GDP. In other words, what we have calculated in the nominal GDP (GDP at face value without taking into account the effect of inflation).



If in 2010, an economy was producing 20 000 loaves of bread at R5 each (assume that this is the only production in the economy), the GDP would be R100 000. If the price of Bread went up by R3 to R8 in 2019 and the economy was still producing 20 000 loaves, the GDP is now at R160 000. Clearly, the increase in the value is only nominal and there has been no increase in the quantity of Bread or productivity of that particular Country. In order to get an accurate picture, a measure of GDP which takes into account the effect of inflation (Real GDP) is used. This is a more accurate measure of the productive capacity of an economy.

Calculation of Real GDP (GDP at constant prices):

The formula for calculating Real GDP is as follows:

Real GDP = Nominal GDP/ (1+Inflation since Base Year)

The base year is the year whose prices are used in order to calculate the Real GDP for the period (That is we assume that prices have not changed since the base year).

Continuing with our example above, 2010 would be our base year and the index in this year would be equal to a 100.

**Step 1:**

Calculate the inflation rate:

Inflation rate = (Price at the end of the period – Price at the beginning)/Price at the beginning) \*100

In example this is (8-5)/5 = 0.6x100 = 60%

**Step 2:**

Calculate Real GDP

Real GDP = R160 000 / (1.6) = R100 000

Clearly as per above the Real GDP has not changed.

Our denominator in the calculation of the Real GDP is known as the GDP deflator. It measures the effects of inflation on output.

The formula is as follows:

GDP Deflator = ((Nominal GDP/Real GDP)-1) x100

Let’s key in our values:

GDP Deflator = ((R160 000/R100 000)-1) x100

=60%.

In other words, inflation accounted inflated the GDP by 60%.

## 1.9 The Concept of Business Cycle and phases in the Business Cycle

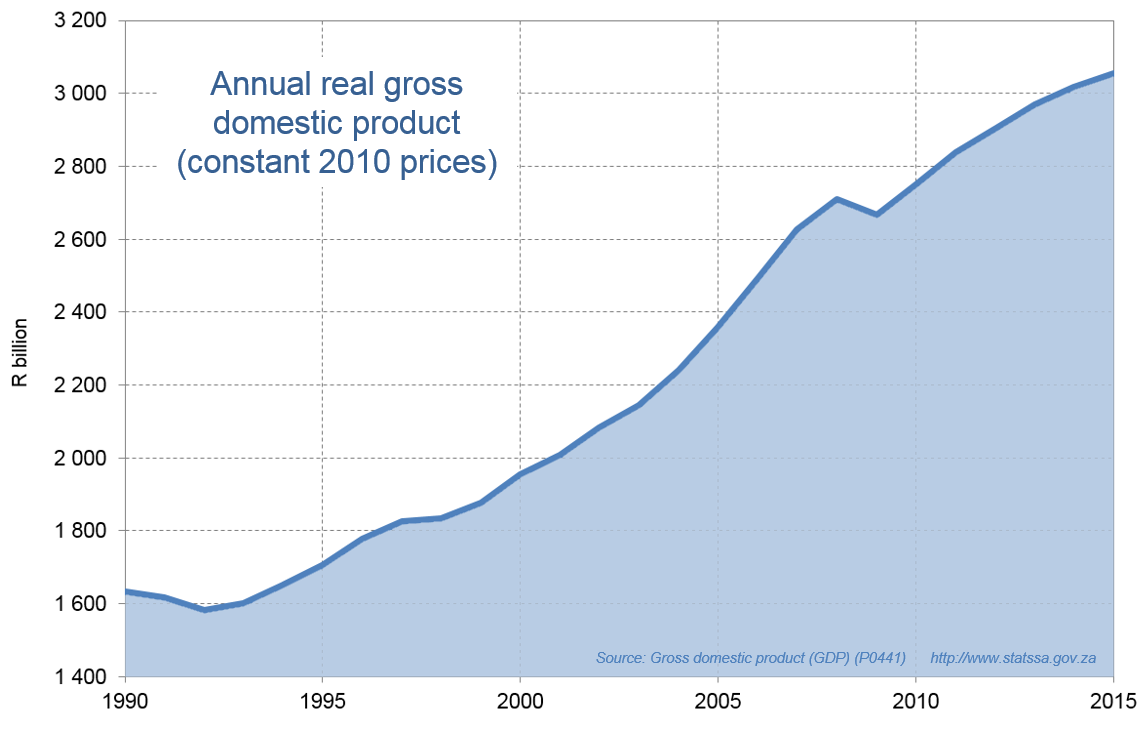
*“SA in longest downward Spiral since 1945.” This screaming headline which made for some interesting reading ran across the website of one of the most respected sources of financial news on the 9th of October 2018. The article further delves dipper into the heart of the matter.” “…the SARB data defines economic growth cycles as representing, “fluctuations around the long-term growth trend of aggregate economy.” (News 24 article 9 October 2018).*

The Economic Business cycle could not have been summed up better than the above definition. The South African economy and economies of other nations grow in the long term. However, this growth is not smooth and fluctuates from lows (known as troughs) and goes through an expansionary phase, reaches peaks and also contract (recessionary phase).

In this section, we will breakdown what the Economic Business cycle is, give an insight on why the words recession and depression are a source of worry for economists and governments and more critically for the investor that who is under your advice.

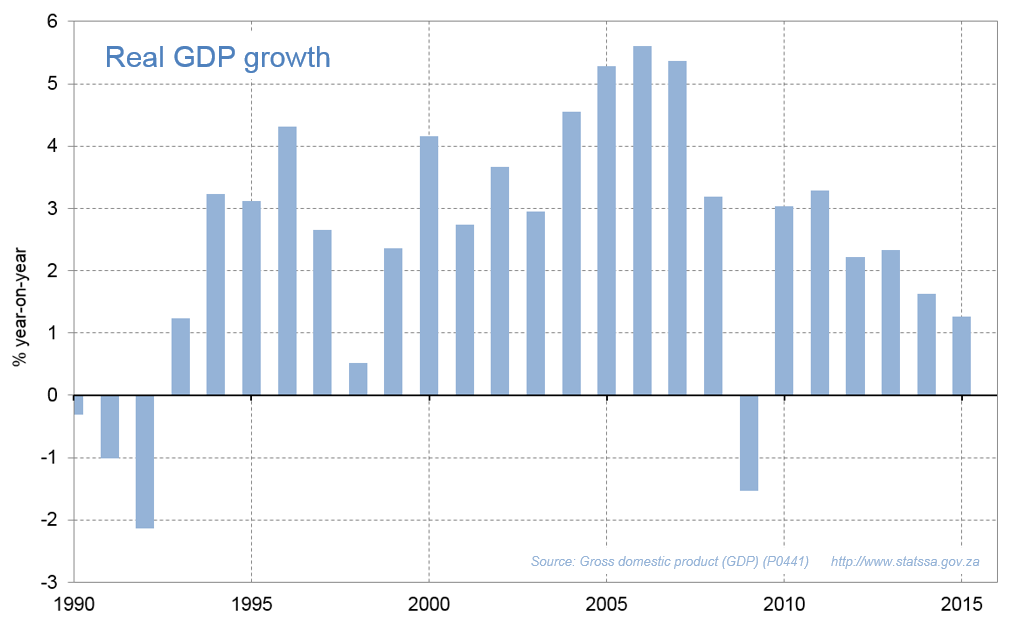
**An overview of the Economic Business Cycle of South Africa over a 15-year Period:**

Fig 10



The above diagram depicted the change of Gross Domestic Product (GDP) of the South African Economy over the years 1990 to 2015 measured at constant prices (2010 prices). The measurement at constant prices ensured that we would not get a misleading measure due to the effect of price increases. In Fig 1 above, it is clear that GDP grew from about R1 600 Billion in 1990 to just above R3 000 Billion in 2015. The above paints a rosy picture about the economic fortunes of our country but does a microscopic view of the rate at which GDP grew from one year to the other reach the same conclusion? Let us look at the Fig 11 below in order to answer this question.

Fig 11



Although the economic growth long term trend has been positive over the period, Fig 2 actually shows that the percentage change in the growth of GDP varies from year to year and is actually negative in some years! 1990 to 1993 was a period of negative economic growth for SA. There was a reversal in this trend from 1994(spurred by the advent of a new democratic South Africa), a decline in 1998(contagion effect of the Asian Economic Crises) and a recovery post 1998 to 2007. External factors were to again impact on SA economic Growth rate with the subprime crisis leading to a negative Growth of -1.5% in 2009. 2010 saw reversal in fortunes and a return to positive territory albeit at a lower growth rate compared to the era preceding the subprime Crisis.

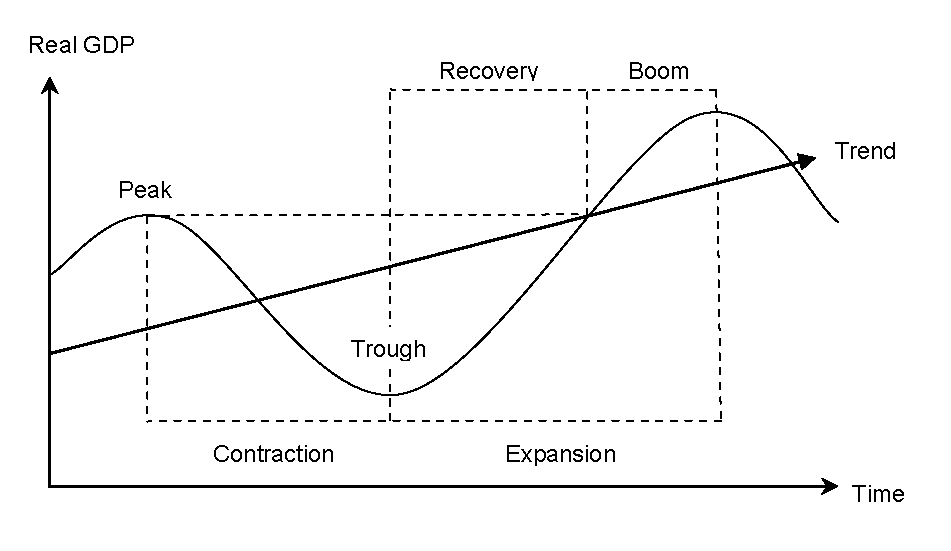
The above is a real-life depiction of the Business Cycle. Although the economy grows over the long term, this growth fluctuates. Before looking at the different phases of the business cycle, a brief discussion of how stats SA measures Economic Growth rate.

According to STATS SA, publication of GDP Growth can be measured on a quarterly on an annual growth basis, Quarterly Year on Year Basis, Quarterly, quarter on quarter basis Year to Date, measured year on year and Year to Date Growth, measured year on year. More information on these different measures of GDP Growth is available on <http://www.statssa.gov.za/?p=9181> . For the purposes of this learning outcome and to keep the illustration straightforward, we will use the growth on an annual basis measurement.

### 1.9.1 The stages of a business cycle

The Business cycle is best explained when illustrated graphically:

Fig 12



When plotted graphically over time, long term GDP growth exhibits the above pattern. A business cycle is comprised of the following stages: Trough, Recovery and boom (expansionary phase), a peak and a contraction (recessionary phase). It is critical for an adviser to know at which stage of the business cycle the economy is at as this has an effect on the value of asset classes and on the Client’s overall financial plan for example a recessionary environment characterized by job losses can trigger the need for a Client to have retrenchment cover (holding all other factors constant). Let us look at the components of the Business Cycle in more detail below.

**Trough Phase of the Business cycle**

A trough is the bottom of the contraction phase of the Business cycle. It is characterized by:

* High unemployment due to a contraction in business activity.
* As unemployment is high, the aggregate demand in the economy is low leading to low sales volumes, declining business earnings and profitability.
* A trough is the lowest point of a contractionary phase and is usually noticed in hindsight that is when the economy begins to grow.
* The trough marks the beginning of a new business cycle as the expansionary phase kicks in.

**Expansionary Phase (Boom) of the Business Cycle**

With the economy having bottomed out and reached the trough phase, a number of factors lead to a recovery in the economy. The current account balance (a measure of exports minus imports) is positive at this stage meaning that South Africa is exporting more than it is importing. Domestic demand for goods and services is very low due to the high unemployment in the preceding trough. The high exports trigger a flow of money into South Africa which increases the money supply and reduces the interest rates. The decrease in interest rates results in an increase in consumer spending and productive borrowing as it becomes more affordable for producers to borrow and invest in their businesses. With consumers and businesses having more money to spend, the aggregate demand in the economy rises which leads to an increased demand in the economy. As business earnings increase, the demand for labour rises thus unemployment falls. Inflation rises as a result of the higher demand for goods. In Summary, the following occurs during the expansionary phase of the Business Cycle:

* Business sales and earnings rise.
* Higher Demand for labour
* High spending by consumers and businesses.
* Low interest rate environment.
* Unemployment falls.
* GDP expands.

**The Peak of a Business Cycle**

The peak of a Business cycle is the highest point of the expansionary phase of the business cycle and it is at this point that the GDP growth, low unemployment and high business earnings level off. In other words, this is the highest point of GDP Growth.

**Contractionary phase of the Business Cycle**

In order to understand the nature of an economic contraction, it is important to recall that just before levelling off at peak, the Economy was characterized by a high demand for goods, increasing output by producers, inflation and a low unemployment rate. There comes a time, because of the rising inflation in the expansionary phase that South African goods become more expensive in foreign markets compared to foreign market local goods. This leads to less exports. In the meanwhile, the South African demand for goods is still high due to the purchasing power of more people who are employed and the low interest environment. This leads to the trade balance (current account) moving into a deficit that is South Africa is importing more than it is exporting. Because of more money leaving the Country (because of high imports), the supply of money decreases and this leads to a rise in the interest rates. The Rand falls in this scenario as South Africa is demanding more foreign goods than South African Goods that are being bought by foreigners. As the Rand falls, imports become more expensive (We are paying more in Rands to purchase foreign goods). Faced with a declining Rand, the SARB raises domestic interest rates in order to attract foreign investors to plug the current account deficit. As we now know, a rise in interest rates can only mean lower spending by producers and consumers as the cost of money (interest rates) is now high. Producers scale back production and inevitably fewer workers are employed (that is unemployment rises).



A good example of how a falling Rand can lead to a dramatic increase in interest rates is the era 1998 to 1999 when the Rand depreciated sharply between May and August 1998. Money market interest rates, prime and home loan rates in September 1998 were 6% higher than in May 1998 and 16% more than inflation. As a result of this, GDP growth which had been forecast to grow at 3% during 1998/99 was revised downwards as private consumption and retail sales stagnated, export growth slowed and business confidence severely dented. (Source:1998 Medium Budget medium term statement).

In a nutshell, the contraction phase of the business cycle is identified by the following:

* Falling GDP output
* Increasing unemployment.
* High interest rates.
* A falling currency (Rand).
* Low Business Confidence and earnings.

The process above continues until the trough which is the bottoming part of the contractionary phase (trough). At this stage, as the rand has declined sharply, imports become expensive (as South Africans now pay more in order to buy foreign goods). In contrast, South African Exports become attractive in foreign markets (they are paying less in their currency to buy South African goods). As a result, the trade balance moves into positive territory (a positive current account Balance). As more money flows into the South African economy (because of foreign demand for South African Goods), interest rates fall and these forces turn the economy into expansionary mode.

**The Concepts of Recession and Depression**

You may be familiar with the term recession as it is frequently in the news as compared to depression. The reason is recessions technically occur more often than depressions. In simple terms, two consecutive quarters of negative growth are termed a recession.



South Africa moved out of the latest recession in the third quarter of 2018 when the economy grew by 2.2% in the three months through September. The previous quarter which preceded another quarter of negative growth had contracted 0.4%.

In contrast, a depression is a long-term contraction in the economy. There have been a few depressions recorded in history with the most notable one being the Great Depression of 1929. A depression is more severe than a recession as it is prolonged typically more than two years. The consequences of a depression are dire. During the Great Depression, unemployment rose to 25% and receded to 9.66% in 1941. Economies contract severely and there is a prolonged period of low productivity at extremely low levels!

# 2. ECONOMIC INDICATORS

## INTRODUCTION

The South African Reserve Bank’s mandate is to control inflation through a policy known as inflation targeting. This policy was adopted in in the year 2000 in order to combat inflation. Currently, the inflation target is to keep inflation within a range of (3% - 6%). There is a raging debate currently on whether the SARB should keep its focus on inflation targeting or use monetary policy to influence other economic variables like unemployment. Why does the SARB deem inflation targeting and controlling it a very important mandate? What is inflation in the first place and how is it measured? What effect does it have on the economy, on the standard of living of South Africans and more importantly, what effect does it have on your Clients? What do you need to be doing as an adviser to cushion your Clients from the effects of inflation? We answer these questions in this section.

We also look at economic indicators and how we harness these in forecasting economic trends. We further expand this to look at the relationship between economic indicators and different economic variables.

## 2.1 The Concept of Inflation



Inflation is the ***sustained*** and ***continuous*** rise in the general price Level of an Economy. It is not to be confused with a once off rise in price in a particular product or sector of an economy. Additionally, the general rise in price levels needs to be significant for it to be termed inflation. ***Deflation*** is the opposite of inflation. It is the general decline in prices of goods and services in an economy. Another important term related to the concept of inflation is disinflation which is the drop in the rate in the rate of inflation. During disinflation, prices are still rising but at a decreased rate compared to the inflationary period. Once disinflation becomes negative, it is called deflation. Although a drop-in price would be welcome by consumers, this may pose a problem as it may be reflecting a contraction in an economy where businesses are reducing prices generally due to lower demand.

### 2.1.2 Causes of inflation

**(a) Cost push inflation:**

Cost push inflation occurs when the cost of producing a good or service rises but there is no subsequent increase in productivity at the higher cost of producing. Because of this, the producer’s margin or profitability is reduced. In order to compensate for lower profitability if goods are sold at the older price, the producer passes on this increase in cost of production to the consumer by charging a higher price.

**(b) Demand – Pull inflation:**

This is the better-known cause of inflation in the economy commonly referred to as “too much money chasing too few goods.” An increase in the demand of a product thereby outstripping supply is accompanied by an increase in the price of that product.

### 2.1.3 The negative effect of inflation:

**(a)Redistribution of wealth:**

Inflation results in a transfer of wealth or in other words redistributes wealth between borrowers and lenders. Borrowers gain and lenders lose.



Suppose you borrowed a R1000 from a micro lender to buy a cell phone at the beginning of 2018. The interest rate is 5% per annum payable and the loan is payable once off (capital plus interest) in December of 2018. In December of 2018, your repayment is R1 050. Let us suppose further that the cost of a cell phone in January 2018 was R1 000 and it goes up by 7% during the year. In December 2018, the cellphone would be worth, R1 070. The buyer in this case, has gained. He/she got a cellphone from the amount borrowed but when repayment is done, the lender is not able to buy the phone bought by the borrower. In other words, the borrower is “wealthier.”



For the redistribution to occur, the inflation rate should be more than the interest rate that is real rates have to be negative. Nominal interest rates are interest rates before taking into account inflation. In our example, the nominal interest was 7%. The real rate of return removes inflation from the interest rate. In our example, the real interest rate would have been (Nominal Interest rate (5%) – Inflation (7%) = -2%.

(b) Effect on pensioners and fixed income earners:

Because inflation diminishes the purchasing power of money, pensioners whose income is fixed (that is invested in interest bearing investment) bear the brunt of inflation as they no longer have the capacity to work and increase their income. This is one of the reasons why you need to encourage Clients to save as much as they can for their retirement.

**(c) Speculative behaviour and loss of productive time:**

In an inflationary environment, a lot of productive time and wastage of resources occur as too much time is spent on trying to achieve the means to beat inflation. This has an overall effect of the GDP of a country.

**(d) Bracket creep:**

Some employers give inflation related salary increases in order to cushion employees from the eroding effects of inflation on their income. However, it is not always the case that the Finance Ministry changes the income tax brackets to take into account the inflation adjusted increase. Let us look at an example for you to better understand this:



In the 2017/18 tax year, the lowest income tax bracket was (R0 – R188 000) and this would be taxed at 18 %. In 2018/19, this income tax bracket is (R0 – R195 850). This is a 4% change in the tax bracket. Let us suppose that you were earning, R188 000 in 2017/18 Tax year. If inflation was 7% and you got a 7% salary increment at the beginning of 2019, this means that your income is R201 160. This means you are no longer in the lowest tax bracket in 2018/19 but in the next tax bracket (R195 851 - R305 850) and now need to pay 26% of income above R195 850). Look at the 2017/18 and 2018/19 tax tables to see this effect.



We now know what inflation is but how is it measured? Who is tasked with the important job of gathering data and measuring inflation? Is it feasible to measure the price change of a huge economy like South Africa?

### 2.1.4 The different methods of measuring inflation

Collecting price data on all the items purchased in South Africa is a daunting if not impossible task. Further, the prices of certain items may not be relevant to everyone for example an increase in the price of a Bentley valued at R5 000 000 may only be significant to only a few high net worth individuals thus it would serve little purpose in gauging the price level in the country. A way to mitigate this problem is to choose a representative basket of goods. Stats SA conducts a Living Conditions Survey and uses other sources to establish products and services that Households spend money on. These items form the basket of goods whose prices are used to calculate inflation. There are currently 412 products and services in the CPI basket of goods and services.

(a) Headline Inflation (Consumer Price Index). The current Base year is 2016 that is prices are compared to 2016 figures.

The headline inflation figure includes all the items that are considered representative for the South African consumer. This is the figure that is commonly reported in the media and is the focal point of analysis for economists, the SARB, Treasury and other stakeholders. The 412 goods and services are classified into the following groups:

* Food and non – alcoholic beverages.
* Alcoholic beverages and tobacco
* Clothing and footwear.
* Housing and utilities.
* Household contents and services
* Health
* Transport
* Communication
* Recreation and culture
* Education
* Restaurants and Hotels
* Miscellaneous goods and items e.g. insurance and financial services

In other words, headline inflation represents the total inflation in the country. As at April 2019, headline inflation or CPI stood at 4.4% which is well within the SARB’s target range of 3% to 6%.

(b) Core inflation:

Core inflation index removes the following items from the CPI basket:

* The prices of food
* Non – alcoholic beverages
* Fuel
* Electricity

The argument for core inflation is that an analysis of the overall picture of the inflation in the Country can be made after taking out the above four items which are more volatile than the other components.



In March 2019, headline inflation rose by 0.8% to 4.5% year on year. Core inflation rose by 0.7%. It can be inferred that the difference in the percentage change is due to the volatile nature of food, non - alcoholic beverages, fuel and electricity. According to Stats SA, higher fuel prices were a contributing factor to the rise in CPI.

(c) Consumer Price Index excluding interest rates on mortgage Bonds (CPIX)

* Until October 2008, CPIX was the target used by the SARB to determine interest policy and decisions.
* SARB now targets CPI for all urban areas in in its inflation targeting framework.
* The logic behind using CPIX as a measure of inflation is that because headline CPI included interest on mortgage bonds to reflect the ownership of a property, CPI would have according to Stats SA, “a perverse effect on CPI.”
* In other words, by including mortgage costs, Stats SA could actually record an increase in inflation caused by its own decision of hiking interest rates which would in turn increase mortgage repayments. This would not be a true reflection of market forces but a change in inflation due to SARB policy changes.



The inclusion of mortgage repayments in headline CPI was discontinued by StatsSA when it adopted the internationally accepted concept of Equivalent Owner’s Rent (OER). This is what is now included in the CPI figure and not mortgage repayments. In other words, Stats SA surveys what homeowners would charge as rent if they were to have a tenant living in their home and includes this in the headline CPI calculation. This means that the headline CPI post October 2008 would no longer be distorted by changes in mortgage repayment changes if the repo rate was changed.

## 2.2 The concept of deflation

It is a concern to policymakers when prices are rising continuously. Of equal concern is deflation. Is everyone not better off when prices are falling and are the standards of living not improving when prices continuously fall? The answer is no. Deflation is a big problem and can trigger a recession.

* Deflation is the general and continuous fall in prices.
* Deflation poses a problem because when people expect prices to be lower in future, they withhold spending now and this leads to a drop-in demand and this can spiral into a recession.
* Recall the formula of calculating real interest rate? It is (Nominal interest rate – Inflation rate). Thus, if the inflation rate is negative, this results in borrowers paying a real interest rate that is higher than inflation. This discourages borrowing to buy durable goods like cars which further affects the demand in the economy. Further, at high real interest rate, there is less borrowing for investment which affects GDP growth.



Let us suppose that the nominal interest rate is 9% and the inflation (deflation) rate is -4 % (negative because prices are falling). The real interest rate is (9-(4)) = 9+4 = 13%. This would discourage borrowing and it not difficult to see why. You would not borrow at a high real interest rate to buy goods that are generally falling in price, would you?

* Deflation also increases the inflation adjusted cost of labour which cuts business profits leading to shutdowns. Wages almost never decrease because the prices of goods are falling. Given this scenario, the cost of doing business increases driving some businesses to close.

## 2.3 Types of Economic Indicators

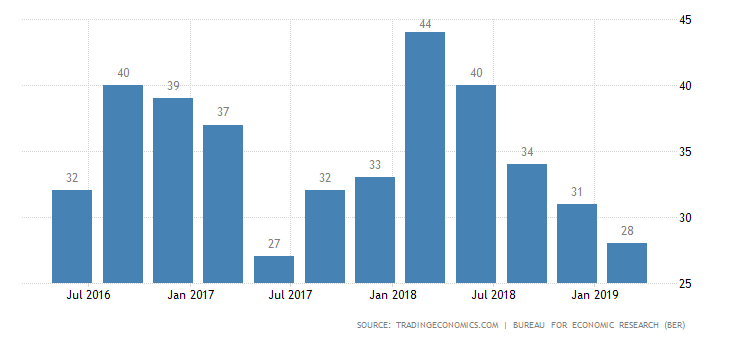
An economic indicator is a piece of economic data that can be used to analyse historical, current and future state of the economy. This analysis can then be used to predict the outcome of investment decisions. It is important as an adviser to know what these indicators are and use these to piece together the economic puzzle and unlock value for your Clients.

There are three important types of Economic indicators namely,

### 2.3.1 Leading Business Cycle indicator:

The leading Business Cycle indicator which is published monthly by the SARB measures economic activity. Shifts in economic activity may be used to predict the onset of a business cycle. The composite Business cycle Leading Business cycle indicator is composed of the following:

* Opinion surveys of volume of orders in Manufacturing: Result of survey showing an increase in volume of orders could reflect an increase in economic activity in the future. A decline in volume of orders could be a signal of low consumer demand and this could lead to a contraction in economic activity and GDP.
* Opinion survey of stocks in relation to demand: manufacturing and trade: This survey analyses stock levels of manufacturers and trade in relation to demand. There could be several reasons why there is a high level of stocks for example, manufacturers could have high inventory in anticipation of a shortage of inputs to produce the final product and not because of low demand of the product.
* RMB/BER Business Confidence index: This index measures business confidence in manufacturing, building contractors, retailers, wholesalers and new vehicle dealers on a scale from 0 to 100, with 0 indicating an extremely low level and 100 being the highest level of confidence. A period of high business confidence is an indicator of a growing economy and vice versa. The below graph shows the business confidence index from 2016 to date.



The index dropped from 44 in Jan 2018 to 28 in Jan 2019. It is not a coincidence that the first quarter 2019 GDP shrunk by 3.2%?

* Composite Leading Business cycle indicator of major trading partner countries: This indicator predicts the direction that major trading partner’s economies are taking. There is a positive impact on the South African economy when the economies of major trading countries are forecasted to grow. Slow growth in major trading partners can affect both imports and exports.
* Commodity prices in US Dollars for a basket of South Africa’s export commodities: 6-month smoothed growth rate.
* Real M1 money supply: Six-month smoothed growth rate: Real M1 money is the quantity of physical currency and coins, demand deposits, travellers’ checks, other checkable deposits. An increase in the Real money supply translates into an increase in demand which increases the GDP.

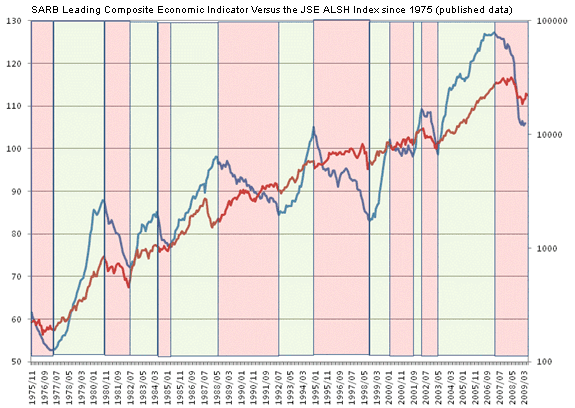


The South African Reserve Bank leading Business Cycle indicator increased in October 2016 by 0.8% on a month to month basis. This biggest contributor to this increase was the acceleration in the six- month smoothed growth of the Real Money M1 money supply.

* Prices of all classes of shares: Six-month smoothed growth rate: It is acknowledged that in an efficient market, the prices of shares reflect the future economic expectation of investors. Strong economic growth is positively correlated to rising share prices as listed companies record higher earnings in the expansionary phase of the Business cycle. This explains the inclusion of this metric in the leading business cycle indicator.



The graph below shows the relationship between the JSE All share index and the leading business cycle indicator since 1975. The graph has been logarithmically scaled to accommodate the long time period and allows us to see peaks and toughs of the JSE.



*Source: powerstocks SA*

The Blue Line is the Business cycle indicator and the red line is the All share index. The graph shows a positive correlation between the leading business cycle indicator and the stock market performance. In other words, the JSE performance has been an accurate predictor of the business cycle indicator between 1975 and 2009.

* Number of residential Building plans passed for flats, townhouses and houses larger than 80 square metres: A rise in this component reflects positive sentiment in the real Estate market which has an impact on the GDP.
* Interest rate spread: Ten-year Bonds less 91 Treasury Bills: Interest rate spread is the difference between the interest on debt instruments of a different maturity profile. For example, if the interest rate on a 90-day Treasury Bill is 7% and the interest for a 10-year Treasury Bond is 12%, the interest rate spread is 5%. Higher interest rate spreads indicate perceived risk. An increase in the interest rate spread would contribute to a drop in the Leading Business cycle indicator.
* Gross operating Surplus as a percentage of gross domestic product: This measures the return on capital employed. A decline in GOS is a discouragement to investors and would contribute negatively to the leading business cycle.
* Labour productivity in manufacturing sector: Six-month smoothed growth rate: An increase in productivity that is output per employee indicates a higher GDP.
* Job advertisements in the Sunday times: Six-month smoothed growth rate: An increase in the number of jobs advertised is an indicator that businesses are upbeat about future economic fortunes.
* Opinion survey of the average hours worked per factory worker in the manufacturing sector: Labour is an input into production. The increase in the number of hours worked can indicate an increase in production which in turn results in a higher GDP.

### 2.3.2 Composite Coincident Business cycle indicator:

This index is made up of economic indicators that occur at the same time as the current stage of the business cycle. Components of the Coincident Business cycle indicator are as follows:

* Gross value added at constant prices, excluding agriculture, forestry and fishing: An increase in the Gross value added is a reflection of increased economic growth.
* Value of wholesale, retail and new vehicle sales at constant prices: Vehicle sales are a strong indicator of consumer demand. Consumption is a component of the GDP formula. An increase in vehicle sales occurs is usually confirmation that the economy is in the expansionary phase.
* Utilisation of production capacity in manufacturing: Manufacturers increase their production in periods of increasing demand.



The utilisation of production capacity by large manufacturers was 80.8% in May 2017 compared to 81.4% in May 2016, a decrease of 0.6 of a percentage point. The increase in underutilisation of 0.6 of a percentage point between May 2016 and May 2017 can be attributed to an increase in insufficient demand.

* Total formal non-agricultural employment: Agriculture is excluded from this indicator due to its cyclical nature. As we have already established, employment is high in periods of economic expansion.
* Industrial production index: Stats SA provides this data that is updated monthly. Periods of low industrial production are confirmation of slow economic growth. According to CEIC (a respected macroeconomic analysis website), a record low of -20.6% of the Industrial index was reached in 2009. This coincided with the Global economic meltdown which started in 2008.

### 2.3.3 Composite lagging business cycle indicator:

The lagging indicator confirms what has already occurred in the economy. Its constituents are as follows:

* Value of non-residential buildings completed at constant prices.
* Ratio of gross fixed capital formation in machinery and equipment to final consumption expenditure on goods by households.
* Nominal labour cost per unit or production in the manufacturing sector (percentage change over months).
* Ration of inventories to sales in the manufacturing and retails sectors.
* Cement sales in tons.
* Ratio of households’ use of instalment sale credit to their disposable income.
* Predominant prime overdraft rate of banks.

# 3. GOVERNMENT POLICY IN THE INVESTMENT ENVIRONMENT

## Monetary policy

## INTRODUCTION

The Reserve Bank Monetary Policy Committee (MPC) pronouncement on the repo rate is a keenly anticipated event. This important decision is a tool that is used by the SARB to implement its monetary policy. What is monetary policy and what is its main goal? Who is tasked with the responsibility of implementing monetary policy? How does monetary policy affect the economy and in particular the investor who is subject to your advice? We answer these questions in this section.

Monetary policy is the framework that the SARB uses to manage the supply of money and interest rates in the economy. The SARB’s main objective is to achieve and maintain price stability in the interest of sustainable and balanced economic development and growth. This is known as inflation targeting. Currently, the goal is to keep the inflation rate in the range of 3% to 6%. Inflation that is lower than 3% is not desirable as it may lead to deflation. An inflation higher than 6% erodes the income of South Africans. There needs to be a balance between high and low inflation. The main tool used by the SARB is the repo rate which is a benchmark for prime interest rates and interest rates in the economy. Other tools at the disposal of the SARB are open market transactions and adjustment of the reserve ratio.

## 3.1 The SARB Monetary policy implementation

An interest rate is the cost of borrowing money. The higher the cost of borrowing money (interest rate), the lower the amount borrowed and vice versa. The interest rates in the economy are influenced by the SARB. The SARB influences the supply of money in the economy through repurchase order system (repo rate), open market transactions and the reserve ratio requirement.

### 3.1.2 How the SARB manages the supply of money and interest rates

### 3.1.2.1 The Repo rate

* The repurchase rate better known as the repo rate is the rate at which the SARB lends money to commercial banks. The SARB is called a lender of last resort in the sense that it lends money to banks that are in need of money. The SARB lends the money through what is called the repurchase order system.
* The repo rate is the interest rate that Banks pay to the SARB for borrowing money. An interest rate is the cost of money. Higher interest rates mean that it is costly to borrow money and this discourages borrowing and consumption.
* When Banks borrow money from the SARB, they pass this cost of borrowing to the consumer. The minimum that an individual can borrow from a bank is the prime rate or slightly lower than this. The prime rate is calculated by adding to the repo rate a margin or profit for the bank.
* After borrowing from the SARB, Banks lend money to individuals and businesses in the economy. In order to make a profit they add a margin to the interest rate (repo rate).
* The prime rate as at 23 May 2019 was 10.25% whilst the repo rate was at 6.75%. This means that the Banks were making a margin of 3.5% for loans that they gave at prime rates.
* High net worth Clients are given loans by Commercial banks at the prime rate or less as they pose less default risk.
* Clients with a higher risk profile will access loans from Banks at prime plus additional percentage points reflecting the higher perceived risk of default.
* It can be inferred from above that interest rates rise when the SARB raises its repo rate, borrowing falls and this reduces consumption in the economy which in turn reduces demand pull inflation.



In January of 2016, the SARB raised the repo rate by 0.5 basis points to 6.75% amidst renewed inflation expectations from a weaker rand. This pushed the prime rate beyond the two-digit barrier to 10.25%. According to experts, after taking into account repo rate increases from 2014 to 2016, the monthly instalment on a 20-year Bond worth a R1m had risen by R1 138. The increased bond repayment had the effect of reducing disposable income for current homeowners and also pricing homes out of the reach of home seekers. This had the effect of reducing demand. When demand is low, prices do not rise as much and the inflation rate slows down.

* The above example shows that the MPC has to delicately balance the primary goal of keeping inflation within its target and ensuring that economic growth is sustainable.



On 23rd of May 2019, the Reserve Bank Governor announced that the MPC decided to leave the repo rate unchanged at 6.75%. The main reason was that GDP was expected to contract in Q1 2019 and there had been negative growth in manufacturing and mining due to Eskom blackouts. Inflation had decreased to 4.5% (from 4.8%) and was forecasted to increase to 5.1% in 2020(down from a forecasted 5.3%) and peak in first quarter of 2020 to 5.5% and settle at 4.5% in the last two quarters of 2021.

From the above example, one can clearly see the role of monetary policy in the economy. The first point we note here is that monetary policy can be used to induce demand. Although this is not the primary goal of the SARB, it has the discretion use the repo rate to ensure, “sustainable and balanced economic development and growth.” The GDP was falling and increasing the repo rate would have had the effect of reducing household expenditure and investment spending. At the same time, inflation outlook was more positive than earlier envisaged hence there was no need to punish spending by raising the cost of debt.

**Five Year trend of the repo rate**

The graphs below show the relationship between the repo rate and inflation between 2014 and May 2019.

**Inflation rate from 2014 to 2019**



**Repo Rate from 2014 to 2019**



The above graphs show that the repo rate is responsive to inflation. The two graphs show that when there has been high inflation, the SARB has intervened by raising the repo rate and there was a subsequent fall of inflation after such intervention.

### 3.1.2.2 Open market transactions

* The quantity of money in the economy is subject to the principles of supply and demand that we have already learnt.
* The SARB influences the supply of money and the level of interest rates through open market transactions.
* When the SARB requires the supply of money to decrease, it issues (sells) Treasury Bills and other Government securities. Money market and Bond participants who purchase these securities will be in fact taking money out of the market and this reduces the money supply in the economy. Because the supply of money is now less, the cost of borrowing which is the interest rate rises which further discourages borrowing for consumption and investment needs. This leads to lower inflation.
* If the goal is to increase the money supply and lower the interest rates, the SARB buys its own Treasury Bills and other securities from the market. This has the effect of increasing the total money supply in the economy and a reduction in interest rates. This leads to higher aggregate demand in the economy and an increase in inflation.

### 3.1.2.3 Cash Reserve requirement/structural liquidity requirement

* A tool that the reserve bank uses to influence the supply of money in the economy is the cash reserve requirement.
* The Banks Act of 1990 requires all commercial banks to keep a prescribed percentage of their total liabilities as cash.
* For example, in July 2016 this reserve requirement was 2.5%.
* If this requirement is raised by the SARB to say 3%, it would lead to Banks extending less credit (as more money needs to be kept as cash at the reserve bank) to borrowers which would reduce money supply in the economy, raise interest rates and reduce inflation.
* Lowering the reserve requirement to say 1% would lead to higher credit creation as banks can now extend more loans as less money is tied up in the cash reserve account with the SARB.

## 3.2 Fiscal policy

## INTRODUCTION

In order to understand fiscal policy, let us restate the formula for calculating GDP. We established that

GDP = C+I+G+(X-M), where

C= Private consumption

I = Gross investment

G = Government spending and

(X-M) = Net exports

It is clear that government expenditure has a bearing on the GDP of a nation.

Fiscal policy is the use of government budget to influence the economy. The government’s policy regarding its spending and taxation is pronounced in the Budget speech and medium-term budget policy statement by the Minister of Finance. The two common forms of fiscal policy are an expansionary fiscal policy and a contractionary policy. We look at these forms of fiscal policy below:

### 3.2.1 Expansionary fiscal policy

* The goal of an expansionary fiscal policy is to increase aggregate demand in the economy which would in turn lead to economic growth.
* A strategy to achieve this is to lower taxes. The effect of this is to increase the disposable income of households which would increase demand. Businesses would respond to the increased demand by producing more resulting in a growing economy and lower unemployment.
* Alternatively, the government could increase its spending without increasing taxes. This is also referred to as deficit financing where the government spends more than it is collecting through taxes.



In the October 2018 medium term budget policy statement, three of the five measures to stimulate the economy were given: Reprioritisation of public spending to support growth and job creation, enhancing infrastructure development and establishment of an infrastructure development fund and investment in municipal social infrastructure development. We can clearly see the government using its spending to influence growth and employment in the economy in this example. It was forecasted that the budget deficit would be 4% of GDP in 2018/19 (meaning that expenditure would be more than revenues from taxes by 4% of GDP) and that the Gross Debt to GDP ratio would be 59.6%.

* A third alternative is to lower taxes and increase expenditure. Increasing expenditure with a lower tax revenue means that the government needs to borrow more to fund the shortfall.
* Supporters of expansionary fiscal policy argue that the government can kick-start a recovery in a recession by increasing demand which would in turn result in firms hiring more people to increase their production. This is known as the “crowding in” effect in the sense that increased spending will induce a participation by business as they respond by increasing production to increased expenditure.
* On the other hand, some economists argue that expansionary fiscal policy has a “crowding out “effect. This view states that increased government spending funded by borrowing has the effect of increasing the interest rates which makes it more costly for private businesses to borrow money. With borrowing costs that are high, private businesses are unable to fund previously profitable businesses which slows down economic growth.
* Opposition to deficit financing also argue that it leads to a growing government debt that may require austerity measures to contain it. Austerity is defined as government measures to reduce public debt.



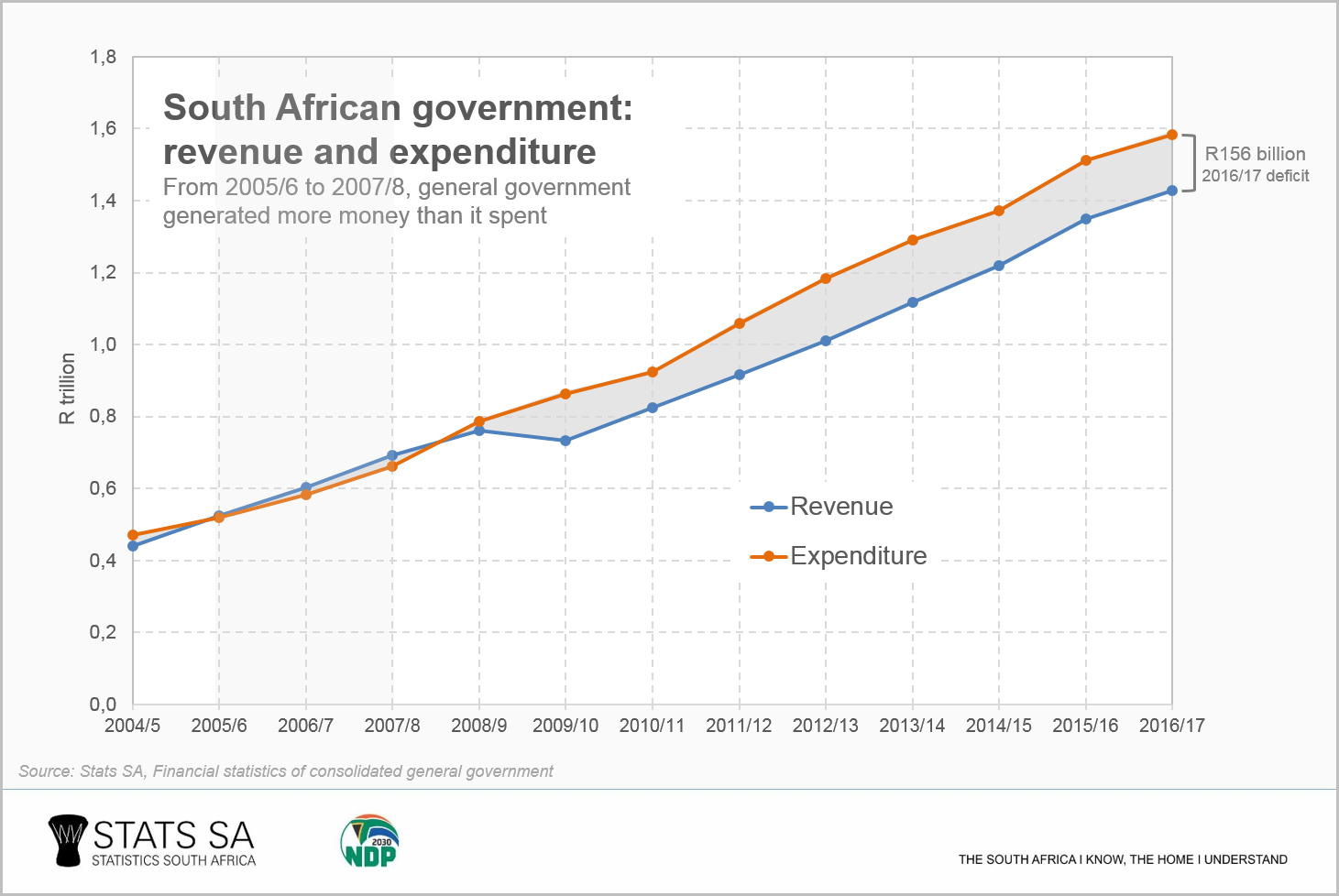
In the 2019 budget speech, the finance minister outlined that government spending would be reduced by R50.3 billion, 54% of which would come from compensation budget adjustments. The minister also indicated that although state owned enterprises would get fiscal support, this assistance would be monitored to prevent the government having an extra debt burden of repaying State owned enterprises debt. The reason for these measures was to reduce the budget deficit and total debt which is expected to be 60.2% of GDP in 2023/24. At the same time, no changes were made to the tax brackets meaning that employees who receive above inflation salary increases would end up paying more tax. This move was expected to raise an additional R12.8 million in taxes. An additional R1.3 Billion was expected to be raised through a carbon tax to be implemented effective 1 July 2019 as well as a further R1 Billion form alcohol and tobacco exercise duty. It is clear that the government is implementing measures to reduce the budget deficit and total debt. This example shows how deficit financing can cause a debt problem in the long term resulting in government taking austerity measures to reverse the debt problem. The diagram below shows how the debt to GDP ratio has steadily grown since 2009:



* As at 2018, the total debt to GDP was 55.8% which is almost twice the ratio in 2009.
* It is also argued that government funded infrastructure development programmes such as the building of bridges for example also “crowds out” private business from that sector which leads to a downturn in the economy.

### 3.2.2 Contractionary fiscal policy

* Expansionary fiscal policy can lead to increase in inflation due to high wages triggered by government spending programmes.
* When this happens, the government resorts to a contractionary fiscal policy to stem inflation.
* Contractionary fiscal policy is a deliberate measure by the government to reduce government expenditure. It is usually accompanied by a rise in taxes.
* The effect of this policy is to curb inflation and avert asset bubbles that occur as result of previous expansionary policy.
* The use of less debt by the government reverses the “crowding out” effect as it becomes less expensive (lower interest rates) to borrow for private firms. This can have the effect of kick-starting economic growth without the undesirable effect of a higher public debt.
* In the recent past there has been a brief period between 2005 and 2007 when Treasury actually spent less than it collected in tax. This is shown in the graph below.



* Between 2005 and 2007, the government spent less than it collected. In other words, we had a surplus. This trend was however reversed from the onset of the global economic crisis of 2008 as economic growth slowed down and revenue from taxes fell.
* The gap has widened since then with Treasury estimating that in 2021/22, 13% of total government expenditure will be going towards repaying debt.
* This explains why Treasury is in a drive to reduce the deficit by cutting down on expenditure and increasing tax collected. This can be termed a contractionary phase in the government’s fiscal policy.

# 4. APPLYING THE FUNDAMENTALS OF ECONOMICS TO THE FINANCIAL SERVICES ENVIRONMENT

## INTRODUCTION

“Shock 3.2% contraction in GDP in first quarter.”

The above headline is taken from the Busineslive edition on the 4th of June 2019. South Africans woke up to the news that GDP had contracted more than expected by 3.2% (the contraction had been expected to contract by 1.7%) quarter on quarter. According to StatsSA, the drop in GDP performance was attributable to an 8.8% decrease in the manufacturing industry, a 10.8% decrease in the mining industry and 13.2% decrease in the agriculture, forestry and fishing Industry. Household final consumption expenditure also decreased in this quarter contributing to -0.5% to the total decline in GDP. The response on the JSE was immediate as banks and retailers share prices tumbled sharply. ABSA lost 3.6% of its value, Standard Bank was down 3.5% and First Rand 2.9%. Truworths was down 3.3%, Clicks 3.9% and Dis-chem 4%. A few questions pop up after reading the above. What are the asset classes available in the investment universe and how do these respond to a negative surprise (when economic variables are below expected results)? What would be the response be in the case of a positive surprise (when the actual outcome is better than anticipated)? What if the actual outcome is in line with expectations? How would different asset classes respond? We seek to answer these questions in this section. We look at the different types of securities that investors can invest in and the impact of macroeconomic variables on these securities.

## 4.1 The money market

The money market is a broad definition of liquid investments with maturities that are less than 12 months. This includes cash (your checking account at the bank), call and notice deposits, Bankers’ Acceptances (BAs), promissory Notes, Negotiable Certificates of Deposits (commonly known as NCDs). A characteristic that is worth noting is that money market instruments are low risk investments with a return that is usually lesser than longer term securities. The primary market of the money market is where the initial money market instruments are issued and the secondary market is where existing money market instruments are traded. Issuers of money market securities include the SARB, Public investment corporation, Industrial Development Corporation.

### 4.1.1 Types of money market instruments

### (a) Treasury Bills,

* Treasury Bills are government issued in order to raise money for government programmes or as a way of implementing monetary policy.
* 91-day Treasury Bills have a maturity of 91 days that is the government through the SARB issue these to market participants and they mature in 91 days. The SARB also issues 182-day Treasury Bills.
* Treasury Bills are considered risk free as governments are not considered to carry default risk.



A government that has a huge public sector debt relative to its GDP may face increasing pressure to reduce its debt as it may become unsustainable to repay debt without resorting to extreme measures such as the printing of more money to repay its obligations. The notion of a risk-free government debt is theoretical. A case in point in recent history is Greece which got to a point of not being able to service its own debt.

* The Treasury bill interest rate is the benchmark used for calculation of the return of other money market instruments and other securities for example the risk-free rate is the benchmark for the Capital Asset Pricing model in calculating the return on Equities. The reason for this is that investors cannot expect a return on any other asset class that is less than the risk-free rate. In other words, they would need additional compensation for investing in more risky assets than the risk-free Treasury bill.
* Treasury Bills are discount instruments that is they are issued at a discount and pay the full value (par value) on maturity.

### 4.1.1.1 Calculating the Purchase Price and the yield of a Treasury bill



A 91 Day Treasury Bill with a nominal value of R1 000 000 at a discount rate of 5% would have its purchase price calculated as follows:

Step 1:

Calculate the amount Discounted first

= Face value x term to maturity x discount rate

365 Days

= R1 000 000 x 91 x0.05

365

= R12 467

Step 2:

Calculate the purchase price.

Purchase Price = Face value – Amount Discounted

= R1 000 000 – R12 467

= R987 533

The buyer of the Treasury bill would pay R987 533 upfront to receive R1 000 000 in 91 days’ time.

The yield (actual return received) on buying and holding this Treasury bill is calculated as follows:

Yield = Discount amount x 365

Purchase amount Days to maturity

= 12 467 x 365

987 533 91

= 0.51 = 5.1%

* Treasury bills are popular with investors due to their high liquidity (they can be traded with ease) and less risk of default.

**(b) Bankers’ Acceptances (Bas)**

* A Bankers’ acceptance is a bill of exchange that entitles the holder of the instrument to a payment of the face value at maturity day by a Bank. The maturity period varies between 30 to 180 days.
* BAs are sold at a discount similar to Treasury Bills. A holder of a BA can sell it on the secondary market at a discount (that is receives purchase price that is less than the face value). The buyer of the BA will receive the face value at maturity from the bank that guaranteed payment of the BA.



Prior to 2013, the SARB could issue and trade in BAs. This was however discontinued on 13 September 2013. BAs however still remain highly marketable and are used by corporates for short term financing needs.

### (c) Call and notice deposits

* Call deposits are interest bearing accounts with banks that can be called at any time by the depositor. The interest rate earned is a function of the amount invested and is paid monthly but calculated on a daily basis.
* With a notice deposit, the investor needs to give notice of withdrawal in advance. The deposited funds earn interest based on the amount invested.

### (d) Promissory Notes

* A promissory note is a written promise by the issuer to pay another party a specified sum of money at an agreed date or on demand.
* The promissory note will contain the principal amount, interest rate, maturity date, date and place of issuance and the issuer’s signature.
* The promissory note is also a discount instrument and the holder at maturity is paid the face value.
* Promissory are an alternative way for companies to get financing from non-banking institutions.

### (e) Negotiable certificates of deposits

* An NCD is a receipt issued by a bank as acknowledgement that an investor has deposited funds with the bank. It offers a market related rate of return
* Instead of holding the NCD to maturity, the holder or bearer of the NCD can sell the NCD in the secondary market.
* NCDs are highly liquid and negotiable and are a good alternative for an investor who is looking for higher yields as they offer market related returns.

### 4.1.2 The effect of different economic outcomes on Cash and money market instruments

* A higher than anticipated inflation figure has a negative impact on real returns for investors in money market instruments. The formula for calculating the real interest rate is Real interest rate = (nominal interest rate – inflation). Assuming that markets are efficient, the current short-term interest rates should reflect the investors’ expectations of inflation and the level of interest rates in future. If the inflation is higher than expected, the income from cash and money market investments loses purchasing power.
* A lower than expected inflation figure is welcome news to investors in cash and money market instruments. It increases their real returns.
* Cash and money market investments are also affected by surprises in GDP.
* A positive GDP surprise occurs when the actual GDP growth is more than forecasted. A rising GDP is triggered by high demand in the economy and this can ignite inflationary pressures. A higher than expected GDP growth could signal to the SARB that the repo rate may need to be increased to reduce inflation. This augurs well for cash and money market investors as this raises the level of interest rates in the economy.
* A negative GDP growth surprise occurs when the actual GDP growth is less than expected. This may move the SARB into cutting the repo rate to induce demand in the economy (provided that inflation is within a manageable range). A repo rate cut lowers the interest rates in the economy and this is not ideal to money market investors.

## 4.2 The Bond market

A Bond is a fixed income security that consists of a series of fixed payments to the investor on specified dates and repayment of the principal at maturity date. Bonds have maturities ranging from 2 to 20 years and trade in the Capital market. Issuers of Bonds include governments and municipalities seeking capital to fund government programmes, State owned enterprises such as Eskom and corporates listed on the JSE. Bonds are issued in the primary market and traded in the secondary market. Bonds are regarded as a conservative investment for investors seeking a return that is higher than money market rates at a risk that is less than investing in more volatile assets like listed shares. The interest payment is regular and this provides liquidity to investors looking to get a steady stream of income from their investment. This is a major difference to some money market securities which we have discussed that are sold at a discount and only pay the par value at maturity.

### 4.2.1The Different types of Bonds

### (a) Coupon Bonds

* Coupon Bonds pay periodic interest payments (known as coupons) at agreed dates for example after every 6 months. The initial amount invested is paid on maturity date. A Coupon Bond that is designed like this and has no additional feature is known as a vanilla or straight Bond.

### (b) Convertible Bonds

* In order to make the Bond more appealing to an investor, a bond can have a convertibility right.
* This option gives the holder of the Bond (the investor) the right to convert the Bond into shares of the company that issued the Bond. These types of Bonds are issued by corporates as it is not possible to own the shares of the government.

### (c) Callable Bonds and Bonds with put options

* A callable Bond gives the issuer the right to buy the Bond from the bondholder (the investor). This feature can be useful to the lender in a declining interest rate environment. The issuer would be able to purchase the Bond immediately and re issue a new bond at lower interest payments.
* A Bond with a put option gives the bondholder the right to sell the bond to the issuer at a special put price. This option is useful to investors in an environment of rising interest rates. The bondholder is able to sell the bond immediately and invest in a recently issued bond that has higher coupon payments.

### (d) Zero Coupon Bonds

* Zero coupon Bonds are sold at a discount and do not pay regular coupons. At maturity, the issuer pays the par value to the investor.

### (e) Inflation linked Bonds

* For all the Bonds described above, the par value and the coupon payments are pre-determined and do not vary. The inflation linked Bond adjusts the initially invested amount that is the coupon rate is calculated on a fluctuating par value that is adjusted for inflation. In inflationary times, this type of Bond provides investors a hedge against inflation.



Investor A invests an amount of R2 000 000 in a Treasury inflation linked Bond at 10% per annum. The coupon is paid annually. At the end of the first year, the Coupon is calculated as (10% of R2 000 000) = R200 000. Suppose that the inflation rate is 3% in the second year. At the end of the second year, the initial amount invested is adjusted for inflation as follows (R2 000 000 x 1.03) = R2 060 000. The coupon in year 2 would be (10% of R2 060 000) = R206 000. At maturity, the initial amount invested adjusted for inflation from start date of the investment is paid back to the bondholder.

## 4.3 Bonds and Risk

Bonds carry a higher risk than money market investments firstly because of the longer life of bonds (which increases default risk) but also because of the following:

### Inflation risk

* This is the risk that inflation could go up and erode the value of fixed coupon payments for Bonds that are not inflation linked. The value of a Bond is calculated by discounting (bringing to present value) the value of all future coupon payments as well as the principal value that is paid at the end of the period. When the interest rates increase because of perceived inflation, the value of the bond falls as it is discounted at a higher interest rate.

### Credit risk

* When the creditworthiness of an issuer deteriorates, investors want a higher interest rate for investing in that Bond to be compensated for increased risk of holding the Bond. As explained above, higher interest rates result in the deterioration in value of the Bond issued by that company.

**R**einvestment Risk

* This is the risk that interest rates may be lower at the time that the Bond is called by its issuer or at the time that a coupon is reinvested. If prevailing interest rates are lower, the proceeds from the callable bond are reinvested at a lower interest rate.

### Sovereign Risk

* Although investments in government securities is considered risk free, a country with high public debt may pose a risk to holders of Bonds issued by that government. This reduces the creditworthiness of the government issued Bonds resulting in loss in value for Bondholders.

### Liquidity Risk

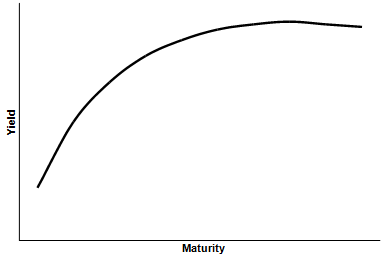
* Bonds that are issued by reputable creditworthy issuers are highly liquid and can be traded at any time as they are sought after due to their increased security. If, however, the creditworthiness of the issuer deteriorates, it may become increasingly difficult to sell the Bond at a good price in the secondary market resulting in losses for bondholders.

### Interest rate risk

* Bonds are sensitive to interest rates movements as the prevailing interest rates are used to calculate the present value of a Bond. Bond prices fall when interest rates rise and vice versa.

### Yield curve risk

* The yield curve is a measure of the yield on Bonds of different maturity profiles. The yield of a Bond is the interest rate that would make all future cash flows of the Bond equal to the present value of the Bond. A normal yield curve is upward sloping that is Bonds that have a longer life should typically give a higher yield than shorter term bonds to compensate the investor for time value of money and perceived risk of investing in longer term Bonds. A typical yield curve would look like the graph below



An equal change in the in the yield curve for all bonds with different maturities is measured by duration. If yields for 10-year Bonds for example change at a rate that is different to 20-year Bonds, there is a risk and this is called the yield curve risk. It simply measures the risk that could affect the yields of bonds of particular maturities and not all Bonds.

### Call Risk

* This risk pertains to Bonds that have call options. When interest rates fall, there is increased risk that the issuer may recall the Bond in order to take advantage of lower interest rates. To an investor this is a risk as the proceeds from the Bond that has been called now needs to be invested at lower interest rates.

## 4.3 The concept of Yield and Price of Bonds

Recall that we mentioned that there is a primary market where Bonds are issued and a secondary market where Bonds are traded. Investors will want to know at what price the Bond is trading at before making the decision to buy it. The price of a Bond is determined by discounting all future cash flows that is coupon payments and the maturity value at the prevailing interest rates.

* When the prevailing interest rates are higher than the coupon rate (the interest rate being paid on an existing Bond), the Bond will trade at a discount (that is at a price that is below the initial amount invested).
* This is because, the price of the Bond has to fall to entice buyers to buy the Bond since investors could get a higher return by investing in a new Bond at a higher interest rate.



Investor A invested R1 000 000 in a Bond that pays a coupon rate of 5% bi annually. The investor has held the bond for two years now and wishes to sell it. The current interest rate is 7%. In order to entice a buyer to buy the Bond, the price of the Bond has to be below a R1 000 000 as the buyer could get a better return elsewhere at 7% by investing in a new Bond issue. The Bond would thus trade at a discount.

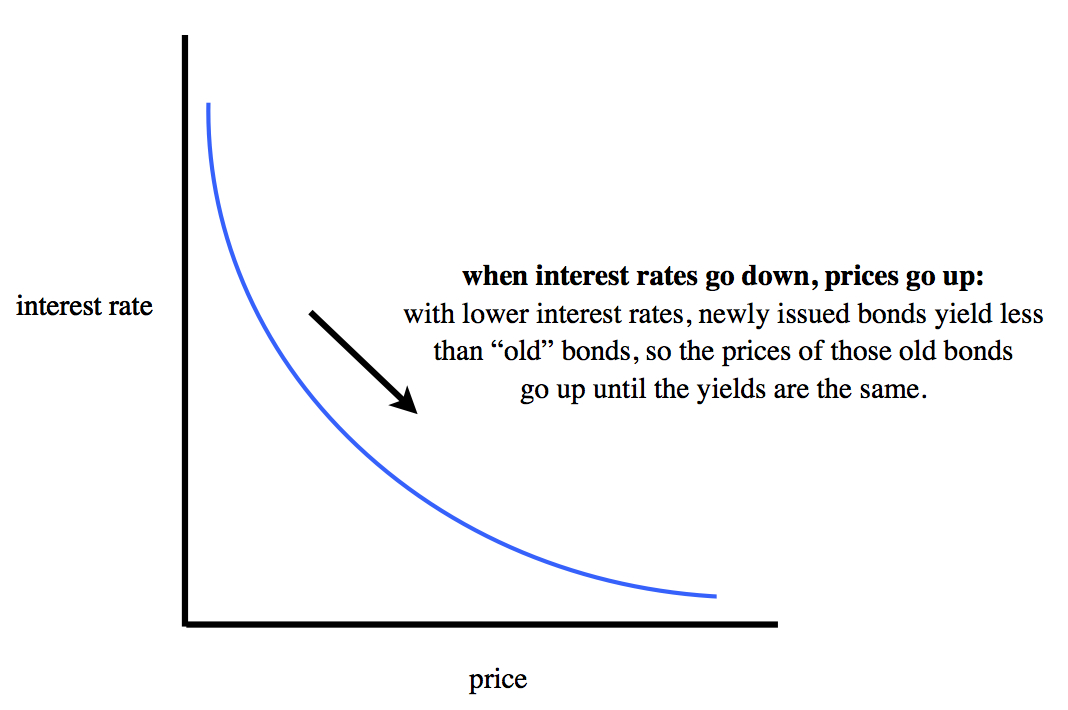
* When the prevailing interest rates are lower than the coupon rate, Bonds trade at a premium that is the price is above the initial amount invested.



Investor A invested R1 000 000 in a Bond that pays a coupon rate of 5% bi annually. The investor has held the Bond for two years now and wishes to sell it. The current interest rate is 3%. In order for the investor to sell the Bond, it has to be at a price that is higher than the initial amount invested. This Bond is in demand because its coupon rate is above what prospective investors could get in the market. The Bond would thus trade at a premium.

* When the current interest rate is equal to the coupon rate on existing Bonds, the Bond trades at par that is investors are indifferent on investing in the current Bond or new issues as they would get the same return.

Below is a depiction of the relationship between Bond prices and interest rates:



## 4.4 Response of Bonds to changes in macroeconomic indicators

* We have established that Bonds carry interest rate risk that impacts their prices.
* A higher than anticipated inflation result may trigger a repo rate increase by the SARB in an attempt to stem demand. The result is a fall of in the prices of Bonds.



In March 2016, the SARB hiked the repo rate to 7% citing a persistent inflation outlook that was protracted and was showing no signs of slowing down.

* The SARB typically responds by cutting the repo rate when the actual inflation is lower than predicted. The result is a rise in Bond prices as we have already established that interest rates have an inverse relationship with Bond Prices.
* When inflation is in line with expectations the SARB may elect to leave the repo rate unchanged. This would not have no direct effect on the Bond prices
* The Bond market can be also be affected by unexpected GDP figures. A higher than anticipated GDP growth could be a signal that aggregate demand is high which could result in a higher future inflation figure. The SARB may respond by hiking the repo rate and the result is a fall in Bond prices.
* A lower than expected GDP result could be a reflection of weak demand which the SARB can respond to by cutting the Repo rate. This results in appreciation of Bond prices.
* A GDP figure may result in no policy shift on interest rates on the SARB part and this may result in no impact in Bond prices as these future expectations would have been priced into the current Bond prices.
* The value of the rand relative to other currencies impacts Bond prices indirectly. If the actual exchange rate reflects a weaker rand than expected, The SARB may hike the repo rate to stem “imported inflation” caused by the depreciation of the rand. This move would have the effect of attracting foreign capital into the Bond market and cause the rand to appreciate. At higher interest rates, the prices of Bonds that are already in circulation would fall.
* Similarly, a stronger than expected rand could trigger a cut in the repo rate. A stronger Rand hurts exports as the price of SA produced goods becomes more expensive to foreign buyers. A cut in the repo rate would result in higher Bond prices.
* An exchange rate that is in line with expectations may result in the Bond market remaining unchanged as these future expectations would have already been priced into the value of the Bond market.



The SARB look at a lot of variables before making a decision on where interest rates should be. Above all the decision on the repo rate should be consistent with keeping inflation within the inflation target range of 3% to 6%.

## 4.5 The Stock Market

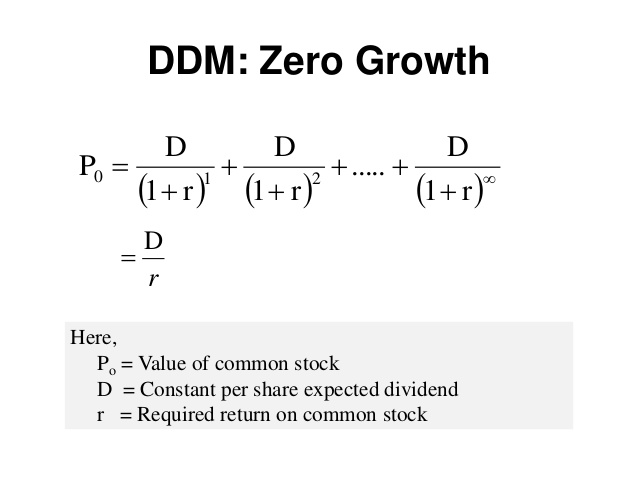
An investment into a share gives the investor a right to share in the future economic fortunes of the company. An ordinary shareholder gets a right to receive a dividend when the company declares one. One of the rights of an ordinary shareholder is to vote on important matters regarding the company such as the compensation company leaders will get. Shareholders also gain when the price of their shares rise above the price at which they bought them for. This is referred to as a capital gain. The reverse is also true. When the value of a company’s shares goes down, investors realize a capital loss. The holding period return measures the return from holding a share over a period and is calculated as the capital gain/loss plus the dividend yield. Listed shares present more risk of capital loss compared to money market and bond investments but can deliver long term inflation beating capital growth. This presents an opportunity to risk taking investors who seek a return that is above the inflation rate. Investors that are risk averse or seek short term investment avenues should be wary and cautious when investing in the stock market.

### 4.5.1 Valuation of shares

In order to understand the effect of macroeconomic variables on share prices, it is important to take a quick look at how shares are valued.

### (a)The Dividend Discount Model of valuing a constant Dividend paying company

The logic behind the dividend discount model is that the value of a share is taken to be the sum total of all future dividends that will be received in future. Its assumption is that the investor buying the share now will receive all future dividends of the company. The present value of a share is calculated as:

Present value of a share of a constant Dividend = 

The above equation assumes that the company will pay the same amount of dividend in perpetuity. The value of a share of a company that pays a dividend in perpetuity is calculated as the constant Dividend discounted by the required rate of return. The required rate of return is the minimum return that investors in the share require given the risk of the share. The risk of the share is measured by how past returns have deviated from average. A share that has historically deviated from the average return is considered a higher risk as they are higher chances of the return not being in line with expectations.



Investor A is interested in buying shares of Bluecomm a telecommunications company listed in the JSE. The current share price is R120 and investor A’s required rate of return is 11%. Advise Investor A as to whether this is a wise investment or not.

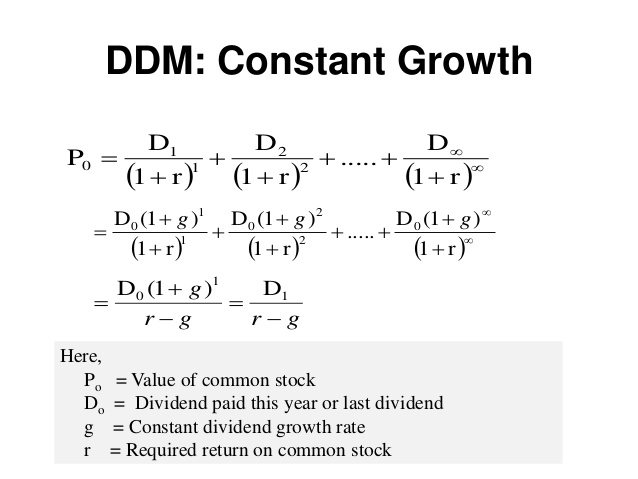
Bluecomm has historically paid a dividend of R12 per share and is expected to pay this dividend into the foreseeable future.

Value of Bluecomm = (12/0.11) = R109

According to the Dividend valuation model, the share price at R120 is too high as the price derived from the Dividend valuation model is R109. Therefore, based on this, the share is overvalued and Investor A may suffer a Capital loss if the share price was to correct to its value that is suggested by the Dividend Discount Model.

Present value of a company paying dividends at a constant growth rate

If a company is paying a dividend that is growing at a constant rate every year, the formula for calculating the value of the company is as follows:





Investor A is interested in buying shares of Bluecomm a telecommunications company listed in the JSE. The current share price is R120 and investor A’s required rate of return is 11%. Bluecomm has historically paid a dividend of R12 per share and this dividend is expected to grow by 3% every year into the foreseeable future. Advise Investor A as to whether this is a wise investment or not.

Value of Share = 12(1.03)

(0.11 -0.03)

= 12.36/0.08

= R154.50

At a price or R120, the share looks to be at a bargain as the dividend discount model suggests that the share price should be R154.50. Investor A should buy the share as it trading at a discount.

### (b) Valuation of shares using Relative valuation models

### Price to Earnings ratio

* The P/E ratio is the price of a share divided by its headline earnings per share. It reflects the price of a share relative to its historical earnings. A forward P/E ratio can also be calculated by dividing the current share price by forecasted earnings of the company. A very high P/E ratio may indicate that the share is overpriced and a low P/E ratio may indicate that the share is trading at a discount.



Although the P/E is a great tool used in stock picking, it is not conclusive. A comprehensive fundamental analysis should be conducted and a conclusion made based on the P/E and the company’s fundamentals.



Investor A is looking at buy Bluecomm shares, a company listed on the JSE. The company has historically traded at a P/E of 10. The current share price is R20 and its latest financial statements show that its headline earnings were R5 per share. Based solely on the P/E measure, should investor A buy the shares?

Current P/E = 20/5 = 4.

The current P/E is 4 which is lower than the historical P/E of 10. This may suggest that the Company’s share is trading at a discount and would be a good addition to investor A’s portfolio.

### (c) Earnings Yield

* The earnings yield is the inverse of P/E and is calculated as (Headline earnings per share/Price of a share). A higher earnings yield indicates that the share is delivering higher earnings given its price and vice versa.

### (d) Earnings per share

* Investors are interested in the bottom line that is what the earnings will be given the price they pay to have a right to the earnings. The earnings per share is calculated as the net profit after tax divided by the total number of ordinary shares. All things being equal, a higher earnings per share is desirable.



A company can report a high earnings per share because of changes in accounting treatment of certain items on the income statements and not because it has been profitable. It is important to analyse financial statements thoroughly to see identify the cause of the increase in earnings. An additional tool to check if the company is really making profits is to analyse the company’s cash flow statement.

### 4.5.2 The relationship between listed share prices and macroeconomic fundamentals

The prices of listed shares reflect the dynamics of the laws of demand and supply that we have already discussed. When there is a high demand for shares, their prices go up. A period where the prices of most shares listed on an exchange are going up is known as a bull market. When the demand for shares falls, there is a surplus of shares and this leads to share prices dropping. A period where the prices of most shares are going down is known as a bear market. There are many factors that drive the demand and supply of shares such as company specific factors such as the company’s operating model, quality of management and corporate governance issues and the market that the listed company provides its services to. On a broader scale, the price of a share is sensitive to political, economic, sector specific and global factors. Of particular interest to us in this section is the sensitivity of economic data of listed shares. We explore this in more detail below.

1. **The relationship between interest rates and Returns of listed shares**

* All things being equal, an unexpected rise in interest rates triggers a drop in listed share prices. It is important to note that market participants forecast the future and there is often a consensus on what the interest rate decision by the SARB’s monetary policy committee is going to be. The effect of the repo rate decision is more pronounced when it is unexpected and affects in particular interest rate sensitive sectors such as financial shares (these may actually rise following an unexpected repo rate hike). This would make sense as Banks make more money in a high interest rate environment as they charge more for lending money.
* Recall that an interest rate is the cost of borrowing money. When the SARB lowers the interest rate, the cost of borrowing money for both corporates and households go down. Businesses can expect increased profitability due to lower input costs for the businesses (because of lower cost of borrowing) and higher consumer spending as this leaves the consumers with higher disposable income to spend. With businesses looking at lower borrowing costs and higher sales due to an expected high demand of consumers borrowing at a low rate, the profitability of businesses is revised upwards. This spurs a demand for shares as investors anticipate higher profits from listed companies.
* The required rate of return on stocks falls when there is a repo rate cut. Recall that the repo rate is termed the risk-free rate of return as a government hardly defaults on its debt obligation. The risk-free rate is included in the formula for calculating the required rate of return in accordance to the Gordon Dividend Discount model that we learnt earlier. When the required rate of return falls (the denominator in the Dividend Discount model), the value of the company increases. Put another way, investors are willing to hold shares in a low interest rate environment as the required rate of return falls in relation to the expected returns that have now been revised to take into account the expected higher future profitability of companies.
* An additional factor that spurs the prices of listed shares is the reaction of money and bond market investors during a low interest rate environment. A sustained cut in repo rates resulting in low interest rates typically triggers a movement of funds from the money and Bond markets as newly issued securities in the market would generate lower yields.



An analysis of the relationship between interest rates and the JSE over a 46-year period shows that there are strong gains in a low interest rate environment. According to this research, there has never been a period with negative returns when there is a low interest rate environment that is as measured by the movement from the highest point to the lowest point in an interest rate cycle as measured on an average of 32-month intervals.

* An increase in the repo rate generally has the opposite effect to a cut and is more pronounced on interest sensitive stocks. The impact is generally more pronounced when the repo rate decision is unexpected as market participants revise their projections on the profitability of listed companies.
* A higher repo rate increases the cost of borrowing for both corporates and individuals. Companies’ higher cost of borrowing may lead to cutting down on profitable projects which reduces earnings. Further, profits are reduced on existing debt if it is on market related interest rates. Additionally, household debt increases as credit related expenses increase for example mortgage repayments. This gives a negative economic projection and results in a “sell off” of shares all things being equal. The impact of this is felt more when the repo rate increase is unanticipated and sustained for a while.



It is important to note that some sectors react differently to interest hikes. Financials whose business is driven by lending could actually record an increase in profitability as they earn more when they charge more interest on funds that are loaned.

1. **The relationship between South African GDP and Returns of listed shares**

All things being equal, a higher GDP growth should translate into company profitability and higher stock prices. We explain this relationship below.

1. The stock market is more sensitive to unexpected economic performance as it is more difficult to forecast returns as compared to money market and bond market securities. A higher than anticipated economic performance is typically met with a rise in share prices as investors re-evaluate the future earnings of the shares of the companies that they are invested in. Higher economic growth than expected reflects higher demand of goods and services than previously anticipated. Companies become more profitable in economic booms and these expectations are reflected in the higher share prices after receipt of the news. A study conducted for the period May 2002 to January 2011 gathered data on 352 occasions concluded that there were changes in the ALSI, Top 40 and other industry specific indices each time there was a surprise in GDP, CPI, PPI, Current account and surprise repo rate decision.
2. Economic performance that is lower than expected tends to have a negative bearing on the JSE. For example, upon the announcement of an unexpected GDP decline of 3.2% in the first quarter of 2019, the share prices of banks and retailers fell sharply with ABSA down 3.6%, Standard Bank 3.5%, FirstRand 2.9%, Truworths 3.3%, Clicks 3.9% and Dis-chem 4%. These sectors are sensitive to GDP growth data as they heavily depend on strength of consumer demand. In a contracting economy, consumers cut down on unnecessary expenditure which affects retailers and banks’ capacity to extend loans may be hampered by a declining industry where production has slumped.
3. Economic performance that is in line with expectations has already been priced into the share price and is unlikely to cause any change in the value of shares on the stock market.



The above analysis is very simplified and assumes that the economy is closed and that listed companies largely generate their income from domestic markets. In reality this is not often the case. For example, Richemont is a company listed on the JSE that derives only 7% of its income from Middle East and Africa as per its published financials dated 31 March 2019. The impact of South Africa GDP Growth would be less than a company with domestic operations only. Other JSE listed companies such as BAT has only 18% of its revenue derived from the Americas and Sub Saharan Africa. In fact, as at June 2019, 6(AB INBEV, NASPERS, BHP GROUP, GLENCORE and BAT) of the top 10 shares in terms of market capitalization relied on revenue from outside South Africa. This would distort the simplified relationship between the South African Economy and JSE listed shares described above

### (c) The impact of unexpected Global Economic factors on JSE listed Shares

Global economic factors have an impact on the JSE directly through the inflow of investment funds from the Global investment community and indirectly through the impact the flows of investment funds have on the value of the Rand.

* The return on money market and Bond markets in large Global economies such as the USA has a direct impact on the flow of investment funds into South Africa. During periods of low interest rates in the US and other developed economies, investors seek returns in emerging markets and this results in a huge inflow of investment to the JSE. The US Fed (the Central Bank of America)’s interest decision on the Fed rate (the equivalent of the repo is a keenly awaited event globally.



The US Fed cut the Fed rate by 25 basis as largely expected by the market. This is the first Fed rate cut in 10 years and was widely expected and had been priced into the market. However, the Fed added a disclaimer that this was not the start of an era of quantitative easing that is an era of further interest rate cuts. The market has largely expected that this would mark an era of low interest rates in the USA, a scenario which would increase investment inflows into developing economies such as SA as investors seek a higher return than the USA market. In response to this, major stock exchanges around the world were down and in particular, the JSE lost 0.26% and in particular Gold miners were down 3.15% and resources 1.45%.

* Unexpected movements in the value of the rand relative to other currencies and commodity prices on the Global market have an impact on the JSE. Generally speaking, a weaker rand is ideal for commodity producing companies such as Gold and platinum miners. Because these companies have foreign currency denominated earnings, they would benefit when they translate their earnings. Similarly, higher commodity prices mean higher profits for commodity producers translate into higher profits. An unexpected negative movement in these variables has an adverse impact on the share prices of these companies.



On the 15th of August 2017, an unexpected change in platinum prices and a stronger rand led to a 0.51% decrease in the All share index. In particular the resources index was down 1.58%. The reason was an unexpected strengthening of the rand to R13.30 against the US$ and a 2% drop in the platinum price.

## 4.6 The property market

An investment in property offers a two-fold return proposition. The property can generate rental income and also capital gains when the value of the property gains in market value. On the flip side, the property market is sensitive to the economy and more specifically to interest rate patterns which may see property values falling and selling of property taking longer a scenario which would pose a liquidity risk to the investor. The investor has a choice of investing in residential or commercial property either directly or through indirect investment for example through property collective investment schemes, buying the shares of listed property companies or Real investment Trusts.

### 4.6.1 Valuation of property

* A key component in calculating the value of a building is its capitalisation rate. It is calculated as first year operating income divided by the purchase price. The capitalization rate is used to discount future cash flows from the building to determine the Present value of a property.



A residential building in Morningside is expected to generate a rental income after costs of R12 000 per month. Its capitalisation rate is 12% what is the property’s capitalized value?

The capitalized value = 144 000/.12 = R1 200 000

### 4.6.2The relationship between property market and unexpected economic changes

There are several factors affecting property values such as location, buyer’s preferences, legislation, location and the type of location. One of the biggest determinants of property values is the economy and variables such as the interest rate and inflation. We look at the impact of economic variables on property values in this section.

### The impact of unexpected GDP changes on property value

The property market value is directly related to the demand and supply in the property market. The state of the economy determines the purchasing power in the economy. All things being equal, periods of solid economic Growth have a positive impact on the property market as unemployment is low and there is positive sentiment regarding the economy. The property market is sensitive to unexpected changes in GDP Growth as we can see in the below example.



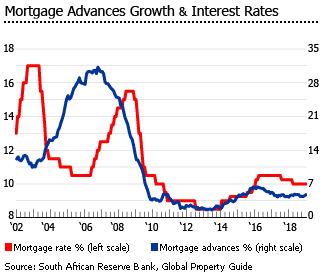
According to the global property guide, the period between 2000 and 2006 saw a boom in the residential housing market with national housing prices growth averaging about 20% annually. A peak in the growth of housing prices was reached in October 2004 with an annual growth of 35.7%. One of the factors behind the boom in the property market was the emergence of a financially stable black middle class supported by a strong economic growth. The stable economic growth buoyed Banks into increasing their mortgage loans with commitments of about R42 Billion of mortgage loans to low to middle income market segment. Unexpectedly, the economic decline triggered by the 2008 sub-prime crisis saw a fall in house prices by about 3.2% between 2008 and 2009. We clearly see the effects of unexpected economic outcomes in this scenario.

### The impact of interest rates on the property market

The level of Interest rates is directly related to the quantity of mortgages advanced by Banks and this has an impact on property prices. High interest rates discourage prospective property buyers from applying for mortgage financing in light of the high mortgage repayments involved. Unexpected changes in economic growth trigger a response by the SARB through changes in the repo rate.



Weak economic Growth may trigger a repo rate cut. On 18 July 2019, the SARB cut the repo rate by 0.5% to take the repo rate to 6.5%. This was as a result of an unexpected drop in GDP Growth of about 3.2% in the first quarter of 2019. The impact of a repo rate cut is felt by house owners whose homes have been financed by a floating mortgage rate. There is likely to be a greater uptake of property due to the unexpected repo rate cut. There is a direct relationship between mortgage rates and the number of mortgages advanced by banks as per below graph:



It is not surprising that the period 2004 to 2006 which has the highest annual growth in residential prices of an average of 20% coincided with a low interest rate environment. Any unexpected changes in economic growth and inflation triggers a response from the SARB and this impacts the value of property.



**Formative activity 1**

Define the Laws of supply and Demand (2)

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**Formative activity 2**

Discuss how equilibrium is achieved in the market as well as what causes a shortage or a surplus. (6)

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**Formative activity 3**

Describe the concept of the circular flow of income in Economics (4)

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**Formative activity 4**

What is the difference between nominal GDP and Real GDP and why is it important to use Real GDP when analysing GDP Growth? (4)

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**Formative Activity 5**

Define the terms inflation, disinflation and deflation (6)

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**Formative Activity 6**

Why is deflation considered a problem in the economy? (2)

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**Formative activity 7**

What are the negative effects of inflation? (11)

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**Formative activity 8**

Name and describe the three composite business indicators (6)

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**Formative Activity 9**

Discuss how the SARB uses the three tools of monetary policy to influence the supply of money and interest rates in the economy (9)

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**Formative Activity 10**

Convertible Bonds and inflation linked Bonds are two types of Bonds in the Bond market. Describe the features of these Bonds. Why would these Bonds be suitable to an investor? (4)

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**Formative Activity 11**

How does the stock market respond to positive and negative economic surprises in the Gross Domestic product assuming a closed economy and that all shares have a primary listing on the JSE and that they all earn income from the domestic market? (4)

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# LEARNING UNIT 2: APPLICATION OF ECONOMIC PRINCIPLES TO FINANCIAL SERVICES SECTOR



**Learning Outcomes**

By the end of this learning unit and having completed all the formative activities, you should be able to:

* Explain the difference between needs and wants.
* Illustrate the basic needs and wants of an individual during the different phases of their Life.
* Apply the financial Life cycle model in real life scenario and identify factors that can cause deviation from the model.
* Explain how attitudes and perception shape a person’s priorities in a financial plan.
* Explain why an individual’s occupation, avocations and lifestyle can shape their wants and needs.
* Illustrate the dynamic nature of income and expenditure in financial Life cycle model.
* Analyse the impact of Lifestyle choice on a financial plan.
* Identify the trigger events that ushers a new phase in a financial plan.
* Provide solutions to the obstacles that can hinder reaching Lifestyle goals at different Life stages.
* Discuss the impact of the external environment on a financial plan.

## INTRODUCTION

All human beings have needs and wants. It is very vital to provide a distinction between the two. A need is something that one needs to survive for example one requires food to survive. Without food a human being cannot survive. In other words, a human being has no choice but to eat food in order to survive. In contrast, a want is something that one desires but can survive without. A want provides a person with a choice and fulfilling that choice has no bearing on one’s survival. In this chapter, we look at the correlation between needs to the life stage that one is at. We also look at how lifestyle choices impact a financial plan and also provide solutions to fulfilling wants at different stages. We cap the chapter by looking at how the external environment can have an impact on a financial plan.

## 2.1 The financial Life cycle model



The financial Life cycle is a model that shows the changes in the needs of an individual caused by trigger events during their lifetime. There are four stages of the financial life cycle namely the first income stage, the Dependants Stage, Growth stage and the retirement stage. Although the terms used to describe the different life stages is not universal, it is agreed that the needs of an individual will change as they progress through each life stage. As the needs change, the allocation of income in order to satisfy these needs will also change. The model provides a financial planner with a framework as a starting point in unearthing the needs of a Client and assisting them to reach their Lifestyle goals. We look at the stages in the financial life cycle model below:

**2.1.1 The first income stage**

* The income of an individual with an entry level qualification and with little or no experience at all is typically low.
* With a few exceptions, the individual is still single and the needs are mainly confined to basics such as food, transport and shelter. These take up a significant portion of the income.
* With few or no assets to resort to in the event of disruption of income due to an unforeseen event, the need for an emergency fund is very high. Further, it is important to develop good financial habits at this stage such as having a budget and having the discipline to stick to it. This will be the first form of savings that an individual makes.
* The earning potential of an individual is the most important asset they have at this stage and to protect this, cover for disability and health insurance are very critical. Life insurance is not a critical need given that there are no financial dependants as in most cases at this stage.
* An individual may have a few debts at this stage and debt servicing may require an allocation of income to service it for example some new entrants may have student loans that need to be repaid upon entry into the workforce.
* If individual has managed to purchase a car at this stage either through savings or financing, car and household insurance is a priority.



Although retirement planning may not be critical at this stage, it is wiser to have a retirement plan as soon as possible in order to benefit from the power of compound returns. If finances allow, investing earlier for retirement will reduce the pressure to put way more at a later stage for retirement.

### 2.1.2 The dependants’ stage

* Having settled down in a chosen career and with income steadily rising due to career development and experience, the next stage is getting married and starting a family.
* A necessity when one starts a family is a good place to live and it is usually at this stage that the first purchase of a home occurs. With the huge outlay required to purchase a house, many go the financing route given that their joint income (if both are working) enhances their borrowing capacity.
* Debt servicing is a critical part of the financial plan at this stage although this is offset by the increasing income as one develops their career.
* It is at this stage that one ponders on the effect of death on dependants. To address this Life insurance is critical in order to preserve dependants’ standard of living in the event of a premature death. Disability cover is still critical at this stage and is reviewed to ensure adequacy of cover.
* Health insurance is enhanced at this stage to take care of the well-being of dependants.
* Income and expenses will have increased at this stage and it is important to budget in order to unlock funds that can be used for short, medium term and long-term goals. In other words, this is the stage that the family begins accumulating wealth in order meet their long-term lifestyle goals.
* An obvious need at this stage is the funding of Education for the kids as well as investing for their future Education typically when they get to tertiary level.
* Retirement planning increasingly becomes important as the individual has about half of their working life lying ahead of them.
* Estate planning is a focus as parents need to structure their Estate in a tax efficient and in a way that is consistent with ensuring the well-being of dependants given unforeseen events that could occur.

**2.1.3 The Growth stage**

* The growth stage occurs at the peak of one’s career where earnings are high and there is a reduction in expenses. The stability in expenses results in availability of more funds for growing assets.
* Kids have either completed or are near completion of their education and most long-term liabilities such as the mortgage bonds have been paid off at this stage.
* This frees up funds for additional investments. Provision for retirement is vital at this stage as there are a few working years ahead.
* There may be a need for a review of health insurance as there could be changes in one’s health at this stage.
* Because of the growth in assets, Estate planning becomes a vital need. A will that provides for distribution of wealth according to one’s wishes and at the same time protecting assets is a priority.
* It is also at this stage as one nears retirement that they make choices on what income they need at retirement and how to fund this need.

**2.1.4 The retirement stage**

* There is a shift from working to accumulate assets to using accumulated assets to earn income at retirement. The default mode is asset preservation.
* On one hand, the focus is on managing existing assets in a manner that ensures that they last throughout retirement years whilst at the same time avoiding the erosion of wealth by inflation.
* Adequate health cover is critical at this stage as the health profile may have changed significantly compared to the working years.
* Although expenses are kept at a minimal level, this is the stage where there is a lot of time to do things that one would not have had time to do during their working life such as travelling to places of interest. This needs to be catered for from the income generated by accumulated assets.
* Estate planning is also crucial at this advanced age. If there are grandchildren in the picture, one may desire to leave a legacy for them and planning for this is a must at this stage.
* Insurance needs are limited to protecting personal assets. The need for Life insurance maybe limited to leaving surviving spouse with an income if this is not catered for by existing assets. Disability insurance is virtually not a requirement as there is no earning capacity to protect.

## 2.2 Attitudes and values and their impact of financial decision making

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Three case studies are given below. Analyse each case and show how attitudes and values cause a deviation from the Financial Life cycle model. Leaners are to the financial Life cycle model presented above as a guidance to identify what has shaped the values and attitudes of the individuals under study.

## Case study 1



Thabo is a 40-year-old single man who is a specialist IT programmer. He started working 20 years ago and is a holder of an MBA. Thabo has been facing some pressure from his friends recently to settle down and get married as they believe that age is no longer on his side. Thabo believes that “marriage is overrated” and believes that one can experience life without getting married and having children. Besides, he is busy with his career and is looking forward to enrolling for a PHD programme in IT.

Thabo earns a net salary of a R100 000. His expenses add up to R110 000 per month with the major expenses being his car repayments for his top of the range cars that total R50 000 per month. He has not bought a house as yet. In his recent application for mortgage financing, his personal banker informed him that he was overcommitted to current debt obligations and should try applying again in 12 months’ time after repaying some of his debt. He regularly uses his credit card and overdraft facility at the bank to fund unexpected events and does not have an emergency fund in place. Thabo believes in “living in the now” and believes that life is too short and one should make the best of it instead of delaying spending for an uncertain future. Apart from his employer provided provident fund, he makes no other contribution for his retirement provision. His belief is shaped in some way by the fact that his parents passed away at a very young age and was raised by his grandmother who has since passed away as well.

For his insurance, Thabo has insured himself for disability and severe illness and also has a medical aid plan provided by his employer. He does not have Life insurance. He regularly participates in underwater diving and other risky water related events. His insurance policy strictly excludes cover for these extreme sports but Thabo cannot resist the sheer thrill of these activities.

Thabo does not plan to retire before the age of 80(if he lives long). He believes that he will make use of his experience and education at a later stage in Life by lecturing and imparting his knowledge to young aspiring professionals. This is one of the reasons why he is enrolling for a PHD soon. He also projects that since he is going to delay his retirement and will be earning an income in his advanced age, he does not need to aggressively invest towards retirement.

**Case study 2**



Lucy is 27 years old and is employed as a fitter and turner by a large construction company. Lucy is still single but she plans on settling down and getting married at the age of 30. She recently inherited a large sum of money from her maternal uncle who passed away at the age of 40.

A financial adviser has advised her to invest a large portion of the proceeds from inheritance in a balanced fund that consists of Equities, Bonds, property and money market investments. Lucy is very risk averse. Her parents were invested in a hedge fund that was unfortunately wiped out during the subprime crisis in 2009. Now in their advanced age and retirement, her parents survive on the government pension and are bitter about their life savings which were wiped away in less than a month.

Lucy has rejected the adviser’s recommendation and has decided that she is going to leave the money in a fixed deposit at the bank. Although she is fully aware of the eroding effects of inflation, she would rather be exposed to this compared seeing her investment fluctuate in value.

**Case Study 3**



Andrew is a 35-year-old self-employed motor mechanic. He is married to the love of his life Jane and the two have been blessed with four Children, Stan (10), Jeff (8), Simon (6) and Shawn (4). The family live in a modest house in the Northern Suburbs of Johannesburg. Andrew’s House has been financed by the bank and he still has 16 years to pay it off. His car is a classic 1982 Mercedes Benz and is not financed. He has used his mechanical skills to ensure that the car is as efficient as newer models that are in the market.

Andrew insured his house against total loss in the event of an unforeseen event occurring. He took out this insurance only because the bank was insisting that this was a condition for him to get the mortgage bond. If that had been the case, Andrew would never have insured his house as he has a strong distaste for insurance. Despite the fact that he is self-employed and could lose his earning ability because of disability, severe illness or death, Andrew does not have Life insurance. He believes that insurance companies are not trustworthy and that he would get nothing in return if he was not to claim. He considers this a loss. He deeply loves his children and wants the best for them but this perception of insurance overrides the risk that his loved ones’ face in the event of his premature death. According to Andrew, he would rather invest the premiums he could pay for Life insurance than pay for a life insurance policy.

The above examples portray how perceptions and attitude can hamper a solid financial plan!

## 2.3 The influence of Occupation, avocation and Lifestyle on needs and wants

## (a) Lifestyle choices

* Lifestyle choices affect spending patterns which in turn have a bearing on disposable income which is available for other financial goals.
* Houses and cars maybe the most important assets that one owns. The choice of the car one drives and how it is purchased can have a huge bearing on one’s budget. This also applies to the home one chooses to buy.
* For some, cars are a means to get to work and have other errands completed and will look for a basic car which can serve the purpose. Other individuals may want extra comfort and will not settle for an entry level vehicle.



Consider two individuals aged 30 with a net income of R20 000 per month. Both of them decide to take car loans. One decides that a car worth R100 000 will suit him at an interest rate of 13.5% and payable over 60 months. The repayment amount for this car would be R2 288 per month. The other opts for a car valued at R200 000 for better comfort. The repayment on this would be R4 576. Individual A would have R17 712 after the car repayment his car whilst B would have R15 424.

* The choice of one’s house may also be influenced by the Lifestyle that one desires. For some, a modest house is sufficient whilst some may opt for a house in a certain location and with enhanced features that may make require more financial resources.



Expanding our example on car financing, suppose that Individual A settles for a house worth R500 000 at an interest rate of 10.25% over 20 years. The repayment would be R4 908 per month. Individual B opts for a Home worth R1 000 000. Repayment over 20 years at 10.25% interest would be R9816. A now has R12 804 left after paying the car and mortgage monthly obligations. B has R5 608 left for other need after deducting the car and mortgage payments.

Clearly, the Lifestyle choices made by individuals have an impact on their financial plan. A Lifestyle that requires more financial resources needs to be matched by an income that is sufficient.

## (b) Avocations

* An avocation is a hobby or any activity that one undertakes outside of their regular occupation.
* Examples include scuba diving, gliding, mountain climbing and motor racing.
* Individuals who engage in avocations may have a greater need to insure the possible loss of income due to death, disability and severe illness posed by these activities.
* From an insurance underwriting perspective, these activities pose a greater risk when assessing the risk of death, disability or severe illness and this may result in higher than normal premiums or exclusions for certain benefits if the risk is deemed to be too high.
* An individual who pursues an avocation that poses a higher than average risk has a greater need for taking out death disability and severe illness cover than someone who does not engage in these activities.
* Further, the cost of insuring oneself will most likely be higher for an individual who pursues avocations deemed to be dangerous than for one who does not. This needs to be considered when setting financial goals.



Chris is a 29-year-old accountant who is a happily married father of two. Chris is an avid scuba diver and when he is not in the office crunching numbers, he is at the local scuba diving resort on regular occasions. Chris has applied for Life and disability cover with a major insurer and has disclosed his scuba diving hobby. In assessing the risk, the insurance company has given Chris two options that is scuba diving will either be excluded from the cover or he pays a higher premium that the average Client.

The insurance company’s position is informed by the greater risk posed by Chris ‘avocation. Given this greater risk, the need for risk protection for Chris is higher than for the average person.

**(c) Occupation**

* A direct link exists between occupation and income and the capacity of an individual to afford meeting Lifestyle goals.
* Income predictability is a huge factor in financial planning. For example, a sales representative whose income is commission based may have huge fluctuations in their income with high sales months generating high income and income being very low in low sales months. This unpredictability of income makes financial planning complex. A good starting point in this case is to have an emergency fund that cushions the individual in a month where income is low.
* The time period that one expects to be employed also plays a huge role in planning an individual’s finances. Consider the career of a sportsman and an accountant. A sportsman’s career is very short with many retiring before the age of 40. This means that unless they find an alternative way of earning money after the age of 40, retirement occurs early and this needs to be factored in in the financial plan. In contrast, an accountant can choose to retire at a later stage with some working well after the age of 65. With a longer work life, an accountant is able to stretch their retirement planning over a longer period.
* Occupation also affects financial planning from a risk perspective. A driver for example is more exposed to the risk of an accident given the time that they spend on the road. This is in contrast to an accountant for example who spends less time driving. Due to the difference in the risk and its effect on earning ability, some occupations may affect the attitude to risk.

## 2.4 The Dynamic nature of income and expenditure

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In the case study of three individuals below,

* Identify which stage the individual is at in the financial life cycle model and give reasons for your choice.
* Compare the level of income and the expenditure at the Life stage that you have identified. What are the reasons for the level of income you have chosen? Learners are not expected to give an actual Rand figure of income and expenditure. They are to identify whether income and expenditure are low, growing, at peak and levelling off
* List the needs of each individual at the Life stage that the individual falls in line with.
* Provide solutions to the needs of the individual in the given life stage
* Compare the level of assets have been acquired, the level of savings/investments at each Life stage and the attitude to risk for each individual.

**Case study 1**

Peter is a 30-year-old recently qualified chartered accountant. It has not been an easy journey to the CA qualification. At the age of 25, he completed his Accounting Degree and then joined one of the big four accounting firms to serve his articles. In comparison to his article years, his income has increased significantly and he is being head hunted by many big corporates. Things are also looking great in Peter’s Life. He married the love of his life Judith in a lavish ceremony and the two are expecting twin girls in two weeks’ time. Judith is also an accountant and still pursuing the chartered accountant qualification. She is employed at a local manufacturing company. The couple has one car, a 1990 model which Peter bought 10 years ago. Of late, it has been giving them problems and Peter worries about this given the kids that are on their way. They still live in the 1 Bed rented apartment that Peter has been renting for the past 10 years. Peter realizes that he needs the help of a professional financial adviser in order to meet his Lifestyle goals. This is your first appointment with Peter and Judith.

**Case study 2**

Obakeng is a 50-year-old Chief Executive officer of a listed company on the Johannesburg Stock Exchange. He is happily married to Agatha who is 47 and is a marketing manager at a local tourism resort company. They got married 25 years ago and they have been blessed with two Children, Thato who is 24 years old and Ndaba who is 22 years old. Both their children have finished their studies and have launched their careers and are now financially independent. Obakeng and Agatha own three properties that have been fully paid up. Two of the properties are occupied by tenants and they earn rental income from these. With no mortgage repayment obligations and no education costs to talk about as well as a reduced living expenses budget, they find themselves in a good position where their expenses are significantly low given their income. In addition to the property investments, Obakeng has investments in the form of company stock options to the value of R5m as part of his remuneration package. He also has long term investments in unit trusts worth a combined R3m and is pondering on the most ideal investment strategy at his life stage. Both of them have provident funds that they have been contributing to since they launched their careers. The thought of what type of retirement income they will be getting has crept into Obakeng more often now than before. Obakeng also ponders about how his Estate would be distributed in the event of death. He would like to leave a legacy to his children and his future grandchildren and would like to structure his estate such that it minimizes tax and protects the inheritance from abuse by the beneficiaries. You have been approached by Obakeng to develop a financial plan that will help him achieve his goals.

**Case Study 3**

Grant and Gill are in their early 70s and retired at the age of 65. They have 5 children and 6 grandchildren. All their children are now financially independent. At retirement, Grant and Gill elected to invest in living annuities which give them the flexibility to change their drawdown percentage at each policy anniversary. They recently sold their home as their home was now too huge for their requirements. With the kids having moved out, there decided to downsize to a two bedroomed modest apartment. Grant and Gill’s health is no longer great as it was in their prime. As a result of this, they plan to move into a retirement village at the ages of 80 in order to get professional frail care. The increasing medical costs worry them and they often wonder if their retirement capital will be able to see them through the remainder of their lives. Grant and Gill love their grandchildren dearly and would like to distribute their Estate equally when they die. Grant and Gill are your Clients and they have asked you to unearth their needs and provide a solution.

## 2.5 The interrelationship between an individual’s needs and financial plan and the implications for a financial plan



We have established that the needs of an individual change as they progress through the different financial life cycle stages. However, knowing the needs alone does not result in one fulfilling those needs. If that is the case, is it possible for one to plan ahead of time in order to ensure that they satisfy these needs in an efficient manner? What are the strategies that a person entering a new life stage can employ in order to achieve good financial outcomes? The section looks at this topic.

**A summary of trigger events at different life stages and solutions are given in the below table:**

|  |  |  |
| --- | --- | --- |
| **Life stage** | **Event/need** | **Financial solution** |
| **First income stage** | 1. Develop good financial habits 2. Financing of emergencies 3. Buying a first car 4. Repayment of debt such as student loans 5. Protection of income 6. Planning for marriage 7. Investment/savings 8. Healthcare needs 9. Protection of physical assets | * Budgeting * Emergency fund * Save * Minimize debt * Income protection policies * Invest for wedding * Invest for short term, medium term and long-term goals * Affordable medical aid plan * Car and household insurance |
| **Dependants stage**  **Growth stage** | 1. Protecting dependants from risk events 2. Education funding 3. Purchasing of property 4. Good health for the family 5. Protection of physical assets 6. Debt management 7. Distribution of assets in the event of death 8. Investments 9. Retirement planning 10. Growth of assets/investments 11. Purchase of additional properties 12. retirement funding 13. Debt management and budgeting 14. Protection of income 15. Good health 16. Distribution of wealth 17. Tax Efficiency 18. Retirement planning | * Life insurance, income protection policies * Invest for future Education costs before or as soon as kids are born * Save for deposit and keep repayments affordable * Comprehensive health cover * House, car and contents insurance * Minimize debt and buy growth assets * Draw up will and nominate beneficiaries on Life policies and retirement funds * Invest in growth assets for long term growth and in conservative assets for short term needs * Set up regular contributions * Invest in high growth assets in early stages * Ensure that repayments are affordable * Maximize retirement contributions * Minimize debt and stick to budget * Income protection policies * Get comprehensive medical aid * Review Estate plan to take into account increased wealth * Employ tax minimization techniques * Maximize retirement contributions |
| **Retirement stage** | 1. Choosing retirement income 2. Minimization of capital loss 3. Longevity Risk 4. Good Health 5. Distribution of wealth 6. Inflation Risk | * Consider the pros and cons of different annuities and make informed decision * Invest in conservative portfolios * Minimize drawdown and manage expenses * Medical aid in line with affordability * Update Will and Estate plan * Conservative investments that outperform inflation |

**The first income stage**

* The first income is the first stage of independence and it is at this stage that good or bad financial habits develop. Lifestyle choices and financial habits developed at this stage can have long term effects such as an unending debt trap throughout the financial life cycle. The starting point is having a realistic budget and using this budget to identify how expenditure can be minimized and as a result releasing some funds for short, medium term to long term investments.
* With limited assets and a new job, the individual does not have an alternative source of income and relies on the salary for income. An unexpected disruption to this income can leave one in an uncomfortable financial situation. This can be addressed from an investment perspective by setting up a liquid emergency fund that is equal to three times the monthly salary at a minimum. Income protection that covers disability, retrenchment and critical illness is an efficient way of protecting income. Life insurance is not a priority at this stage unless one has financial dependants.
* The first car is typically purchased at this stage. This has to be planned for and a saving for a deposit if financing will be required should be made well ahead of time. The golden rule should be to keep repayments in line with affordability.
* Funds available for investments should be invested in line with goals. Funds for short term goals should be conservatively invested to minimize capital losses and long-term funds more aggressively to outperform inflation and provide real growth.
* Car and household insurance is a must at this stage as well as an affordable medical aid that is in line with affordability.

**The dependants’ stage**

* A rise in both income and expenditure is a characteristic of this stage. It is important to contain expenses and debt to ensure that these do not exceed the income.
* A great need at this stage is family security. A good home that is spacious and conducive to raise a family becomes a necessity. In meeting this goal, the couple should balance affordability and the kind of home desired. It is important to ensure that mortgage repayments do not become a drain on income which could leave other needs unattended to.
* A good Education for children is the desire for most parents. In order to be able to afford this, investments for children’s education should commence as soon as they are born and, in some cases, even before they are born. Education inflation is higher than CPI and if not planned for, the increase in Education costs will put pressure on the family budget.
* Unplanned hospitalization can occur at this stage. A typical example is a child with a broken hand during school activities. If not planned for, this may compromise the health of the family. Good medical coverage that is in line with affordability is essential.
* As the breadwinners, anything that prevents a parent from earning income affects the overall well-being of the family. Comprehensive income protection and Life insurance is an effective way of providing for this need. In addition, an Estate plan needs to be in place focussing on tax efficiency and the distribution of assets according to one’s wishes.
* The rise in income provides a platform to create wealth through investments. For long term goals, growth assets that provide long term capital growth would be ideal. Diversification is important to reduce asset specific risk.
* Retirement planning is a must at this stage. Investing for retirement earlier has long term compound growth benefits.
* To avoid total and partial loss of physical property, car and contents insurance should be put in place.

**The Growth stage**

* The growth stage sees a reduction in debt obligations as property and car debts are paid off. Further, children are now independent and there are no education and upkeep costs to take care of. The capacity to invest is highest at this stage.
* The need to invest wisely and to maximize returns is great at this stage. Growth assets in the form of shares are a good way to grow capital if the individual can tolerate short term fluctuations in the value of investments.
* Income protection is a must in order to protect earning ability.
* High net worth individuals pay higher taxes. Products and strategies that minimize tax such as tax-free savings accounts and endowment policies should be considered.
* There may be adverse health conditions that come with age setting in and a good medical aid plan is an effective solution to this need.
* A review of Life insurance policies given the reduction in dependants and contingent liabilities such as outstanding mortgage payments can release additional funds needed for investments.
* Now is a good opportunity to maximize retirement fund contributions as retirement beckons.

**Retirement stage**

* Retirement stage requires adequate preparation. If planned properly and on time, it can be a fulfilling stage of life where one suddenly has enough time to pursue interests that were not possible to engage in due to work commitments.
* The retirement income that is needed to meet expenses is determined upon retirement. Retirement capital should be used to generate an income that should see the retirees through retirement years. Depending on personal circumstances, a choice should be made on what type of annuity to purchase, how much to commute as a lump sum and whether provision for spouses’ pension is made in case of death of spouse. The eventual choice has an effect on the monthly income.
* Retirement capital and other investments should now be conservatively invested as this is the usually the only source of income and any capital loss would have far reaching implications.
* A greater danger to retirement income is inflation. Whilst cushioning assets from capital loss is important, the investment strategy should aim to outperform inflation. A product such as an inflation linked annuity is a good option for retirees.
* Adequate medical aid cover is essential to maintain health as there may be significant health changes.
* There may be a need for lifestyle changes such as downsizing of home in order to minimize expenses.
* Estate planning is very critical and an update of will to reflect one’s wishes; tax efficiency and succession planning is very important at this stage.

## 2.6 Changes in the external environment and the impact on financial planning

A financial plan that does not take into account external factors is bound to fail. An individual has control over their budget and spending needs but has no control over external factors such as economic growth, legislative changes and other factors. A financial plan therefore needs to cognisant of these factors and harness them for good financial outcomes. Below are the external factors that have a bearing on a financial plan.

1. **Political environment**

* A stable political environment is a pre requisite for economic growth which augurs well for financial planning. An unstable political environment impacts on the right to own property and also has poses a risk to one’s assets. This is a reason why individuals may choose to invest their wealth in countries that are stable politically.
* The political government of the day determines government policy. Fiscal and monetary policy are shaped by the political and economic views of the government of the day.



The SARB’s main objective is to keep inflation within a manageable range through a policy called inflation targeting. The current range is 3% to 6%. The SARB uses the repo rate to determine the level of interest rates in the country. High interest rates are favourable for individuals whose investments generate an income but this is not the case for young individuals seeking to purchase their first property at a variable interest rate.

1. **Legislative Environment**

* Changes in legislation have a huge impact on financial planning. Planning has to be done in full compliance of the law.
* Without a doubt, there has been significant legislative changes in the retirement funds industry and this had a huge impact on planning for retirement.



The final default funds regulation was released on August 2017 by the Minister of Finance. The focus of the regulation is to ensure better financial outcomes for retirement. Amongst the raft of changes is the requirement for retirement funds to provide a default investment portfolio and preservation portfolios. This is meant to simply investment strategy for members as well as encouraging exiting members to preserve their accumulated savings. Additionally, all retiring members are to be now provided with a default annuity strategy upon retirement. Retiring members now have a simplified solution for their income requirements upon retirement.

The 2017 Taxation amendments Bill now permits a retiring member to transfer retirement funds benefit to a retirement annuity. This now enables members to consolidate their retirement funds before making the final decision to retire. Under the “Draft response Document on Taxation Laws amendment”, members can now also transfer their retirement annuity funds to a preservation fund subject to the rule that they cannot withdraw all the proceeds from the preservation fund.

A proposed legislative amendment which has been postponed to March 2019 is the requirement for provident fund members to annuitize their benefits upon retirement that is provident fund members would no longer have the option to cash out all proceeds upon retirement. This would only apply to contributions made after the implementation date and would also not affect members who were close to retirement. However, provident fund members would still continue getting the tax deductibility benefit of contributions which was introduced in 2016.

All the above changes have had a major impact on how members plan for their retirement.

1. **Social factors**

* Human beings are social beings. As such the society in which they live in will have bearing on financial decisions made.
* A nation with a high savings culture will have individuals who prioritize savings and investments and vice versa. In 2015, South Africa was ranked amongst the countries with a low savings ratio to GDP. At 15.4% savings as percentage of GDP, South Africa lagged behind China at 50% of GDP, India at 30%, Brazil at 25% and Australia at 22.5%. One could argue that salaries are low and the cost of living is high. However, a Country like China has lower incomes and yet they still manage to save about 50% of their GDP. Developing a culture of saving will influence individual saving across the board.
* Closely linked to social factors are religious beliefs and personal principles. A good example is an individual who will not invest in financial products of a company that does not support sustainable growth or economically friendly principles. In addition, there are religions that may prevent an individual from investing in certain sectors of the economy for example investments that generate a return in the form of interest. All these decisions would ultimately affect one’s investment strategy and their investment universe which has an effect on the return.
* Societal changes in consumption patterns driven by technology has also had an impact on the uptake of financial products by individuals. Whilst it used to take an effort for a financial service to get to its target market, the harnessing of digital technology by society has made the delivery of financial solutions easier and timeous. Internet and social media platforms have opened up new avenues to find financial solutions. New innovations such as online quote comparison tools are changing delivery channels for financial products.

1. **Economic factors**

* Economic trends have a huge impact on financial decisions
* Any projection of future needs is influenced by the inflationary outlook. In planning for retirement for example, a forecast of future inflation is done and this has bearing on the decision on how much to invest in order to sustain standard of living after retirement. Inflation impacts current spending as well. Periods of high inflation put pressure on the household budget and adjustments have to be made accordingly. The impact of high inflation is mainly felt by retirees who are in most cases on a fixed income whose purchasing power is reduced.
* Interest rates have a direct impact on the amount of debt of households in the economy. High interest rates mean high higher repayments for debt financed assets such as cars and mortgage Bonded Houses. Additionally, interest rates have an indirect effect on the economy. Businesses cut down on debt financed projects in periods of high interest rates which slows down economic growth and thus leading to higher unemployment. High interest rates are good times for pensioners and recipients of interest income. On the other hand, pensioners bear the brunt of low interest rates as can be seen in the below example



The global financial crisis of 2008 saw a decline in economies around the world. In response to the crisis, central banks’ policy response was “quantitative easing” This meant a reduction of interest rates in some cases into negative territory. Pensioners have felt the aftermath of the low interest rate regime as income from conservatively invested fixed deposit accounts plummeted. According to cnbc.com, the US Fed cut its interest rate target to as low as 0 to 0.25% since 2009 resulting in American savers losing between US$500 to US$600 Billion in interest payments on bank accounts and money market funds.

* Stock markets rise in periods of expansion as Business profitability is high. This a good time for investors and results in better financial outcomes. Periods of contraction impact stock markets negatively and a financial plan that has stocks as part of the investment strategy will be impacted negatively.

1. **Global factors**

* In an increasingly globalized world, an individual in South Africa may be affected by Global issues that had nothing to do with South Africa from the onset. The Global financial crisis of 2008, sparked by the subprime crisis in the US had contagion effects on the economy of South Africa and other emerging markets. More recently, the trade spat between the USA and China has seen international investors pull out of emerging markets such as South Africa due to perceived risk. The rand lost 0.56% on 17 May 2019 as the trade war between the two super powers escalated.
* Commodities and resources such as gold and platinum are one of South Africa’s highest revenue earners and their prices affect SA GDP and the JSE and in particular the resources and commodities listed shares. Additionally, the mining sector plays an important part of the economy in as far as employment and social development is concerned. The health of this sector is dependent to an extent on the prices which are determined in the international market.



**Formative activity 1**

Describe the difference between needs and wants in the context of financial planning. When advising a Client, is it important to prioritize needs or wants? (4)

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**Formative Activity 2**

“Income protection and being on a good medical aid plan should take precedence over Life insurance for a young working adult with no dependants to care of. “Do you agree or disagree with this statement? Give reasons for your answer. (5)

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**Formative Activity 3**

In the financial Life cycle model, income typically is at peak during the growth stage and expenditure levels off or actually declines at this stage. What are the factors that lead to this scenario? (12)

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**Formative Activity 4**

A good financial plan should always include good budgeting skills and an emergency fund. Why are these two components of financial planning important? (4)

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# LEARNING UNIT 3: CURRENT AFFAIRS IN FINANCIAL SERVICES SECTOR



**Learning Outcomes**

* Analyse the regulatory structure of the financial services Industry.
* Illustrate the synergies between the role players in the financial services Industry.
* Give reasons for the need to change the regulatory framework in the financial services industry.
* Discuss the implications of non-compliance by regulated entities in the financial services industry.
* Show the role of professional bodies in the financial services industry.
* Explain why Ethics are important and how Ethics are enforced in the industry.
* Explain the rationale behind continuous professional development and its contribution to a more professional industry.
* Assess the impact of the South African constitution with reference to the right to information.
* Outline the factors that have brought change in consumer behaviour in South Africa.
* Analyse how changes in the consumer environment may affect the financial services industry.

## INTRODUCTION

On the 31st of March 2018, the Financial Services Board closed shop. A new regulatory Board named the Financial Services Conduct Authority (FSCA) was birthed and became the regulatory Board charged with regulation and supervision of the conduct of financial institutions in South Africa. At the same time, a Prudential Authority was established as an arm of the South African Reserve Bank tasked with supervision of the safety and soundness of financial institutions, banks and insurance companies. These changes were a culmination of a new regulatory framework first mooted in a policy document titled, “a safer financial sector to serve South Africa better.” The policy document gave the foundation of the Financial Sector Regulation Bill which would give effect to a twin peaks model of financial sector regulation. What led to this shift in government policy on the regulation of the financial services sector? How are financial services structured and how is it regulated? What are the implications for non-compliance by an FSP? The chapter explores these very significant topics in the discourse of financial services in South Africa.

## 3.1 Structure of the financial services sector and the synergy between role players

Any business rendering a financial service in South Africa had to be registered in terms of the FAIS Act by the FSCA. A financial service is defined as:

* The furnishing of advice or
* The furnishing of advice and an intermediary service or
* The rendering of an intermediary service

It is important at this juncture to provide a distinction between the rendering of advice and the provision of an intermediary service.

**3.1.1 What constitutes advice?**

Advice is terms of the FAIS Act is defined as any recommendation, guidance or a proposal of a financial nature, furnished by any means or medium to any Client or group of Clients in respect of the following:

* The purchase or investment in any financial product,
* The conclusion of any other transaction aimed at incurring any right or benefit or liability in respect of any financial product (this includes loan or cession); and
* The variation, replacement or termination of any financial product.

Further it does not matter whether the advice is furnished in the course of, or is incidental to financial planning in connection to the affairs of the Client and the advice does not necessarily have to result in any purchase, investment transaction, variation, replacement or termination.

**3.1.2 What Advice is not.**

* Factual information in respect to the procedure to be followed to enter into a financial transaction,
* Description of a financial product,
* Answering Routine administration question,
* Objective information about a particular financial product,
* The display or distribution of promotional material

**3.1.3 Definition of an intermediary service**

An intermediary service is any act other than the furnishing of advice, performed by a person for, or on behalf of, a client or product supplier,

* As a result of which the Client may, or does, enter into a financial product transaction with a particular product supplier with a view to,
  + - 1. Buying, selling, managing, keeping in safe custody, maintaining or servicing a financial product, purchased by a Client from a product supplier or in which Clients are invested,
      2. Collecting or accounting for premiums or other monies payable by the Client to a product supplier in respect of a financial product,
      3. Receiving, submitting or processing the claims of a Client against a product supplier



For the purposes of defining advice and intermediary service, the advice must be related to a financial product. It therefore follows that advice related to wills and trusts do not fall within the auspices of FAIS. A financial product is defined here as any financial product including,

* Shares (excluding time shares),
* Debentures,
* Money market instruments,
* Collective investment schemes
* Long- or short-term insurance policies,
* A benefit provided by a pension fund organisation or friendly society,
* A foreign currency denominated investment instrument,
* Deposits as defined in the banking act,
* A Health service benefit provided by a medical scheme as defined in section 11 of the medical schemes act,
* Any other product similar in nature to a financial product and any combination of products.

A Client is defined as a specific person, group of persons but excludes the general public. What guides the interpretation of a Client is the relationship between the person giving the advice and the person or group of persons who are recipients of the advice.

## 3.2 The Different categories of financial services providers under the FAIS Act

A Financial services provider (FSP) is any person other than a person who furnishes advice, furnishes advice and an intermediary service or renders an intermediary service as a regular feature of their business. An FSP can be licenced under the following categories:

**Category 1 - FSP**

Under this category are all persons other than persons referred to in Categories II, IIA, III and IV who are authorised to render financial services (other than financial services mentioned in Categories II, IIA, III and IV).

Category 1 FSPs are further categorized into 19 sub-categories covering different types of financial products that can be sold by an FSP and its representatives. An FSP can in its application for a licence select any financial product or combination of products to be marketed.

**Category II FSP – Discretionary FSP**

Also known as “investment managers”, FSPs in this category are licenced to render an intermediary service without “bulking” that is without consolidating funds of different Clients together. An example of such a service is the switching of portfolios.

**Category IIA – Hedge fund FSP**

This category of FSPs, renders intermediary services of a discretionary nature regarding a hedge or fund of hedge funds. This intermediary service has to be in connection with a financial product.

**Category III - Administrative FSPs**

FSPs in this category are FSPs other than a discretionary FSP that render an intermediary service in respect of financial products on the instructions of a Client or another FSP and through the method of bulking. Linked investment service providers known as LISP platforms fall under this category.

**Category IV - Assistance Business FSPs**

These offer an intermediary service with regards to the administration of assistance policies on behalf of an insurance company based on a mandate given by the insurer to the assistance business FSP.

## 3.3 The Regulatory requirements for an FSP

An FSP cannot operate without appointing a key individual who oversees the activities of the business. In addition to overseeing the running of an FSP (that is a legal person such as an incorporated company), a key individual also manages the activities of a juristic representative. A juristic representative is a company or close corporation as defined in section 1 of the companies Act 2008 that is appointed as representative of only one FSP and has a written mandate from the FSP to render a service for a particular financial product and has entered into and maintains a guarantee policy or a contract as contemplated in part 4 of the short term insurance regulations. There is no prescription as to the number of key individuals although it may make sense from an operational point of view to appoint more than one KI.

Changes of a key individual have to be approved by the Commissioner of the FSCA. The KI individual has to meet fit and proper requirements which will be discussed later on in this chapter. Appointment of key personnel such as directors, members, trustees or partners have to be reported within 15 days to the FSCA and the FSCA may suspend or withdraw the licence of an FSP such appointment if the appointed person does not meet the fit and proper requirements of honesty and integrity.

**3.3.1 Duties and obligations of a registered financial services provider**

**(a) Requirement to maintain operational ability**

FSPs are required to comply with Board notice 106. The requirement for an FSP to maintain operational ability is to safeguard the interests of Clients that would be jeopardised by operational weaknesses of the FSP. Section 8 lists pre requisites for maintaining operational ability such as the following:

* The FSP must have a fixed address,
* Adequate access to communication facilities to ensure communication with Clients,
* Adequate storage and filling system for safekeeping of records,
* An account with a registered bank where funds separate from Client funds are kept,
* Processes that ensure compliance with FAIS Act and related laws such as FICA and anti-terrorist and anti-money laundering act.
* Internal control procedures to safeguard Client information and records such as Disaster recovery plans and data security, training of key individuals and representatives and a business continuity plan among other requirements.
* Recording of all financial and system procedures to enable reporting,
* Suitable professional indemnity and guarantees to protect Clients from fraud, dishonesty or negligence

**(b) Requirement to maintain Financial Soundness**

As per Section 9 of Board Notice 106, an FSP is required to be financially sound. The following is the criteria used to assess financial soundness:

* The FSP cannot be insolvent, liquidated or be under provisional liquidation,
* The assets of the FSP must exceed liabilities,
* Current Assets must be sufficient to cover current liabilities,
* Liquid assets must at all times be equal to or greater than 4/52 weeks of expenditure

**(c) Requirement to appoint a compliance officer**

An FSP that has more than one key individual or one or more representatives is required by section 17 of chapter V of the FAIS Act to appoint a compliance officer who has qualifications and experience to the satisfaction of the Commissioner of the FSCA. The Compliance officer’s role is to;

* Monitor compliance by FSP and representatives with FAIS Act,
* Establishing maintaining compliance procedures and submission of an annual compliance report

An FSP that has one KI and individual and one representative is also required to fulfil these obligations. The appointment of a compliance officer does not absolve the FSP from reporting any irregularity of non-compliance to the regulator. Any non-compliance with the act by a compliance officer can result in the registrar disapproving the appointment.

1. **Record keeping requirements for an FSP**

An FSP is required for a minimum of 5 years to keep records electronically or in another format which is easily accessible and readily reducible to written or printed format. Record keeping is required in the following instances:

* Known premature cancellations of transactions or financial products by Clients of the FSP,
* Complaints received as well as the steps taken to resolve the complaint.
* Continued compliance with fit and proper and other licencing requirements,
* Cases where the was non-compliance with the act and the reasons thereof,
* Records related to continued compliance with the Act by FSP representatives.

**(e) Requirements pertaining to Accounting and audit requirements**

A registered FSP is required to maintain full and proper accounting procedures and prepare financial statements annually that reflect the financial position of the business. The annual financial statements must be audited by an auditor to the satisfaction of the commissioner. In addition to other requirements, the FSP is obliged to show in its financial statements that its financial affairs were kept separate from Client funds. See Section 19 of Chapter V of the FAIS Act for the specific requirements.

(f)Requirement to display licence

A certified copy of the FSP Licence must be prominently displayed in the premises of every branch of the FSP. Where an FSP uses promotional material to market its services, reference to the Licence must be made.

## 3.4 The Role of representatives in the Financial Services Sector

The FAIS Act defines a representative as a person who has contract with an FSP and who renders advice on behalf of an FSP in accordance to a contract entered into by the FSP and the representative. Individuals who offer clerical and administrative functions and whose role does not entail the use of judgement in leading a Client to make a financial transaction are excluded from the definition of a representative.

A representative can be a natural person or a juristic representative that is a legal person authorized to act on behalf of a registered FSP. As stated already, the juristic representative’s function should be supervised by the KI of the FSP.

A representative must meet the fit and proper requirements of honesty and integrity, competence (experience, qualifications, and continuous professional development and pass regulatory exams) and operational ability.

An FSP is required by the FAIS Act to maintain a register of representatives and the categories that the representative is authorized to give advice. The register must state whether the representative is acting under supervision and any changes to the register should be reported to the FSCA within 15 days of the change.

Where a representative does not meet one of the criteria of competence (experience, qualifications and regulatory exams), they are required to render their services under a supervisor and are said to be giving advice under supervision for a period of 24 months from date of first appointment. Additionally, they are required to have passed first Level regulatory exam by 30 June after the expiry of the supervision period. A second level regulatory exam is supposed to be completed after 72 months from date of appointment.

A representative who no longer complies with the fit and proper requirements of the FAIS Act can be debarred by the FSP or FSCA. The FSP has an obligation to report the debarment of representative within 15 days. An application for reappointment can be made after 12 months from date of debarment.

## 3.5 Corporate governance and Ethics in the Financial services Sector

**History of Regulation of Financial Services in South Africa**

Prior to the introduction of the FAIS Act in 2004, the regulation of financial services was mainly limited to self-regulation through industry established bodies for the various financial services that the market offered. Although this was a good initiative, it clearly was not effective enough given the prevalence of cases where Clients were losing their hard-earned wealth through fraud and negligence and other unscrupulous acts. The intangibility of a financial services products makes it very difficult for a Client to compute the value to be derived from it and this puts the Client in a vulnerable position where an unregulated industry may lead to Client suffering losses. This is further complicated by the complex nature of financial services products and hence the need for regulations that penalize service providers who have not made adequate disclosure. Apart from protecting the interests of the Client, regulation plays a key role of protecting the integrity and reputation of the industry. A public with a positive perception of the industry augurs well for the economy as consumers of financial products would have full confidence that the industry is serving their interests and that they are not vulnerable to unlicensed and unethical providers.

### 3.5.1 The introduction of the twin peaks model

Back in 2011, National Treasury, although acknowledging the strides that had made with regards to regulation through the FAIS Act from 2004, released a white paper titled, “A safer financial sector to serve South Africa Better.” This marked a shift from the fragmented financial regulation at the time to a more comprehensive form of regulation that would plug loopholes in an industry that still had players who were exploiting weaknesses in the system to avoid compliance with regulation. National Treasury rightly termed this behaviour “regulatory arbitrage”. This marked the shift towards the twin peaks model of financial regulation which is in line with international best standards. Twin peaks model has a two-pronged approach that is prudential and market conduct regulation. The prudential component is under the auspices of the SARB. The Prudential Authority oversees the safety and soundness of Banks, insurance companies and other financial institutions. The Market conduct of all financial institutions now falls under the FSCA and began operating in April 2018. The FSCA has replaced the FSB. One of the key functions of the FSCA is outlined in a discussion document titled” Treating customers fairly in the financial sector: A market conduct-based policy framework for South Africa.”

### 3.5.2 Treating Customers fairly Outcomes

At the core of the new regulatory framework is Treating Customers Fairly (TCF) outcomes. The TCF model seeks to embed a client centric culture within a service provider’s business processes and any deviation from the model is punishable by the FSCA. As already discussed, the information asymmetry that exists between service providers and Clients leaves the Client in a position of vulnerability. As a result, the TCF outcomes require FSPs and representatives to ensure that adequate information is disclosed through all the phases of the financial planning process. In applying TCF to business processes, service providers would have ensured that Clients are treated fairly and this would result in higher confidence in the Industry. The TCF outcomes that are expected at all the stages on interaction with the Client in the financial planning process are as follows:

**TCF Outcome 1** – Consumers can be confident that they are dealing with Businesses where the fair treatment of consumers is central to Business culture.

**TCF Outcome 2** – Products and services marketed and distributed in the retail market are designed to meet the needs of identified customer Groups and are marketed accordingly.

**TCF Outcome 3** – Consumers are provided with clear information and are kept appropriately informed before, during and after point of sale.

**TCF Outcome 4** – Where consumers receive advice, the advice is suitable and takes into account their circumstances.

**TCF Outcome 5** - Consumers are provided with products that perform as businesses have led them to expect and the associated service is both of an acceptable standard and what they have been led to expect.

**TCF Outcome 6** - Consumers do not face unreasonable post-sale barriers to changing a product, switching a provider, submitting a claim or making a complaint.

The above, when incorporated fully into the business processes of the service providers should result in clients having greater confidence that their interests are at the core of the financial services industry.

### 3.2.4 Retail Distribution Review (RDR)

A press release by the FSB in 2014 titled, “Retail Distribution review,” was out of the realization by the FSB that the advice and distribution models of FSPs needed to be closely aligned to the TCF outcomes. Of concern to the FSB was the increasing number of cases of unsuitable advice and lack of transparency in as far as the disclosure of fees charged by the businesses were concerned. The intended outcomes for RDR are to:

* Support the delivery of suitable products and provide fair access to suitable advice for financial customers.
* Enable customers to understand and compare the nature, value and cost of advice and other services intermediaries provide.
* Enhance standards of professionalism in financial advice and intermediary services to build consumer confidence and trust.
* Enable customers and distributors to benefit from fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of service.
* Support sustainable business models for financial advice that enable adviser businesses to viably deliver fair customer over the long term.

In order to meet the above outcomes, RDR seeks to revamp the types of services provided by intermediaries, the relationships between product suppliers and intermediaries and how intermediaries are remunerated.

The aim of RDR is to eliminate conflicts of interests that arise due to the nature of the remuneration to advisers whilst at the same time ensuring that Clients are treated equitably through transparent disclosure of remuneration structures, relationship between financial planners and service providers and the costs associated with the product proposed. The Client is in a better position to make an informed decision.

## 3.3 The benefits of compliance to an organization

As already seen, the FAIS Act requires service providers and representatives to comply with the Law and in the process ensure favourable outcomes for the consumers of financial services products. It is important for service providers to be aware that compliance with the act is not only for the purposes of fulfilling the requirements but that non - compliance presents risk in different dimensions not only to the service provider but to the industry as a whole.

Compliance risk refers to the current or future likelihood of reputation damage or financial soundness due to non-compliance with regulation and the expectations of stakeholders in the industry. Compliance with regulation has immense benefits mainly:

* Efficient business model that delivers value to Clients
* It embeds a culture of treating Clients fairly
* Better reputation for the service provider and the industry as a whole,
* Increased profitability in the long run.
* It boosts the morale of the organization and ultimately the performance.

### 3.3.1 Implications of non-compliance

**(a) Financial implications**

There are severe financial penalties for non-compliance as per section 36 of the FAIS act.

* Any person who contravenes or fails to comply with a provision of sections 7(1), 8(8),13(1),14(1),19(2) or 34(4) or 6 or in any application in terms of this act, deliberately makes a misleading, false or deceptive statement, or conceals any material fact is guilty of an offence and is on conviction liable to a fine not exceeding R1 000 000 or to imprisonment for a period not exceeding 10 years, or to both such fine and imprisonment.
* It is clear from the above that non-compliance has huge financial implications for the business and these penalties could actually trigger a collapse of the business.

**(b) Debarment/loss of licence**

* For representatives, non-compliance may result in debarment as already discussed in the section on representatives. Debarment whether initiated by an FSP of the FSCA has serious ramifications as it means that the adviser cannot give advice in the entire industry. In other words, debarment means one cannot practice in the profession for the period during which they are debarred.
* The FSCA can declare a business undesirable if the practice by the FSP has the effect of:

1. Harming the relations between authorised financial services providers or any category of such providers, or any such provider, and clients or the general public;
2. Unreasonably prejudicing a Client
3. Deceiving any Client or
4. Unfairly affecting any Client

And that if the practice is allowed to continue, one or more objects of the FAIS act will, or is likely to be defeated.

* In a move that will result in closure of the business, the FSCA can revoke the licence of an FSP

**(c)Reputational Risk**

The perception of the Business and the financial services industry in general is very vital for the continued existence of the business. Businesses should therefore be aware that compliance is not only about ticking the rules that have been complied with but goes a long way in protecting the integrity of the industry. A business that develops a reputation of putting its interests first before the client will realize a drop in productivity. This is more pronounced in the digital world that we live in where information is easily shared.

## 3.4 Ethics, the role of professional bodies and the importance of continuous professional development in the Industry.

Regulation of the financial services industry has become more important than ever following the Global financial crisis of 2008 and numerous cases where the reputation of the industry has been harmed by unethical behaviour of representatives and FSPs. The difference between regulation and Ethics is that the former is an external measure that is meant to dissuade and penalize behaviour that will harm the interests of the public while ethics are defined by personal and business values that one believes in. In other words, ethics is about doing what is right. The industry could do with an industry that places Ethics first over and above any other objective.

To be ethical is to be able to separate right from wrong and choosing right in all activities related to one’s profession. In other words, ethics are the moral principles that govern a person’s behaviour or the conducting of an activity. An industry that places ethics first creates an environment that is conducive for ethical individual decision making.

**3.4.1 What causes unethical behaviour?**

In order to set up processes and procedures that cultivate an ethical culture, businesses need to identify the factors that contribute to unethical behaviour. Once identified, these ethical loopholes can then be plugged for a better financial services industry for all. Below are the factors that can create an ethical dilemma:

* **Conflict of interest**

The financial services industry has for long been criticised for some remuneration structures. The introduction of RDR is meant to curb incentive structures that encourage financial planners to prioritize short term profitability ahead of Client interests.

* **Complexity of financial products**

One of the outcomes of TSF is to ensure that the industry designs products that are easy to understand and that are designed to suit the needs of a particular group. Historically, an ethical dilemma existed as a result of products that were difficult for Clients to understand and as a result the Client had to rely on the information provided by the financial adviser regarding the product. Further, the remuneration for the advisers was complex to understand which resulted in Clients not being fully informed at the time of purchase of the product. This created a breeding ground for unethical behaviour with non-disclosure being at the forefront.

* **Incompetency**

One of the “fit and proper” requirements is competency which comprises of qualifications, skill and experience. Although regulation has resulted in an increase in the capabilities of financial planners, ethical transgressions have been committed because of incompetency. This has resulted in Clients suffering long term loses. It is encouraging to see that regulators have identified this and now require proof that a financial planner is committed to long term continuous professional development in order to remain competent.

* **Social orientation**

Society, culture and beliefs can shape an individual’s morals. In order to develop an ethical culture in such a person, education programmes and an ethical environment need to be in place.

**3.4.2 Examples of unethical behaviour**

* Fraud
* Dishonesty
* Non-disclosure of important information to Client
* Deliberately misleading Client
* Incorrect advice
* Lack of diligence and professionalism
* Violation of the FAIS code of conduct
* Forging of documents

**3.4.3 The traits of ethical behaviour**

* Trustworthiness
* Professionalism and treating Clients with integrity
* Diligence and care for Clients
* Client confidentiality at all times
* Full disclosure through every stage of the product Lifecycle
* Having the required knowledge, experience and skill in serving Clients

## 3.5 The enforcement of Ethical standards in the financial services sector

There are various enforcement efforts that are meant to curb unethical behaviour and these are:

**3.5.1The FAIS Act and subordinate Legislation**

The instrument used to curb unethical behaviour in the industry is the FAIS General Code of Conduct. The Code of conduct sets a benchmark for acceptable ethical behaviour and all non-adherence to the code has serious consequences to FSPs and advisers. The General duties of an FSP under the FAIS code of conduct requires that FSPs and representatives in rendering financial advice to Clients should do so:

* Honestly
* Fairly
* With Due skill, care and diligence
* In the interests of Clients and the financial services industry

In addition to the general requirements, the specific requirements are as follows:

**(a) Client Interaction**

The code of conduct outlines the required conduct when engaging with a Client. The following principles should be applied in all interactions with the Client,

* Every transaction or execution of a task should be in accordance to the Client’s instruction and should be in the Client’s best interests. In addition, Client instructions are supposed to be executed timeously and with the Client’s best interests at heart.
* All information pertaining to the Client is to be treated with confidentiality except where disclosure is required according to the law.
* This section of the code of conduct prohibits insider trading and execution of Client transactions to the benefit of the representative and FSP based on non-public information

**(b) Disclosures to the Client**

In order to provide for Clients to make informed decisions based on the information provided by the FSP or representative, full disclosure relating to the product supplier, FSP and representatives and the financial service should be made.

1. Disclosure relating to product suppliers:

When making a recommendation to a Client, the following information about the product supplier should be furnished to the Client:

* + The location of the product supplier as well as contact details
  + The nature of the relationship between product supplier and the FSP,
  + Compliance department details of the product supplier,
  + Conditions or restrictions if any of the ability of the FSP to sell the product supplier’s products,
  + Whether the FSP has a financial interest in the product supplier that is more than 10%
  + Whether the FSP has received more than 30% remuneration from the product supplier during the last 12 months,

1. Disclosure relating to FSP/it’s representatives
   * Full names of the business, physical location and all forms of contact details,
   * The Legal status of the adviser that is who bears responsibility for the actions of the adviser,
   * Details of financial services the FSP is authorized to sell and any restrictions for example whether the representative is working under supervision or not,
   * Details of professional indemnity cover for the representative,
2. Disclosure relating to the financial service,

All the disclosures relating to the disclosure of the financial service will not be listed here as it is quite a comprehensive section. For a list of the full disclosures required, please refer to Section 7 of the FAIS code of conduct. In a nutshell, full disclosures relating to the type of financial product, all the related charges and fees, past performance and projections including whether there are guarantees or not should be made to the Client in order for the Client to make an informed decision.

**(c)The requirement to disclose and manage conflict of interest**

The Code of conduct requires FSPs and representatives to totally avoid putting themselves in a position that creates conflict of interest that could affect their ability to act in the best interests of the Client. The Disclosure should be related to the following:

* Financial interest in the financial service rendered,
* Ownership interest of the FSP or representative,
* Any relationship with a third party that creates a conflict of interest

Section 3 goes on to further list the type of financial interest that is remuneration that is acceptable in terms of legislation. The Code further prohibits FSPs from remuneration structures that discourage representatives from rendering fair and unbiased financial service. In addition, all FSPs are required to have a conflict of interest management policy that provides rules and regulations on managing conflict of interest including adequate disclosures where there is a potential conflict of interest.

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In addition to requirement regarding Client interaction, financial service disclosure and managing conflict of interest, there are other requirements in the code of conduct that regulate the manner in which FSPs and representatives should conduct themselves in order to protect the interests of the Client. Read the FAIS Code of conduct and list these requirements. For three of the code of conduct requirements, identify court cases that were brought up after violation of the specific requirement of a code of conduct. What were there penalties or implications for violating the code?

## 3.6 The role of professional bodies in cultivating an ethical culture in the financial services industry

A professional body has a code of conduct that members must abide by and one of the conditions of membership is to uphold the code on ethics of the body. Membership to these professional bodies is indication of the commitment by the member to uphold the highest ethical standards in all interactions to stakeholders. There are many professional bodies in the financial services industry that play a key role in cultivating an ethical culture amongst members and this in turn has a ripple effect on the Industry in general. One such body is the Financial Planning Institute (FPI). We take a look at its code of ethics and professional standards below:

**3.6.1 The Financial planning institute code of ethics and practice standards**

Membership of the FPI entails a member making a pledge to adhere by the FPI’s code of ethics and practice standards which are built on the 8 principles. By having this requirement, the FPI is actively making ethical conduct a requirement and this has gone a long way in establishing an ethical industry. The principles of the FPI code of ethics are as follows:

* Client first principle: Members of the FPI must ensure that they place the interests of Clients above all other interests.
* Integrity principle: The member should have integrity given the position of trust that Clients bestows on the member. Integrity entails fairness, honesty and consistency in all professional activities
* Objectivity principle: This principle requires mitigation or management of conflict of interest that may impair the member’s judgement in providing a financial service to a Client.
* Fairness Principle: Fairness entails rendering a financial service to the best of one’s professional ability, timeously and in unbiased manner including disclosure of conflict of interest when one exists.
* Competence principle: This principle requires members to have the adequate knowledge and skill to execute their duties to the optimal benefit of the Client. Further, the member is required to pledge to continuous professional development to ensure that their knowledge is up to date and relevant.
* Confidentiality principle: Members are required to treat Clients information confidentially and only disclose information as per Client instruction or as required by the law.
* Diligence principle: This principle requires member to be thorough and fully apply themselves in a timeous manner in their dealings with Clients.
* Professionalism principle: Members should carry themselves in a dignified and courteous manner in their dealings with all stakeholders in order to enhance the financial planning profession’s image in the public arena.

These principles of the code of Ethics are supported by the practice standards which outline the steps that a financial planner should take in rendering a financial service to a Client. The standards outline what is known as the 6-step financial planning process in the industry. By following the practice standards, the adviser ensures that the financial service rendered is appropriate. The steps are summarized below:

1. Client engagement
2. Collection of Client information’
3. Analysis of client’s information
4. Identify possible solutions to Client’s situation and develop recommendations
5. Implementation of recommendations
6. Ongoing review of the Client’s position

Other professional bodies that play a key role in enforcing and cultivating an ethical culture in financial services in South Africa include:

* The insurance institute of South Africa <https://www.iisa.co.za/>
* The Fiduciary society of South Africa <https://www.fisa.net.za/>
* The institute of risk management South Africa <https://www.irmsa.org.za/default.aspx>

## 3.7 The role of continuous professional Development in the financial services Industry

One of the “fit and proper” requirements, key individuals, FSPs and representatives for a category 1 FSP is competence. Competency entails having the requisite knowledge, skill, qualifications and experience. In order to ensure that key individuals, FSPs and representatives have the knowledge and skill to diligently execute their duties, the FSCA now requires representatives to commit to lifelong continuous professional development through engaging in “cpd” activities. These cpd activities should be offered by accredited professional bodies and are accrued on a yearly cycle beginning on 1 June of every year to 31 May of the following year. The first cpd cycle commenced on 1 June 2018 and ended on 31 May 2019. This follows the publication of Board Notice 194 of 2017 by the then regulatory Board the FSB. This is a step by the regulator to ensure that Clients who are recipients of financial services are served by representatives, Key individuals and FSPs who have committed to lifelong learning for the benefit of Clients and the professionalism of the Industry. FSPs, representatives and key individuals must meet the required “cpd” points depending on the nature of the financial service provided. According to Board notice 194, the cpd activities that must be engaged in must:

* Contribute to your skill, knowledge, expertise and professional and ethical services required
* Address any identified needs or gaps in your technical, generic and legal knowledge and
* Adequately take into account changing conditions relevant to the financial products for which you are authorized.

A cpd activity is defined in the Board notice as a verifiable activity that is accredited by a professional body who also allocates an hourly value or part thereof to the activity. These activities do not include activities performed in order to gain a qualification and also exclude product specific training. Class of business training does in certain cases is recognised as a “cpd activity.”

The number of CPD points that a representative or key individual must obtain is dependent on the nature of financial services rendered as per below table:

|  |  |
| --- | --- |
| **Nature of financial service** | **Minimum cpd points required** |
| A single subclass of business within a single business class | 6 hours of cpd activities per cpd cycle |
| More than one subclass of business within a single business | 12 hours of cpd activities per cpd cycle |
| More than one class of business | 18 hours of cpd activities per cpd cycle |

FSPs are required by the regulator to ensure that they take decisive action in order to ensure that representatives meet the cpd requirements before the end of the cpd cycle. Any representatives that have not met the minimum cpd requirement are to be removed from their representative register and their mandate withdrawn. Section 14(1) of the FAIS act requires the FSCA to debar the representative who has not met the cpd requirement as they are no longer considered “fit and proper”.

It is clear that continuous professional development is very vital for the continued endeavour to make the industry more professional. Non-compliance now has serious implications that can see a representative being debarred.

## 3.8 The consumer environment in the financial services sector

Given the complexity of financial products and the low financial literacy in South Africa, Consumers are in a vulnerable position. As a result, the Protection of information Act has been enacted in order to protect consumers’ right to privacy which is enshrined in the Section 14 of the South African constitution. POPI regulates the protection of personal information without hampering the legitimate use of information to execute business.

**3.7.1 The objectives of POPI**

The act seeks to achieve the following:

* To promote the protection of information processed by the public and private bodies
* To introduce certain conditions so as to establish minimum requirements for the processing of personal information
* To provide for the establishment of an information regulator to exercise certain powers and to perform certain duties and functions in terms of the act and the promotion of Access to information Act 2000
* To provide for the issuing of codes of conduct
* To provide for the rights of persons regarding unsolicited electronic communications and automated decision making
* To regulate the flow of personal information across the borders of the Republic
* To provide for matters connected herewith

In pursuance of the above objectives, the FSCA requires all FSPS to incorporate in their policies and procedures the following principles with regard to Client information:

* FSPs processes must ensure accountability and compliance with the law
* In processing Client information, there must be fairness and compliance with the law.
* Processing of information must only be in pursuance of a set purpose and no other reason,
* The processing of information must be within the boundaries defined by the purpose to be fulfilled
* The FSP is fully accountable for the quality of information processed
* There should be fairness and transparency in the processing of Client information
* The FSP should have processes that safeguard the loss and unauthorized access to Client information. Further, Client information should be protected from interference, modification, destruction or disclosure
* There should be no hindrance to a Client accessing or requesting correction, deletion or update of information that is in the hands of the FSP

Non-compliance with the above provisions may incur fines to the tune of R10 million, imprisonment, litigation costs and reputational damage

## 3.9 The changing needs of the consumer in the financial planning landscape

The consumer environment in the financial services industry has gone through many changes in the last two decades largely driven by increased regulation of the financial services industry and a technology revolution that has changed the way in which Consumers want to do business. The financial services industry needs to adapt to these changes or risk being irrelevant. We look at some of these factors below:

**The rise of the digital and more knowledgeable consumer**

* The emergence of the internet and related technology has presented consumers with a wide array of resources to use to gather information. A good example is quote comparison tools that are readily available for consumers to compare product offerings with no assistance from a financial adviser. The emergence of artificial intelligence has further broadened digital capabilities to an extent that a consumer can be guided by a robot to make a financial decision at a lower cost than going through a financial adviser. Most service providers now have “service bots” on their websites to handle any online queries that an existing or potential Client may have. The harnessing of digital technology by consumers has triggered a response by service providers.



Standard Bank recently announced that they would be closing about 1200 branches countrywide. According to the Bank, the way people banked had changed. Gone were the days where consumers would be able to only transact during banking hours but consumers needed a banking experience where they could transact at any time and at any place that was convenient for them. Standard Bank further announced that they were going into partnership with Microsoft in order to accelerate its digital transformation.

* Technology has also enhanced the speed with which a consumer can make their dissatisfaction with a particular service provider known. Social media platforms have of late become platforms for consumers to vent out their anger over poor service. This has further placed scrutiny on unethical and unfair practices by financial services providers.
* The modern consumer seeks a personalized and client centric service through the digital capabilities. The increasing use of digital applications that can be downloaded on smart phones for example has improved Client experience and satisfaction. Providers who do not harness this consumer need face extinction in this era of digital technology

**The impact of increased Regulation on Consumer behaviour**

As discussed above, regulation is increasingly playing a role in shaping the ethical standards in the Financial Services Industry. As this occurs, consumers are becoming more aware of the standards that they should expect from the financial services industry. The adoption of the twin peaks model of regulation closes some loopholes in the sense that some financial products that did not fall within the ambit of the former regulator (the FSB) are now under regulation. With this information at the disposal of the consumer thanks to the power of technology in particular the internet, today’s financial services consumer is more knowledgeable compared to the previous era.

## 3.10 Adapting to the changing consumer environment

Financial service providers need to adapt to the changes in the consumer environment in order to remain valuable. The following strategies are examples of Industry response to a consumer that is becoming increasingly knowledgeable and digital minded.

* Increased regulation means increased costs in order to comply for financial service providers. For example, the requirement form 2018 to meet minimum cpd requirements means that representatives and KI now have to invest in recognised cpd programmes that are offered by professional bodies at a cost. In order to remain viable, there is a need to streamline operations in order to reduce operating costs without affecting the value of the service provided to Clients.
* The market conduct focusses that regulation has targeted now means that service providers have to align their processes to the concept of Treating customers fairly and meet the requirements of the Retail Distribution Review (RDR). This means that service providers need to overhaul the way they do business and this may necessitate the need to outsource expertise in order to assist with aligning with regulation.
* The ability to harness technology in order to personalize an efficient consumer experience is key going forward. Leading financial institutions are harnessing Artificial intelligence into their systems to deliver a more efficient service. Consumers are increasingly becoming cost conscious and there is a demand for transparent cost structures but more importantly low-cost solutions to financial needs.



In response to the need for a low-cost investment solution, the first platform that uses technology to construct a portfolio based on artificial intelligence in South Africa was birthed. Bizbank is an investment management firm that has harnessed technology in order to provide investment solutions to Clients at a reduced cost and with more efficiency. Instead of paying fees that have been traditionally to financial advisers and asset managers, a Client can use the Bizbank platform to have a portfolio that match their risk/return profile set up for them. This solution reduces costs which reduce investment returns over time.



**Formative Activity 1**

What is the difference between Advice and intermediary service? (5)

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**Formative Activity 2**

Is advice relating to wills and trusts regulated by the FAIS act? Give reasons for your answer (2)

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**Formative Activity 3**

What are the fit and proper requirements for a representative and what are the consequences for failing to meet fit and proper requirements? (3)

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**Formative Activity 4**

Give reasons on why it is vital to regulate the financial services sector (3)

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**Formative Activity 5**

What is the main difference between regulation and Ethics? (2)

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# LEARNING UNIT 4: RISK IN THE FINANCIAL SERVICES ENVIRONMENT



**Learning Outcomes**

* Apply the concept of risk related to investment planning.
* Illustrate the different forms of investment risks.
* Explain how historical returns are used as a factor in calculating probable returns of investment assets.
* Outline the importance of consideration of risk by an investor in investment decision making.
* Categorize different investment assets in terms of their risk/return trade off.
* Define the concept of financial markets and the role they play in the economy.
* Discuss how different economic indicators impact financial markets.
* Identify Global factors that impact on South African financial markets.
* Summarize the information required to generate a Group investor profile and use the information to develop an investment proposal for the Group.
* Apply the concept of risk and return in order to recommend the appropriate investment for an investor.

# INTRODUCTION

Perhaps you are acquainted with a popular adage, “fortune favours the brave.” In the investment world, there is another popular saying that goes as follows; “high risk begets high return.” This saying makes a lot of sense to an individual who is well versed in how financial markets and assets work but requires elaboration to the Clients who are subject to your advice as an investment advisor. You need to be in a position to clearly breakdown what investment risk is and how it is linked to Risk appetite and tolerance. In order to adequately advise Clients, you also need to be able to interpret measures of investment risk and how these affect the forecasting of potential returns and risk. On a macro level, a competent financial adviser must be able to assess the effect of different factors on financial markets where the assets that investors invest in are issued and traded. These issues are explored in this learning unit.

# 4.1 THE CONCEPT OF RISK IN INVESTMENTS



An investment in a financial asset carries an element of risk. Investment risk is defined as the uncertainty or the deviation from expected outcome of an investment decision. The main risks that investors face include business risk, volatility risk, inflation risk, interest rate risk and liquidity risk. Risk appetite of a Client is the right balance of these risks in order to achieve Client investment objectives. Factors that determine the risk appetite for a Client include:

* Client’s natural attitude to risk
* The Client’s target rate of return that is investment goals
* The time that the investor has to achieve investment objectives
* Investor’s personal circumstances that is the capacity for loss

## 4.1.2 Forms of investment risk

Investors are faced with the following investment risks that could affect their investment outcomes:

* **Business Risk:** This is the risk that a business that an investor has invested funds in ceases to be a going concern due to a collapse in its operating model and goes bankrupt. Holders of ordinary shares bear the most risk as they are in last to be paid out in the event of a liquidation. Lenders to the liquidated company also bear default risk and risk of capital loss of there are insufficient assets to repay debts.

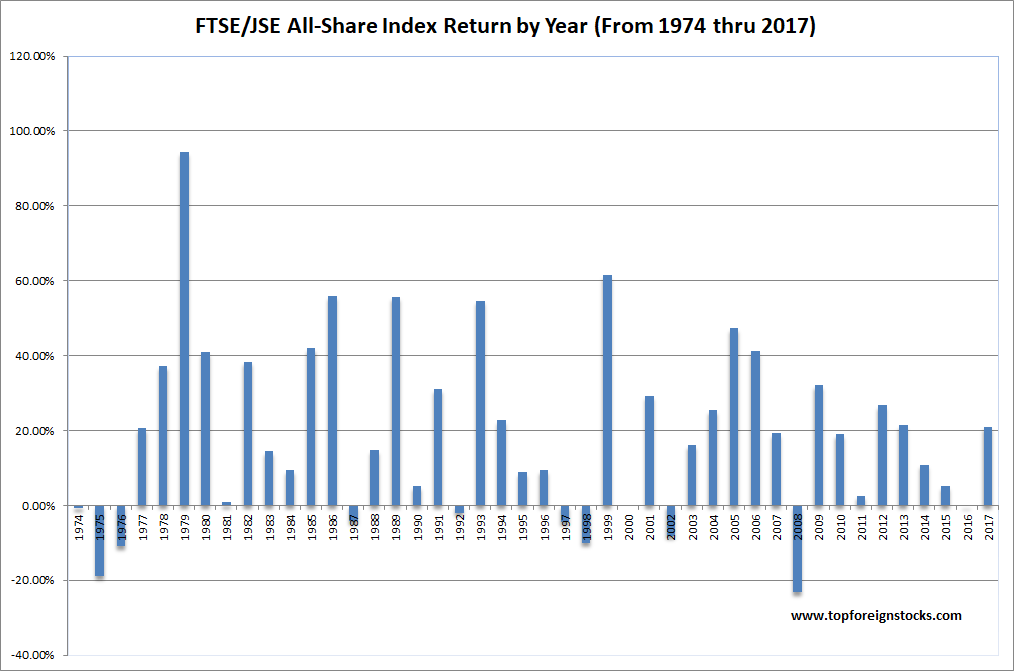


African Bank was a listed company on the JSE. Between 2003 and 2005, its share price rose from R5.25 to R22.50 and has a dividend yield above 9%. However, in 2014, the share price collapsed and was suspended from the JSE and the business placed under curatorship by the SARB. This resulted in huge capital losses to investors in this share which had been one of the jewels of the JSE prior to collapse. This is an example of business risk posed by investment in a business.

* **Volatility Risk:** This is the risk of an asset price going up and down in response to supply and demand which are determined by company specific and market wide forces. The risk affects are more pronounced in certain asset classes for example listed shares and is not applicable to asset classes whose prices do not change for example money market instruments.



A look at the historical returns of the JSE all share index shows how volatile the stock market is. This is depicted in the Graph below:



During the period 1974 to 2017, the JSE shows pronounced fluctuations in returns over a number of periods. For example, an investor in the JSE all share index would have realised a return of 19.2% in 2007 but the return would have been -23.2% in the following year (2008). The total return over these two years would have been -4%.

* **Inflation Risk:** When talking of investment risk, attention is always given to volatility risk. Whilst the risk of capital loss is a more tangible and of immediate concern to investors, investors often ignore a very critical element that that they should incorporate when determining their risk appetite. Inflation is the risk of an investor’s wealth losing value due to the eroding effect of inflation. Volatility risk averse investors often opt for fixed income investments that provide a certainty in investment returns. In periods of high inflation, these fixed returns diminish in value. Stock market denominated investments also bear this risk in periods of sustained low or negative growth.
* Interest rate risk: This risk particularly affects bond prices. Interest rate movements triggered by SARB decision on the repo rate impacts the prices of bonds that are in circulation. When interest rates to up, Bond prices fall and vice versa. This relationship is explained in more detail in the discussion on the risks of Bonds in learning unit 1.
* **Liquidity risk**: This risk is present when an investor cannot liquidate their investment on time or if the liquidation comes at a substantial cost. Deterioration in the credit rating of an issuer for a bond for example can create difficulties to holders of the Bond wishing to sell. The structure of a product that an investor invests in can also present liquidity risk. Investment products that carry huge penalties for early termination can actually result in an investor incurring a capital loss.

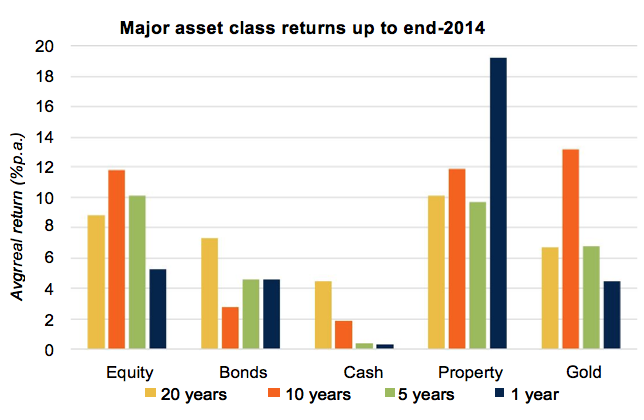
## 4.1.2.1 Factors affecting risk appetite

Risk appetite measures the ability and amount of risk that an investor has to take in order to achieve their investment goals. It is determined by balancing the risks discussed above with the following factors:

* **Personal/natural attitude to risk:** The natural attributes of an individual could be the ultimate factor in determining what risk to take on in their investment portfolio. Risk aversion is a term used to describe the unwillingness of an investor to take any risk of capital loss which is present in highly volatile assets such as shares. Risk takers are those investors who are prepared to have fluctuations in their investment values in pursuit of potential high returns in Bull markets. Individuals who are risk takers in other areas of their lives are more likely to take on volatility risk whilst it is very unlikely that those who are naturally cautious would do the unusual and desire risk in only the financial aspect of their lives. It is important for a financial adviser to advise Clients on the implications of talking on volatility risk.
* **Investment Horizon:** This is one of the most important factors in determining investment strategy. Asset classes behave differently in different time horizons and investors need to match the right asset classes to their investment goals given the time that they will be invested for.



An analysis of the returns of different asset classes over 20 years from 1994 to 2014 shows that Shares (Equity) and property and Gold have outperformed Bonds and cash investments over 20,10- and 5-year periods. Although these asset classes have delivered long term outperformance compared to the less volatile Bonds and cash, a look at the 1 year returns of all the asset classes that there is no significant difference in the 1 year returns for shares, gold and Bond investments over a 1-year period. This depicted in the graph below.



*Source, financial markets journal*

What this means is that although an investor may desire a certain return, the investment time horizon has a huge bearing on the asset to be invested in. For an investor investing for less than a year given the above analysis, it would not make sense to choose highly volatile equities instead of Bonds when the 1-year return is almost similar. This shows that the risk appetite is determined to an extent by the investment horizon.

* **Age of investor:** The age of the investor is to an extent related to the investment time horizon and ultimately affects the investment decision. A 20-year-old investing for retirement for example has a long term to invest until retirement and has the capacity to invest in long term capital growing volatile assets such as shares. This is not the case for a 64-year-old planning for retirement the following year and who seeks to protect accumulated savings from volatility. Having said this, it is also important to note that retirees are exposed to inflation risk as the fixed income investments that protect capital result in reduction in purchasing power in periods of high inflation. This needs to be considered in the determination of risk appetite of an investor.



Most retirement funds consider age as one of the most important determinants of risk appetite and have crafted what are commonly referred to as “Life stage” funds as the recommended strategy for retirement planning. The strategy adopted is to invest in volatile growth assets for members who have more than 10 years to retirement and then default into capital preservation stage by investing in shares and Bonds as the member nears retirement.

* **Investor’s personal circumstances:** The risk that an investor is willing to take may depend on the value of the investment in relation to net wealth. All things being equal, investors are averse to capital loss if the amount at risk is high in relation to net wealth and vice versa. Additionally, the nature of the investment can be affected by whether the investor has alternative sources of income in the event of adverse markets conditions. It would be unwise to lock all the investment in a fixed term capital growth only (invested in shares for example) for an individual seeking a monthly income from the investment.
* **Legislation:** Some legislative requirements shape the amount of risk that an investor can take. Regulation 28 of the pension funds act has the following limits for retirement fund investments: Equity 75%, listed property 25%, offshore assets 30% and hedge funds 10%. Regardless of the capacity and willingness to take on risk, an investor cannot invest beyond these limits which are prescribed by law.

## 4.1.2.2 How to determine a Client’s Risk appetite

Having established the investment risks and the factors that determine capacity to take on risk, how then should you guide Clients in determining their risk appetite? The below are key considerations:

* The Client should consider what the overall financial effects are of a loss in the intended investments. If any capital loss would result in financial strain on investor and dependants, the Client is better off trading volatility risk for inflation risk that is investing in conservative assets such as Bonds and money market investments.
* Investors should determine their investment goals in determining risk that that they can take on. If a higher rate of return is not negotiable, the investor should be aware that this can only be achieved by investing in high risk assets such as shares, property and gold.
* The time frame to invest is an important consideration. Short term investments that is investments under five years could be subject to risk of capital loss if high risk assets are selected. A longer time frame does gives scope for a client to take on risk. Having said this, it is important for Clients to understand that not taking any volatility risk at all could subject them to inflation risk. A compromise may need to be reached where a combination of volatile assets is combined with conservative assets.

## 4.1.3 Probability and investment risk/return



Suppose an investor was to ask you how much return one can expect if invested in a Unit Trust that invests in shares listed on the JSE 100%. What would you answer be and with what certainty? Would your prediction of a return on Equity Unit Trusts be as accurate as the prediction for a Unit Trust that invests in money market instruments? Well, there fortunately is a mathematical tool that can be used to forecast the future of the uncertain markets that we operate in. That tool is probability! We look at the use of probability in managing risk in the investment arena in this section.

## 4.1.3.1 Using probability to measure expected return

We use historical data in order to calculate the return that we could expect in future. In simple terms, the return that one could expect for investing in a given asset is the probability distribution of possible returns. Let us use an example to illustrate this.



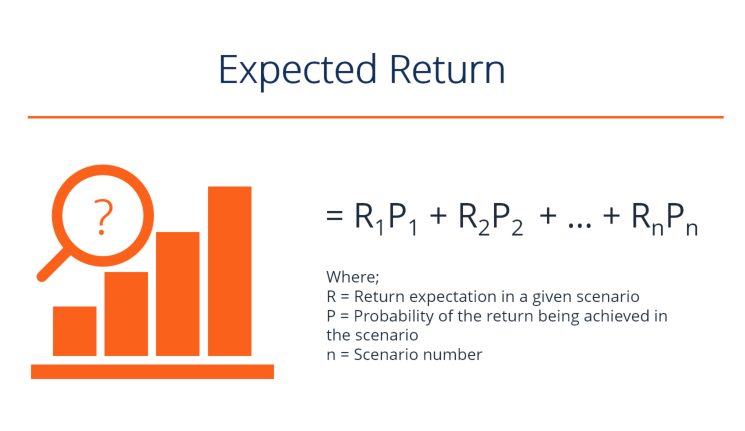
Let us suppose that a Client would like to invest in the shares of BlueComm Limited, a company listed on the stock exchange. Suppose that over a 20-year period, investment in the company has given a 20% return per annum 50% of the time, 15% return 30% of the time and 10% return 20% of the time. What would be the expected return for the share going forward? The expected return would be the probability weighted averages of the return calculated as follows:

(0.5) (0.2) + (0.3) (0.15) + (0.2) (0.1)

= (0.1) + (0.045) + (0.02)

= 0.165 = 16.5%

In other words, the expected return is the sum of all historical returns multiplied by the probability of that return. This is generalized in the below formula:



## 4.1.3.2 Using probability to measure volatility risk

In our earlier example, we calculated expected return of BlueComm shares to be 16.5%. What if a Client was to ask you to what degree of certainty your calculation of expected is? What would you answer be? Fortunately, you do not have to thumb suck. The principle of probability assists us in determining how historical returns have deviated from expected returns.

Investment risk is defined as the chances of an investment not performing as it is expected to. The difference between expected and actual returns of an investment is measured by the standard deviation of the investment. An investment with a high standard deviation has more volatility risk compared to an investment with a lower standard deviation. It follows therefore that a risk averse investor prefers investments with a low standard deviation whilst investors who have more risk appetite will prefer investments with a high standard deviation.

## 4.1.4 Importance of interpreting risk



Suppose you are presented with the choice of two different investment options. Option 1 is an investment that has given a 10% return in 2018, -20% in 2017, 0% in 2016 and 45% in year 2016. The second option is an investment that has returned 10% from 2016 to 2018. Which investment would you prefer if you are averse to risk of capital loss? Investment 1 has a high standard deviation as the returns fluctuate wildly from year to year. Investment 2 has zero standard deviation completely as the investment returns are constant from year to year. It is very vital for a Client to understand that although investment A has generated a return as high as 45% in one year, its return distribution shows huge fluctuations and if that was to be replicated, a Client would suffer huge capital losses. This shows that in guiding a Client to an investment decision, it is vital to interpret the risk given the return in order to match the Client’s risk appetite.



Note that the standard deviation is only one of the measures that can be used to measure investment risk. There are other statistical tools that are used in conjunction with the standard deviation such as Beta, Treynor measure, Sortino ratio and Sharpe ratio. These are beyond the scope of this book but it would be of great help if you read more about these as they can be useful in guiding your Clients.

## 4.2 The relationship between Global factors and South African Financial Markets

We have established in the preceding discussion that the expected return on an investment could vary and this presents investment risk to an investor. In learning unit 1, we discussed how different local economic outcomes could impact asset classes and returns. As an emerging market economy, South African financial markets respond to developments in the Global world. It is important to know what these factors are and how they could impact South African Asset returns.

## 4.2.1 The impact of Global Economic factors on South African Asset returns

* Economic events on the Globe affect the value of the rand, stock prices, Bond Prices and on a broader scale the South African Economy in General.
* Developments in the United States in particular have far reaching implications on our Economy and Financial markets. Generally, a slowdown in Global Economic growth has ripple effects on the South African Economy in general.



The recent trade war spate between USA and China has dampened the Global Economic Outlook. Developing countries feel this effect on a wider scale as global investors in South African Listed shares and Bonds sell off assets in developing markets that are considered risky when the Global Economy is slowing down. The lacklustre performance of the JSE since the beginning of 2019 is attributed to an extent to the trade war. The relationship between the Global Economy and South African markets is long term given the importance of the South African Financial markets as an attractive investment destination for Global investors. The movement of capital between SA markets and the world has an effect on the value of the Rand which ultimately affects inflation (a weak rand causes long term inflation as imports become more expensive). Additionally, a weaker rand results in lower earnings to Global investors when they restate their earnings to their currency. This results in huge investment outflows causing stock prices and Bond Prices to fall.

* Economic policy in Developed financial markets have a huge bearing on SA investors. The USA Federal Market Committee interest rate decision is a keenly followed event in South Africa. When the Fed rate (equivalent to the repo) is increased, SA financial markets experience capital flight as Global investors seek a higher return in “safer havens”.



On 18 September 2019, the JSE all share index was 1.19% at close of trading with traders citing uncertainty and a cautious approach pending the US Fed interest rate decision which was forecasted to remain unchanged.

## 4.2.2 The impact of Global Political factors on South African Investment Returns

* The political views of influential World leaders have far reaching implications for the South African Economy and financial markets.



In 2018, a tweet by US President Donald Trump on South Africa’s land reform programme caused major upheavals on the Financial Markets. The rand tanked by 1.9% in immediate reaction to this political statement. This was due to concern that the USA could punish South Africa by removing tariff concessions which could affect South Africa’s trade with the USA and ultimately impact economic growth.

* Political stand offs between world superpowers are not conducive for economic growth and when they do occur, it is emerging markets like South Africa that bear the brunt of the tensions.



A drone attack on Saudi Arabia Oil facilities had far reaching implications for the Rand as investors scurried for safer havens mainly the US$ and Gold. To further dampen investor expectations, the price of Brent crude oil jumped by 9% a scenario which would see net importers of oil like South Africa having to pay more and, in the process, driving up inflation. The rand’s loss was however a gain for investors in Gold as the Gold price surged by 1.8%. Gold is considered a safe haven and often rallies when Global investor risk appetite is low.

## 4.2.3 The impact of Global Health factors on South African Investment Returns

I am sure the terms swine flu and bird flu are familiar to the reader. These are instances of Global health scares that had far reaching implications on world economies as Governments struggled to reign in the effects of these epidemics on their economies.



A good example of the impact of health factors on the global economy is the recent outbreak of African Pig swine flu in China. The outbreak of this epidemic is said to have affected about half of China’s pig herd whose industry is valued at US$128 Billion. Although this loss would have a big effect on the Chinese economy, contagion effects were felt in the US which Is the primary supplier of soya bean which is used as feed in the Chinese pig industry. As already discusses, a slowdown in a key sector in major economies has ripple effects on emerging markets such as South Africa.

* Global health factors affect economies through reduced production in the food industry, a decline in global tourism as travellers become sceptical about travelling at heights of health epidemics.
* It is difficult to gauge when the next Global health scare is going to be. Global health epidemics occur randomly and spread rapidly and are difficult to control and the extent of the damage to economies can only be quantified after occurrence.

## 4.2.4 The impact of Global environmental factors on South African Investment Returns

According to the united states-based NASA research institute, 2016 was the hottest year on record with global temperatures that were 1.3 degrees Celsius warmer than the pre-industrial era in the late 19th century. This scenario is a summary of a global environmental issue known as global warming. It is widely accepted that global warming poses a significant risk to the South African economy and the Global world at large.

* South Africa is expected to become hotter and drier which impacts agricultural production and biodiversity.
* Rainfall patterns are projected to change and even in regions where an increase in rainfall is expected such as in the Eastern parts of the country, the rainfall pattern is forecast to be unpredictable and may occur at inappropriate times leading to flooding. Floods are destructive to infrastructure and the economy at large.
* Already, the impact of climate change is being felt the most in the Northern regions of the country where the production of rooibos (a unique and proudly South African range of tea earning good expert revenue and employing thousands in the value chain) has dropped by about 40% in 2004/2005 due to prolonged drought.



From 1990 to 2010, 12 of the 20 years have been categorized as drier years. In other words, we received normal rainfall in only 7 years in this 20-year periods. 2014 to 2016 recorded three consecutive seasons of below average rainfall resulting in drought conditions across South Africa. These drought conditions were more severe in Western Cape extending into 2017 with dam levels falling below 20%. The change in the rainfall patterns has largely been attributed to global warming. This had an effect on the economic output. Western Cape alone lost about R5 Billion in economic output to drought and this is telling as Western Cape contributes about 22% to the Country’s entire agricultural output. Between 2015 and 2017, the average growth of the South African economy was a mere 1.1% per year with agriculture growing at a very low 0.5%. The impact of this has been higher food prices which erodes purchasing power of fixed income earners, higher unemployment, inequality and poverty. A deeper look at the effect of the drought in Western Cape reveals the economic risks that drought as a result of global warming poses to the South African economy. The total number of Tourists vising Cape Town grew by 1% between 2016 to 2017 down from 7% for the previous period. This poses a threat to the 300 000 jobs that are in this sector. About a quarter of Agricultural farm workers are in the Western Cape. In a 2017 labour survey, approximately 25 000 agricultural jobs were lost nationally with Western Cape accounting for about 20 000 of these.

The effect of the drought pushes the inflation index up and the SARB’s policy response is to push up the repo rate to stem the inflation. This results in lower spending and GDP Growth. Additionally, national Treasury has had to channel resources to drought relief initiatives. It is estimated that in 2019, the government may need up to R3Billion to assist farmers who are under the drought strain.

In a nutshell, global environmental factors impact the economy negatively and has the effect of affecting the returns of investors in financial markets. Inflation, unemployment, low GDP growth and depressed financial market performance have a real possibility of affecting expected returns for investors.

## 4.3 Development of a Group investor profile

We have established that in order to gauge a Client’s risk appetite, it is important to take into account the different risks that could impact the Client’s investment as well as the investor’s personal circumstances, personality regarding taking risk, the capacity to take losses and the investment horizon among other factors. This analysis focussed on an individual investor. Suppose that you were approached by a group of 20 individuals who would like to invest for the next 5 years. How would you ensure that you come with the appropriate investment? What sort of information would you require in order to develop your recommendation? We explore this subject in this section.

## 4.3.1 Gathering information required to develop a Group investor profile

In order to develop a Group investment profile, the adviser needs to gather the following information:

* **The total amount that is to be invested and the type and frequency of the investment:** All things being equal, a higher investment amount may constitute a substantial portion of the Group invertor’s wealth and as such this may result in the investor not wanting to bear capital losses. Additionally, the frequency of the investment has a huge bearing. A once off lump sum investment has a different profile to a monthly investment. Due to the phasing in nature of monthly investments, the risk of buying assets when markets are at a peak and the investment subsequently falling in value when markets retreat is eliminated. Monthly investments benefit from Rand cost averaging in declining markets and as such has a different risk profile to a single lump sum investment.
* **The Group investor’s investment horizon:** It is essential to have a clear picture of how long the investor expects to be invested in the proposed investment. Assets with high volatility such as shares and property are not suitable for short term investment horizons as there is a risk of capital loss. Similarly, investing in conservative assets where the return is predictable may not ideal for long term investments as the risk of underperforming inflation in the long term is high.
* **Income requirements from the investment:** The need to draw a regular income from an investment is an important consideration. If income is a requirement, the investment should be structured such that disinvestments to meet income needs do not come at a financial cost. For example, it would be folly to invest a Client with income needs’ funds in a 5-year endowment which has restriction periods for withdrawals. Further, income needs should be matched with income producing assets such as money market investments. A high income need Client invested in shares for example could incur capital losses in declining markets.
* **The value of the investment in relation to Group investor’s net worth:** An investment whose ratio to the investor’s net worth is high would have huge financial implications on the investor in the event of capital loss and vice versa. This would mean that the capacity for volatility risk is low. It is very vital that this information is disclosed in order to aid the adviser in making the right recommendation.
* **The investor’s personal attitude towards risk:** Regardless of how the investor may respond to some of the points discussed above, it is important to gather information on how the investor feels about a range of different investment outcomes. This will serve as a guide on the nature of the assets to be selected for the Client. Clients who feel very strongly about not losing any of their capital would certainly be unhappy Clients if invested in volatile assets in declining markets. Similarly, Clients who cannot afford to underperform inflation may be disappointed in inflationary times if invested in fixed income investments. In order to refine the information regarding attitude to risk, it is vital to establish how Clients would react in adverse market conditions. An investor who is most likely to disinvest in declining market conditions is most likely to turn paper losses into real capital loss and may not be right Client to be invested in assets with a capital loss risk.
* **The average age of the members of the Group investor:** The age of the members of the Group is closely linked to the investment horizon of the investment. All things being equal, younger members may have a longer-term investment horizon compared to members who are in their advanced ages.
* **The target return of the Group investor:** The return requirement of the investor will point the adviser to the asset classes that can achieve this for the investor. An investor seeking to maximize return would best served by capital growing assets such as shares but the risk of capital loss and short-term fluctuations should be clearly outlined to the investor. Similarly, investors looking to outperform inflation should be made aware that this may entail taking on of risk in order to achieve their goals.

## 4.4 Group Investor profile

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You have been approached by Kusile, a recently formed investment club that would like to make a monthly investment of R10 000 in order to achieve their investment goals. You have an internal questionnaire that is used to profile investors that you need to use in order to develop your proposal. This questionnaire has been presented to the Client and the Client’s responses are highlighted in yellow. We use this as an example to develop an investment proposal for Kusile.

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| --- | --- | --- | --- | --- | --- |
| 1 2 3 4 5 | | | | | |
| Q1: How long are you planning to be invested for? | | | | | |
|  | Less than a year | 1 -3 years | 3 – 5 years | Between 5 and 10 years | More than 10 years |
| Q2: What is your main investment goal? | | | | | |
|  | To draw an income monthly | Stable returns with minimal income | Stable inflation beating returns with no income requirement | High inflation Beating returns with no income requirement | Long term capital Growth |
| Q3: Do you prefer Capital Growth or return to be in the form of income distributions? | | | | | |
|  | Income Distributions only irrespective of interest rate levels | Income Distributions in the form of interest and dividends | An equal combination of income and Capital Growth | A higher level of capital gains with low income distributions | Capital Growth only |
| Q4: What is the value of this investment to the investor Group’s total wealth | | | | | |
|  | 100% or almost all our assets | About 75% of our assets | About half of all assets | About 25% of total assets | Less than 25% of total assets |
| Q5: In a year period, what would you say would the best return for your investment? | | | | | |
|  | 10% | 20% | 30% | 40% | 50% |
| Q6: In a year period, what would you say would be the worst return for your investment? | | | | | |
|  | 0% | -5% | -10% | -15% | -20% |
| Q7: In the event of declining market conditions, how are you likely to react to lower investment performance? | | | | | |
|  | Immediately withdraw everything | Withdraw 50% or more and leave some of it until it recovers | Withdraw less than 50% and leave the rest until markets recover | Withdraw less than 25% and leave the rest and until markets recover | Leave the investment untouched until recovery |

**Guide to Interpretation of scores**

The questions that are highlighted in Blue pertain to the investor’s ability to take on risk.

The questions highlighted in Red pertain to the willingness of an investor to take on risk. The corresponding scores for every question are added to give the total score which is then used to interpret the investor’s risk appetite.

**Ability to take risk**

|  |  |  |
| --- | --- | --- |
| Score | Ability to take risk | Interpretation of score |
| 4-7 | Low | No capacity at all to lose capital. Capital preservation is paramount. |
| 8 – 11 | Moderately Low | There is a need to grow capital but you are not able to lose capital |
| 12-15 | Moderate | There is a balance between capital growth and capital preservation |
| 16 - 18 | Moderately High | You seek to invest in the long term with high growth but would be happy with not too excessive volatility risk |
| 19 - 20 | High | Long term investor with high return objectives and can live with huge negative fluctuation of investment values |

**Willingness to take risk**

|  |  |  |
| --- | --- | --- |
| Score | Willingness to take risk | Interpretation of score |
| 3-5 | Low | You will not take any losses at all even if it means low returns |
| 6 – 8 | Moderately Low | You are prepared to take only a low level of risk of capital loss. You desire inflation beating returns with very low risk of investment value fluctuation |
| 9-11 | Moderate | You seek above average returns and would achieve this by investing in a diversified portfolio |
| 12 - 13 | Moderately High | You are willing to take on some significant risk in pursuit of long term capital growth. However, there is a ceiling on the level of risk that you can take |
| 14 - 15 | High | You have long term investment goals and will take on any amount of risk in order to achieve long term capital growth |

**Recommended investments for the different scores:**

|  |  |  |  |
| --- | --- | --- | --- |
| Ability to take risk | Willingness to take risk | Risk category | Suggested asset Classes |
| 4-7 | 3-5 | Low | Money market |
| 8-11 | 6-8 | Moderately Low | A combination of money market and Bond investments |
| 12-15 | 9-11 | Moderate | An equal weighting to growth assets (shares, property, Gold) and low to medium risk assets (money market and Bond investments) |
| 16-18 | 12-13 | Moderately High | Significantly higher weighting to growth assets (shares, property and Gold) and very minimal exposure to money market and Bond asset classes |
| 19-20 | 14-15 | High | Select only long-term capital growing assets (Shares, property, Gold) |

Let us suppose that the Group investor’s answers to the questionnaire are the ones highlighted in yellow. How would you develop a recommendation to the Client and support it?



As a general rule of thumb, the investor should not take on risk of capital loss when the ability to take risk is lower than the investor’s willingness to take risk. For example, it could be ruinous for an individual with a natural inclination to take risk to invest in a high-risk investment when they are to be invested for less than a year and if the investment constitutes more than 75% of their total wealth!

## 4.5 Investment decision making incorporating risk principles



Thabo is a 30-year-old Client who has just received a windfall inheritance from his Uncle of R3 million. This was a largely unexpected development and Thabo is still trying to believe his good fortune. Thabo has approached you to assist him in selecting the appropriate investment given his circumstances.

In your discussion with him, you have gathered the following information. Thabo is a chartered accountant and his earnings have significantly increased over the past 2 years when he qualified to be a CA. Because of his steady income stream, he will not be needing an income from the investment. Given his high level of financial literacy, Thabo is aware that investing in the stock market has a potential for long term capital growth but has significant short-term downside risk. Thabo does not have a pre-determined investment horizon. He could invest for the long term but he wants to retain the flexibility to withdraw the funds at short notice should an alternative use of the funds crop up. Thabo is a high-risk taker by nature. On weekends, it is either he is bungee diving on a Saturday or racing his sleek high-speed convertible. Following your first interview with Thabo, you managed to get him to complete a questionnaire. The scores on the questionnaire reveal that Thabo has a medium risk appetite because of uncertainty of the investment horizon. He also feels that he owes it to his Uncle to be prudent with his fortune as losing it would be a great injustice to his Uncle’s kindness. At the same time, being an accountant, he is fully aware of the ravaging effects of inflation and how not taking any form of volatility risk can expose him to this risk. You are presented with the following investment choices for Thabo:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Listed shares of Blue Comm Ltd | ABC Money Market Unit Trust | XYZ Balanced Unit Trust | MN General Equity Unit Trust | OP Endowment Fund |
| Expected Return | 30% | 8% | 15% | 25% | 32% |
| Investment strategy | Investment is in the Listed shares of Bluecomm only | Diversified unit trust of 200 different issuers of money market instruments | A mix of asset classes as follows: 25% in listed shares,25% in property,25% in Bonds and 25% in money market investments | Investment is in shares of 50 companies listed on the JSE | Investment is in 25% in listed shares,25% in local property,25% in money market instruments and 25% in Bond investments |
| Standard Deviation | 15 | 0.001 | 3 | 10 | 8 |
| Current and projected inflation | 9% | 9% | 9% | 9% | 9% |

Based on the information that you have and knowledge of risk, which would be the best investment for Thabo. Give reasons for your answer.

**Possible investment options for Thabo:**

**Option 1: Investment in Blue Comm shares:**

The investment offers the potential for a high return that is 30% which is the second highest return for the investment options available. Thabo seeks to earn a high return and based on the expected return; this investment could maximize returns for Thabo. The shortfall however is that it has a very high standard deviation (the highest actually). Thabo has indicated that if opportunity beckons, he may liquidate the investment to pursue other investment goals. With such a high standard deviation, it is possible that Thabo might want to disinvest when the share price is high which is very likely given the volatility. As such this investment would not be the most ideal for Thabo.

**Option 2: ABC Money market investment:** The money market investment has the lowest return but also has the lowest standard deviation. In terms of capital protection, this would be the investment to serve that purpose. The challenge however is that with inflation at 9%, this investment’s return is -1% in real terms. Thabo detests erosion of purchasing power effect of inflation. This investment would there not meet his goals.

**Option3: MN General Equity Unit Trust:** This unit trust invests 100% in listed shares. It is much more diversified than a sole investment in the shares of one particular company. As a result, its standard deviation is less than the investment in Bluecomm at 10. However, the standard deviation is still very high and Thabo would be at risk of a capital loss was he to immediately withdraw when the stock market is performing badly. As a result, this investment would not be ideal for Thabo

**Option 4: Investment in OP Endowment Fund:** An endowment is an investment that only allows for a single withdrawal within 5 years and even then, the withdrawal is limited to capital contributed plus a compound return that is fixed depending on the legislation at the time. The investment has attributes of a good investment. Of all the available investments, it has the highest return at 32% and even has lower standard deviation than other funds that have a lower return than it. However, the restriction on withdrawals is the biggest setback and regardless of how attractive the return looks, the investment will not serve Thabo’s goals effectively.

**Option 5: XYZ Balanced Unit Trust:** The Unit Trust has a 50% weighting in volatile assets (property and shares) and a 50% weighting in more secure assets (money market and Bond investments). Thabo does not want to expose his capital to excessive risk and at the same time does not want to underperform inflation. The 12% expected return is safely above inflation and at a standard deviation of 3, returns could deviate negatively from the expected return by a magnitude of 3(which would give 12% return) and still be above the inflation rate. The Unit trust dies not have investment restrictions and Thabo would be able to disinvest at any time. Given Thabo’s goals, this is the recommended investment.

The consequences of not selecting the correct investment have been given in the analysis on the different investment options.



**Formative Activity 1**

Risk appetite involves balancing of risk to achieve Client investment objectives. What are the investment risks that investors face when making investment choices? (5)

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Briefly describe the nature of these risks (5)

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**Formative Activity 2**

Having considered the investment risks inherent in investments, give any factors that an investor needs to consider in determining their risk appetite and briefly describe why these factors are important in the analysis. (6)

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**Formative Activity 3**

For an individual who is a natural risk taker, it may not always the best investment option to invest in highly volatile asset classes such as shares. Give two reasons why this statement is correct (4)

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**Formative Activity 4**

Inflation risk is a risk that is not so obvious that could negatively impact investor returns. Which asset class is most exposed to this risk in the long term? (1) What may an investor need to do in order mitigate this risk (2)

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