INVESTOR CAMPUS

CoB: Securities and Investments Course

Module #1 Component #1

The Basics of Investment Instruments

This succinct component focuses on the basics of investment instruments, covering equities, bonds, property and the money market. We look at the risks and returns of these instruments, looked at from the perspective of the institutional investor.

Objectives

To identify the basics of the four major investment instruments.

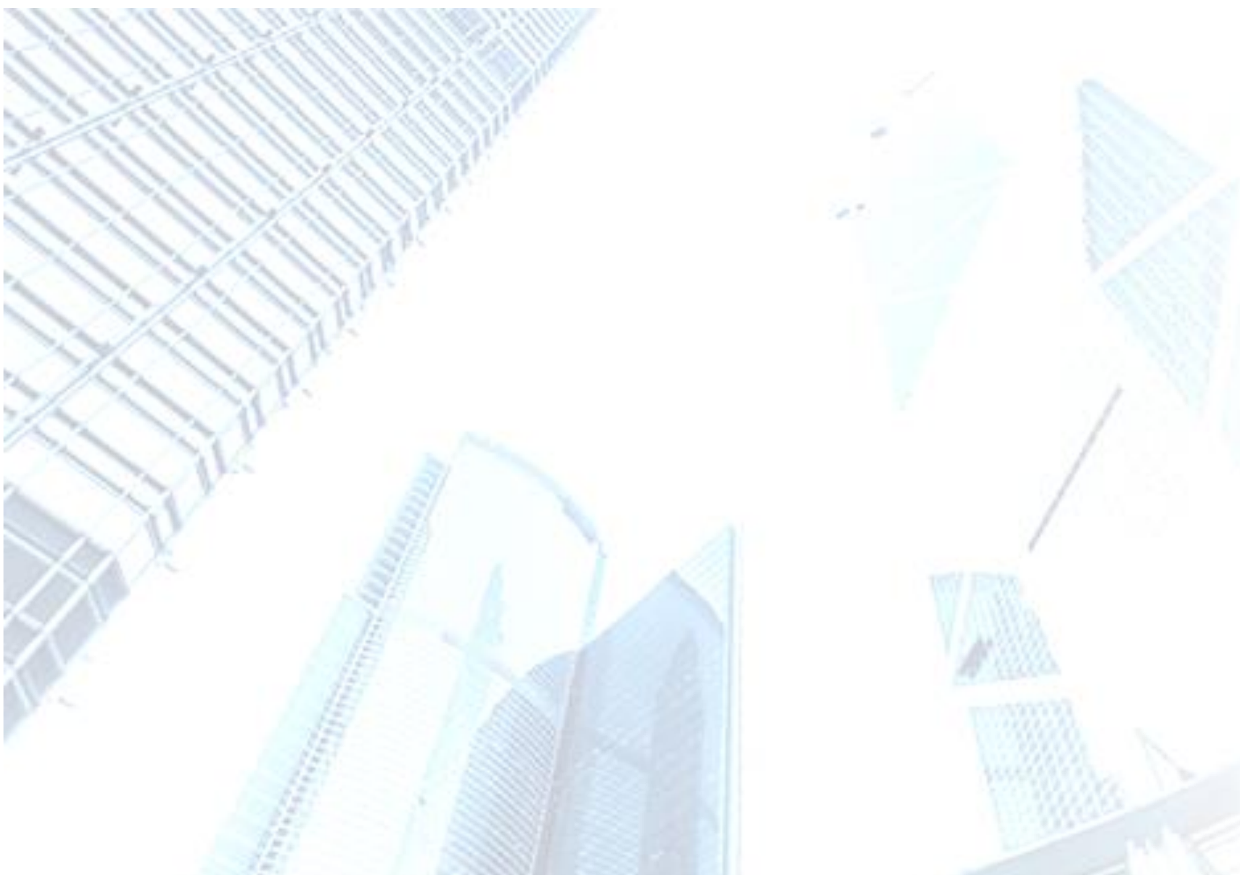
Expected Outcomes:

- ☑ To understand the basics of the money markets.
- ☑ To understand the fundamentals of equities.
- ☑ To understand the three categories of equity investment.
- ☑ To understand the basics of the fixed property market.

Financial Instruments

It is useful for potential investors to gain an essential understanding of all financial instruments and the nature of the markets in which they trade.

Investments or securities may be traded on a formally organised exchange (market) developed for the purpose of trading specific securities, or in a relatively informal and loosely organised 'over-the-counter' market, which usually deals primarily in those investments not listed or traded on organised exchanges. The essential purpose of a securities market is to provide for the orderly transfer of both product and information between buyer and seller. Efficient securities markets facilitate continuous modifications and transfer of portfolio holdings, so as to meet the changing needs of investors. Securities markets are classified according to geographical location, nature of claims traded and time to maturity.



The Money Market

Investments in the money markets are debt instruments with maturities of under one year, usually 90 days or less. Because the minimum investment required to purchase money market instruments is generally very large, the market is dominated by commercial banks, national and local governments and other financial institutions including life insurance companies, pension funds and mutual funds. These large investors purchase money market instruments to convert temporary cash surpluses into highly liquid interest-bearing investments.

Although the various money market instruments have individual differences, they are close substitutes for one another in many investment portfolios and the rates of return on these securities tend to fluctuate closely with short term interest rates. The principal money market instruments used by life insurance companies are treasury bonds, negotiable certificates of deposit, commercial paper and Bankers' Acceptances (BAs).

Although treasury bonds do not offer the highest yield among short term debt instruments, they are very liquid because they can be quickly converted into cash without undue risk of capital loss. In fact, in most jurisdictions they are considered absolutely risk-free because they are fully guaranteed by the local government.

A Negotiable Certificate of Deposit (NCD) is in essence a receipt issued by a bank, financial institution or large corporation in exchange for a deposit of funds and which may be transferred (negotiated) from one owner to another. The issuing institution agrees to pay the amount deposited, plus interest, to the bearer of the receipt on the date specified on the certificate, usually at some time (from one month to a year) after the time of deposit.

Drafts which have been drawn on a bank by a customer and which bear the bank's promise to pay them at maturity are called Bankers' Acceptances. The acceptance reflects the obligation of both the bank and the drawer to pay the face amount. Normally used to finance trade, Bankers' Acceptances are considered among the safest of all money market instruments. They have become of increasing importance as *inter alia*, they set a standard for short-term interest rates and serve as a short-term haven for funds before they are invested in longer-term avenues.

The Capital Market

The capital market is the composite of all markets where long-term securities originate and are traded. The new issues market, a part of the capital market, acts to transfer savings to those with productive ideas by means of the sale of new issues to the investing public.

While money market securities purchased to earn a modest rate of interest on temporary cash balances are of short duration and low risk, capital market investments are of low liquidity and higher risk and therefore generally provide higher returns than those on the money market. Capital market instruments include a variety of paper with either a fixed term to maturity or for perpetuity. Capital market investment alternatives include various kinds of bonds and capital assets. The true nature of a bond is best revealed by defining it as a *contract* to pay money. Under this contract, the issuer agrees to pay the principal sum and a specified rate of interest for the use of the 'borrowed' money. Bonds are issued by governments, municipalities, local authorities and large corporate entities.

The Market in Equities

Equity is the interest of ordinary shareholders in a company, or the market value of a debtor's property in excess of all debts to which it is liable. The word 'equity' is derived from the Latin *aequitas* or *aequus* meaning level or equal.

The equity capital of a company absorbs profits or losses as they arise from the operations of the company. It consists of the issued ordinary share capital and the reserves of the company which may be either distributable or non-distributable to shareholders. Non-distributable reserves will usually include any share premium and other proceeds of a capital nature specified by the memorandum and articles of association of the company. Accumulated, retained earnings normally make up the distributable reserves.

A shareholder enjoys beneficial ownership in the shares of a company he owns and through this, he owns a proportionate share of the net asset value, earnings and dividends of that company.

Ordinary shareholders have rights which are specified in the Memorandum and Articles of Association of the company and which usually allow them to participate in both the profits and net assets after all creditors and other parties who have special privileges have been given their rights. Shareholders are not protected against loss of their contribution to the common stock or equity of a company but, in the case of limited liability companies, any loss to ordinary shareholders is limited to the extent of the nominal value of their shareholding.

(a) Fundamentals

If one owns a percentage of the shares of a company, one owns that same percentage of the company's net worth. Shares (or equities) differ considerably. Each particular issue of shares carries with it certain rights and restrictions for its shareholders as owners of the company. In a company there may be both preference and ordinary shareholders. Although both are owners in the company, the particular nature of each kind of ownership depends on the type of shares held.

Ordinary shareholders simply have an equity in the company and their shares may or may not give them the right to vote at shareholder meetings, depending on the type. Perhaps the most important privilege ordinary shareholders enjoy is that in the event of extraordinary business success they are usually the only group to participate in the increased earnings via increased dividends. They are not personally liable for debts incurred by the company but in the event of business failure or liquidation, ordinary shareholders are the last to be paid. They do however, retain residual rights to any assets that may remain after all the creditors have been settled.

An indirect method of acquiring ordinary shares is to purchase non-equity investments, which give the holder the right to convert all or part of the investment into ordinary shares under specified terms and conditions. The convertible investment is usually in the form of a debenture or a preference share. There are usually a number of provisions included in the terms of a convertible security to protect the holders. One of the most attractive features of equities listed on recognised stock exchanges is that the investment is readily marketable and can be more easily purchased or sold than many other forms of investment.

(b) Three Categories of Equity Investment

i) Direct equity investment
An investor may purchase an equity by making use of the services of a stockbroker who will act as an agent for the buyer. Alternatively, where shares are not publicly listed, the investor may approach other investors with a view to directly buying or selling such shares.

ii) Securities that are convertible
Ordinary shares may be acquired in an indirect way through the purchase of non-equity investments which give the owner the right to convert all or part of the investment into ordinary shares under specified terms and conditions. These are usually debentures or preference shares and the provisions which apply to the convertibility of the instruments will vary greatly.

The desirability of investing in convertible debentures depends on the attraction of the conversion price and its probability of attainment as well as on the coupon (interest) rate. From a taxation point of view, investments can be made in interest-bearing assets or dividend-paying equities with different resultant net rates of yield. However, where an optimistic assessment is made of the prospects of an ordinary share into which the debt is convertible at some future date, the higher yield generally available on this class of security prior to conversion can be usefully employed to upgrade the yield on the overall portfolio, while at the same time offering an option to accumulate an equity participation in the company at the conversion date.

iii) Derivatives

Derivatives are financial instruments that have no residual value of their own. They are called derivatives because they derive their value from the value of some other underlying asset and serve to hedge the risk of unexpected price fluctuations in that asset. They hedge the risk in owning things like bushels of wheat, French francs, government bonds and common stocks or equities.

In short, they hedge the risk of any asset whose price is volatile. They do not reduce the risks that go with owning volatile assets, but they determine who takes on the risk and who avoids it. Derivatives come in two forms, namely *futures*, which are contracts for future delivery at specified prices, and *options* that provide investors with the opportunity to buy (call) or sell (put) securities at a pre-arranged price and time. These are the most sophisticated of financial instruments and are viewed in some quarters as the most intricate, most arcane and even the riskiest of investments.

A call option (or warrant) gives the holder the right to buy or subscribe for a given number of ordinary shares at a specified price, over a specified period or upon a given date. It is a hybrid security in that a right of this nature is neither a debt of the company nor part of its equity capital. It is simply a contract between the issuer and registered holders of the options and is sometimes used as a 'sweetener' when selling debentures or preference shares in order to lower the cost of raising finance for high-risk investments.

(c) Characteristics of Equities

i) Volatility
The examination of any portfolio of quoted ordinary shares will illustrate that the nature of equity investment is that its value fluctuates constantly. The volatility of a share or portfolio of shares may be measured by expressing the deviation from a moving average of the share price over a period of time, as a percentage of the relative moving average value.

This series of deviations can be chartered along a zero axis to give a volatility pattern which is used by analysts in order to project buying or selling indicators. The degree of volatility will vary from share to share as well as within the price behaviour of the share itself. From an investor's point of view, volatility is analogous to profit or loss and is one of the most dramatic measures of risk, it being necessary that as far as possible these very short-term trends be correctly anticipated. Long-term investors, like life insurance companies, realise the importance of investment timing when reference is made to volatility.

ii) Marketability
Ordinary shares can more easily be purchased and sold than many other forms of investment and this makes them attractive to most investors. Like all other commodities, share prices are subject to the basic laws of supply and demand and the marketability of the share is related to such factors as issued share capital, free-float (percentage of shares held by the general public), the control of the company, the future prospects of the company and the net asset value of the company.

iii) Growth prospects
The ability of equity returns to grow provides investors with an incentive to invest these relatively low-yielding securities when compared with high-yield fixed interest investments. To maintain the real value of shareholder's equity, a company's earnings must continue to grow faster than the rate of inflation. Growth companies are usually intent on financing their own expansions from a high level of retained earnings. This generally results in low dividends, but such investments invariably yield substantial capital gains over time.

iv) Voting rights
Certain classes of shareholders may be entitled to vote for, or against, any proposal put forward by the Board of Directors of the company. However, certain classes of shareholders may not be entitled to vote on issues likely to affect the company and it is clear that the absence of a voting right attached to any ordinary share will therefore reduce its value.

v) Taxation
In most jurisdictions, the dividend income generated by investment in equities is not taxable or is taxed at a favourable rate. In addition, capital gains made on realisation of a profit on the sale of the shares is either not taxed at all or taxed at favourable rates. Investors therefore have a considerable incentive to attempt to secure these two forms of income as distinct from the more highly taxed income generated by fixed-interest investments.

(d) Suitability for investors
It has been argued that equity investment is most suitable for conservative investors for a number of important reasons: First, over the long term, better results have been obtained from this type of investment than from fixed-interest stocks in many cases. Second, equity investments serve as a good hedge against inflation because of growing dividends and capital growth.

Overall return, comprising both capital appreciation and dividend income, is considered from a growth point of view to be superior to the static returns available on fixed-interest securities over any length of time. In addition, equity investment has proved to be an essential ingredient in the linked insurance market as it is one of the investment avenues capable of providing long-term growth for the ultimate benefit of widows, orphans and pensioners.

The Fixed Property Market

Property has certain specific characteristics which distinguish it from all other investment avenues. These are its tangibility, uniqueness, size of investment, long-term nature, growth potential, inflationary hedge and the cyclical nature of the market. Its illiquidity contains an element of prestige and requires a high level of expertise not only for the initial investment decision, but also for the subsequent management process.

Investment in fixed property has its own peculiar problems but life insurers and pension funds have found this medium of investment of considerable attraction since the earliest times. The possibility of high yields plus capital appreciation are attractive advantages which frequently offset the disadvantages of illiquidity and interference by forces other than those of the normal market, such as rent-control and town-planning authorities.

(a) Historical Background

After the end of World War II, financial institutions directly owned less than 10% of the industrial, office and commercial properties of the developed world. The properties in which they had invested included those that they occupied themselves. The market was dominated by a few large life insurers and pension funds.

Traditionally, institutions built office blocks in major downtown central business districts. Gradually, however, this trend has changed and in the late 1950s and early 1960s investment swung to the industrial sector, with institutions entering into industrial lease-backs, chain store and shopping centre developments, strip-malls and suburban residential developments. Today, insurers are known to invest in almost every type of fixed property, subject to the policy considerations and criteria which follow:

(b) Policy Considerations

The long-term, relatively illiquid nature of property investment demand that questions of policy are carefully considered before decisions are made on this type of investment.

i. Geographical diversity

Historically, institutional investors have tended to invest only in major city centre areas. More recently however, as a result of the growth of retailing and shopping centre development, direct investment in property has spread to secondary development areas and today geographical diversity is considered important.

ii. Tenant diversity
It is not wise to invest too heavily in one particular tenant or trader. Institutional investors have been criticised for supporting one retailer more heavily than another. Whilst it would seem prudent to spread investment by tenant, fund managers often tend to more readily support established large retail chains and can sometimes become too heavily exposed to them.

iii. Building diversity
Ideally, investors should own a spread of investment properties by building type. As with all portfolios, diversification is necessary for risk reduction. Property, however, is slightly different in that not all life offices have in-house management divisions and are therefore reluctant to invest in management-intensive buildings. They are, therefore, often restricted to tenant lease-backs or investment in property unit trusts.

(c) Investment Criteria
Whilst a good location is perhaps the single most important criterion for all property investments, the other essential investment criteria for each section of a property portfolio may be described as follows:

Office Accommodation:
In the central business districts increased use of clerical labour that uses public transport to get to and from work, will generally continue to entrench established companies in these areas. However, decentralised office developments have been made use of by those tenants who have smaller numbers of clerical workers and who are, for example, smaller industrial firms, advertising agencies, construction professionals, computer companies and other service businesses.
Developing electronic technology, the personal computer at home with the decentralised branch office linked to a central file server, are leading to ever-greater staff decentralisation and thus more dispersed property development. Nonetheless, the adequacy of road systems, public transport, parking, water reticulation and power supply will continue to constrain this category of property investment for decades to come.

Residential Accommodation:
Government intervention such as rent control, or the threat of its imposition has been an important reason for institutions remaining relatively small investors in this sector. In addition, adverse publicity has to be faced when rents are increased, or tenants ejected for developments in line with market forces. Institutions are often accused of 'milking the poor' or abusing the aged. This is a sector therefore, which will be of interest only under specific conditions favourable to the investor.

Residential Sectional Title:
A number of institutions have entered into this market with considerable success in recent decades. However, the decision must be made as to whether the short-term capital profit, which arises from most such developments, is preferable to an escalating yield from a longer-term investment.

Commercial Property:
Life insurers and pension funds traditionally concentrated their property investments in this area. Provided that shopping centres are well-located and designed, and have the correct tenant mix, with a major anchor tenant, they seem generally to prosper. The decision to invest in this sector will be affected by the duration of leases which can be signed, their built-in escalations and the possibility of linking such escalations to the growth in tenant business volumes (turnover). In addition, the ratio of offices to shops in such developments should not be so high as to threaten future margins.

Industrial Property:
This sector of the property market tends to follow the economic cycle more closely than other sectors of the property market. The purpose for which the industrial building is to be used is an important consideration in the investment decision. Buildings created for manufacture are usually purpose-built and fairly inexpensively constructed, frequently in somewhat undesirable locations. This type of industrial building would be less attractive than warehousing and distribution centres, for example, which often afford excellent investment potential. These are usually fairly flexibly designed so that should the original tenant grow out of the premises, re-letting is not difficult. As with all property, location is critical, and the premises should enjoy ready access to major road, rail, port or air networks.

Specialist Buildings:
Apart from a few notable exceptions, it is generally not prudent for institutions to invest in this type of development. They are usually purpose-built and therefore carry a very high risk factor. Those usually classified as unsuitable for institutional investment would include clinics and nursing homes, bowling alleys, entertainment centres, free-standing cinemas, multi-storey warehouses, manufacturing buildings and petrol or gas stations. However, certain specialist buildings may be regarded as suitable investments for institutional investors and could include hotels and parking garages in central business districts.

(d) Other Policy Considerations:
The decision-making structure of financial institutions is particularly important in the area of property investment. It is often incomprehensible to developers, brokers and retailers that some institutions find it impossible to make a decision on property acquisition in under two or three months. Whilst one may recognise that any investment decision requires scrutiny and that at a Board level invaluable advice is often available, it is preferable that all the decision makers should be located under one roof if the institution is to be serious about successful property investment.

Access to high-quality property expertise is important when making a property investment decision. Valuations based on land value, open market rental value and replacement cost value are necessary before the investment decision can be made. In addition, research into the proposed property investment is required in the areas of title deeds (including servitudes), mortgage bond documentation (is the purchaser entitled to cancel a mortgage bond?), planned future road development, existing leases, permissible bulk, zoning, parking and height restrictions. Again, building suitability, flexibility, environment, design and location are among the important considerations.

Another important consideration for the maximisation of yield is the availability of competent property management and administration. This can be carried out either in-house or by employing the services of reputable outside agencies. In this regard, it is important to pay attention to capabilities such as the drawing and renewal of leases, enforcement of escalation and turnover clauses, the timeous collection of rentals, the letting of vacant areas and effective building maintenance and repairs.

Moreover, intelligent tax planning will be required. This may mean *inter alia* that it will suit the institution to vary the vehicle in which the property is held from time to time.

(e) Methods of Investment
The methods by which property investments are made vary according to a number of factors, most of which are dictated by market forces but some of which are the result of a set of decision-making parameters.

Many life offices and certain large pension funds have their own in-house property divisions. These divisions not only make decisions as to new property acquisitions but also manage the existing property portfolio. It is sometimes debatable whether such a division is as efficient as an outside management company, as it may not be as in touch with the market, particularly with regard to rentals, as an independent agent may be. For this reason, many in-house property departments still make use of brokers operating under various guises including property brokers, real estate agents and property economists.

Property may also be acquired through property unit trusts. These have the advantage of being readily available on registered stock exchanges and therefore considerably more liquid than direct property investments. In addition, property unit trusts permit wider diversification and often may be purchased at lower than net asset value.

(f) Conclusion
One of the most crucial ingredients in successful property investment is vision. A relatively small expert property management team, which can make bold decisions quickly and which has a 'feel' for the market environment, is likely to enjoy more success than large bodies of widely dispersed investment decision makers.

Conclusion

The money market, capital market, equity market and fixed-property market represent the four principal avenues for the investment of institutional funds. The general categories found within each of these avenues bring with them their own characteristics, risks, methods of evaluation and selection, and suitability as life office investments.

Money market investments have the distinct advantage of a known yield with a high degree of certainty and security of capital. Their disadvantages include lack of any real growth prospects and the fact that their proceeds are fully taxable. Investments in the capital market, on the other hand, can provide certainty of income but unless held to maturity, carry with them the risk of capital gains or losses depending on interest rate movements. Capital market instruments are usually purchased in anticipation of a fall in interest rates and sold in anticipation of an increase in interest rates.

The equities market has become more important to institutional investors today than in earlier times. Equities are today considered more suitable investments for institutional investors than was the case before the 1950's but they demand a high level of investment expertise and much more active management than before. Significantly more expertise is required for investment in derivatives and the general rule today should be that derivatives are used only to hedge against possible losses which may occur on other non-derivative instruments. This means that, where an event causes a loss to be made on a derivative instrument, that same event will cause an equal or greater profit to be made on another investment held in the same portfolio.

Direct investment in property should only be made where the investment team is known to have a good 'feel' for the market environment, is capable of establishing whether or not the property is well located (a key decision element) and treats residential accommodation, industrial property and specialist buildings with a high degree of circumspection. Where such an investment team is not in place, investment in property unit trusts provides much wider diversification and often at a discount to net asset value, without the burden of ongoing administration which comes with all direct property investment.