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BUILDING CAPITAL: THE CORNERSTONE OF AN INVESTMENT PORTFOLIO

South African investors do not make adequate provision for retirement because they have too little exposure to equities while building capital, and they wait too long before constructing an investment portfolio, according to research conducted by Plexus Asset Management.

“The latest figures released by the Association of Savings and Investments South Africa (ASISA) reveal that only around 22% of the R706,3 billion local assets is invested in pure equity funds,” says Johan Pyper, head of research at Plexus Asset Management.

The recent JSE rally achieved a 37% return, which translates into proceeds totalling R9 250 for a portfolio of R25 000. Although this return cannot make a significant difference to a person’s wealth at retirement, it makes a huge difference on large portfolios: on R250 000 it amounts to R92 500, and on R2,5 million it amounts to R925 000. “This does not mean the R9 250 return is not important to the R25 000 portfolio,” says Pyper. “The amount could equal quite a few months’ contributions and is essential to a portfolio that seeks to build capital.”

According to Pyper one should distinguish between the phase in which an investor focuses on capital building and the phase in which the focus is on capital growth. “A R250 000 portfolio is not built up overnight. It is a difficult and lengthy process,” he says. “During the capital-building phase, monthly contributions usually play a bigger role in the growth of the portfolio value than market yield. The portfolio will enter the growth phase only once the market yield starts to play a more important role than the monthly contributions.”

Another difference between the phases is that the investor can take more risk during the capital-building phase, whereas diversification and capital protection become increasingly important in the growth phase. “The investor thus plays a more important role than the portfolio manager in the final outcome of the capital-building phase, while the portfolio manager plays a bigger role during the growth phase,” he says.

To validate this statement, Pyper uses the example of two investors who invest R1 000 monthly in an equity unit trust from 31 July 1999. Both investors enjoy the benefit of rand cost averaging and over time both should outperform the market.

Unlike investor A, investor B decides not to make a fixed monthly contribution but intends to increase his contribution by 50% for every 5% that the market declines from its previous high. He decides to limit the increase to four times his contribution. The results of both investors’

portfolios are shown in Graphs A below. What is striking is that both cumulative market contributions for 75 months (up to 30 September 2006) were less than their cumulative monthly contributions.

During the period investor A contributed capital of R75 000 and the market contributed growth of R76 000, which brought the portfolio to R151 000. Investor B contributed capital of R108 000 and the market contributed growth of R116 000, bringing the portfolio value to R224 000. During the period equities returned 19,6% per annum. Investor B achieved a return of 20,8% per annum and investor B 22,0% per annum.

According to Pyper this calculation was applied to the period starting when financial markets had stabilised following the 1998 emerging-market crisis when equities were sold off sharply in a very short time. To test the calculations' validity, they were applied across a different period, from 31 March 2002, shortly before the bear market of 30 June 2002, to 30 April 2003.

The results of the new calculations for the portfolios are given in the second set of graphs (Graphs B). For 52 months (up to 30 June 2006) market contributions were less than investor A's monthly contributions. Investor B's cumulative market contributions were less than his monthly contributions (indicated by the dotted line in the second graph) for only 47 months (up to 31 January 2006).

During this period investor A contributed capital of R52 000, while the market contributed growth of R52 000 to bring the portfolio value to R104 000. Investor B contributed capital of R73 000 and the market growth of R82 000, bringing the value of the portfolio to R155 000. By 30 June 2006, when investor A's monthly contributions and market contributions broke even (indicated by the solid line in the second graph), investor B had made capital contributions of R76 000 and the market had already contributed R96 000 to bring the portfolio value to R174 000. During the period equities returned 20,4% per annum. Investor A earned a return of 29,8% per annum and investor B 30,4% per annum.

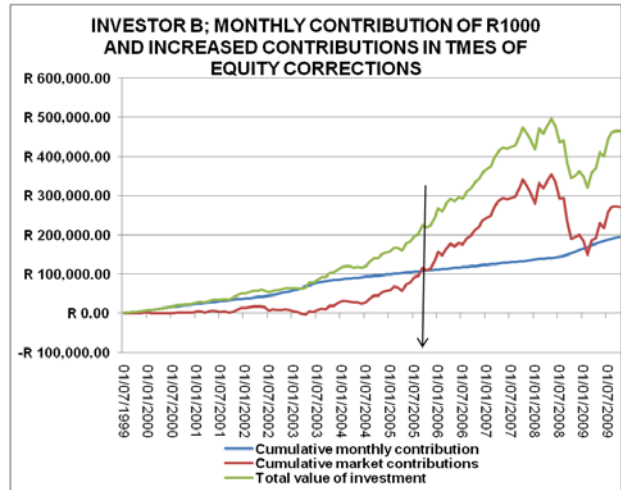
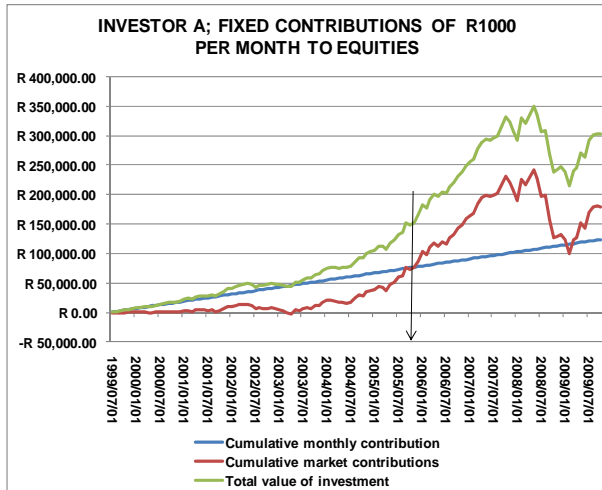
The main difference between the two periods is that the bear market from 30 June 2002 to 30 April 2003 occurred late in the first investment term, but occurred early in the second investment term. "The effect thereof on the final results shows that the benefits of rand cost averaging only came into play late in the first investment term but fairly early in the second term," says Pyper.

According to Pyper the lessons to be learnt from this are:

- Building a reasonable capital base in a portfolio takes time and the capital-building phase should start as early as possible.
- Rand cost averaging is a powerful tool in the hands of the investor and offers maximum benefits in bear markets or in times of market corrections. Investors should not suspend their monthly contributions or invest in the money market during such times.

- Using a good fund manager who outperforms the market and the benefits of market timing to increase contributions could enhance results, but these cannot surpass the importance of the investor and rand cost averaging in the capital-building phase of an investment portfolio.

Graphs A



Graphs B

