Don't let financial jargon throw you off your game

Some key terms to know when it comes to your investments

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For Financial Advisors and their Clients

Novice investors are often overwhelmed by some of the jargon investing professionals use, to the point where it can feel almost like listening to or reading a foreign language.

There's no Duolingo edition that translates financial "industry-speak" to English (at least, not yet), but the following glossary is a start. Of course, this is just the tip of the iceberg, and new investing terms come into vogue all the time. But at a minimum, the terms defined below should serve as a starting point for novice investors or those who are sometimes left scratching their heads after reading a fund manager's quarterly message.

Compounding
"the snowball effect"

Albert Einstein famously referred to the compounding effect as the eighth wonder of the world. In short, it means the longer you keep your money invested, the more likely it is to grow.

Each year you have the opportunity to achieve growth, not only on the money you've already invested, but also on the growth you might have already experienced within your investment. So essentially you earn "interest on interest".

Think of your investment as a snowball, gathering magnitude as it rolls down a slope. The longer the slope (i.e. your time horizon), the larger and faster the snowball becomes.

Learn more about compound interest here

Equities

Equities, also known as stocks or shares, are what many investors first think about when it comes to investing. When investors buy shares, they effectively become a part owner of that company – a shareholder. The reason stocks and shares are synonymous with equities is because owning a share of a particular company means you own equity in that company. As a shareholder, an investor benefits from any share price appreciation (which is linked to the underlying earnings of the company) as well as any dividends the company pays.

Equities in public (listed) companies can be bought and sold on a stock exchange such as the JSE (Johannesburg Stock Exchange). Private Equity refers to ownership in a company not yet listed on a stock exchange.

Over the long run, a well-diversified portfolio of equities is expected to generate sizeable returns above inflation. Over the short term, however, you need to strap in and be prepared for a bumpy

ride as share prices are often impacted by a multitude of factors. Along with their higher growth prospects, equities typically carry higher volatility in the short term in comparison to more stable assets such as cash and bonds.

Bonds

Bonds are usually described as loans to institutions, such as governments and companies, that need to raise capital to fund projects or initiatives. As a bond investor, you're giving your money to the government or company that's issued the bond for an agreed period of time.

In return, the issuer (government or company) pays you a series of interest payments during the period of the loan. The annual interest paid on a bond is called a coupon. At the end of the agreed-upon period (maturity), the issuer repays the original face value amount that you loaned them.

The bond yield is the total annual income you earn from bond coupon payments, stated as a percentage of the price of the bond. Whilst providing a more predictable return than equities, bonds are not without volatility. Bond prices are sensitive to changes in market interest rates (in South Africa, the repo rate). An increase in the repo rate generally causes bond yields to go up, and bond prices to go down. Typically, there is an inverse relationship, as higher interest rates generally cause bond prices to fall, and lower interest rates cause bond prices to rise.

Bonds are typically used within investment portfolios to provide income and to reduce overall portfolio risk when combined with equities.

Learn more about bonds here

Diversification
"not putting all your eggs in one basket"

Diversification is an important investment strategy that spreads investment funds among different assets that are less correlated with each other. This approach helps to reduce risk while maximising return.

The best way to understand diversification is with an example:

It would be particularly risky to invest your entire life savings into a single company, taking a binary bet that the company is going to perform well and generate wealth. If that company performs poorly, you stand a chance of losing everything. Without diversifying, you would inherently be taking on increased company-specific, industry-specific, and country-specific risks. By spreading your investment across several companies that operate in different industries and geographies, you are reducing these risks significantly – and in effect creating a diversified equity portfolio.

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The above is an example of diversifying assets within a single asset class, namely equities. A manager of a multi-asset portfolio will diversify even further, by combining several different local and offshore asset classes, such as equities, bonds, money market (cash) and property within an investment portfolio. Multi-asset managers thus pay close attention to the most appropriate asset allocation for each strategy to both reduce risk and maximise return.

Asset Classes and Asset Allocation

Think of *asset classes* as the different ingredients in your recipe; and *asset allocation* as the recipe itself. Asset classes are categories of investments. Very broadly, the four main ones are equities (also known as stocks and shares), bonds, property (listed real-estate investment trusts or REITs) and money market investments (including cash). Your allocation (%) to different asset classes is called your investment portfolio's asset allocation.

The asset allocation of your portfolio will be closely aligned with your risk profile and the financial needs analysis conducted by your financial adviser. The process of determining the correct asset allocation for one's investment portfolio depends on numerous factors including, but not limited to:

- What level of return do you want to achieve? Do you want to achieve a return in line with inflation to preserve the purchasing power of your investment, or do you want to grow your wealth by achieving above-inflation returns?

- What is your time horizon – i.e. how soon will you need to withdraw from your investment? Certain asset classes require a longer time horizon than others.

- How much volatility can you stomach during the course of your investment period? Will you be able to stay the course in equities or are you prone to panic if you experience a large drawdown in the value of your investment?

The asset allocation recipe varies significantly between a conservative investor, who is less tolerant of volatility and may have a shorter time frame, and an aggressive investor, who seeks to maximise wealth growth and has the time to tolerate volatility.

The below chart shows the asset allocation of a conservative portfolio, for an investor who has a shorter 3-year time horizon. You will notice that the portfolio is made up predominantly of South African (SA) Bonds and SA Cash (money market):

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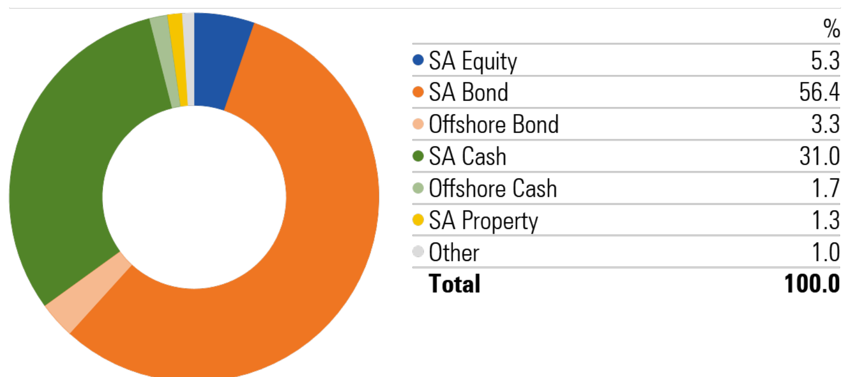
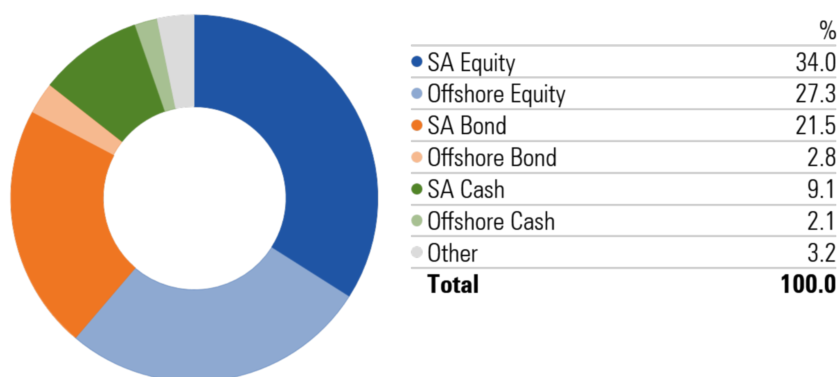


Source: Morningstar Direct as of 31 March 2024

The below chart shows the asset allocation of a moderately aggressive portfolio, for an investor who does not require their money for at least 7 years. You will notice that the portfolio has a significant allocation to local and offshore equities, however, it also includes an allocation to bonds and cash to provide diversification and dampen volatility:



Source: Morningstar Direct as of 31 March 2024

Volatility

Volatility marks how much an investment's price rises or falls. If an investment's price changes more dramatically and/or more often, it's considered more volatile. During periods of heightened market volatility, equity prices will typically move up and down erratically from one day to the next.

Price volatility is usually expressed in terms of standard deviation, or how much an investment's price has fluctuated around its average price over a certain period. A higher standard deviation implies an investment's price is more volatile.

The below chart plots the annualized return (y-axis) and the standard deviation (x-axis) for SA Equities, SA Bonds, and SA Cash over 15 years:

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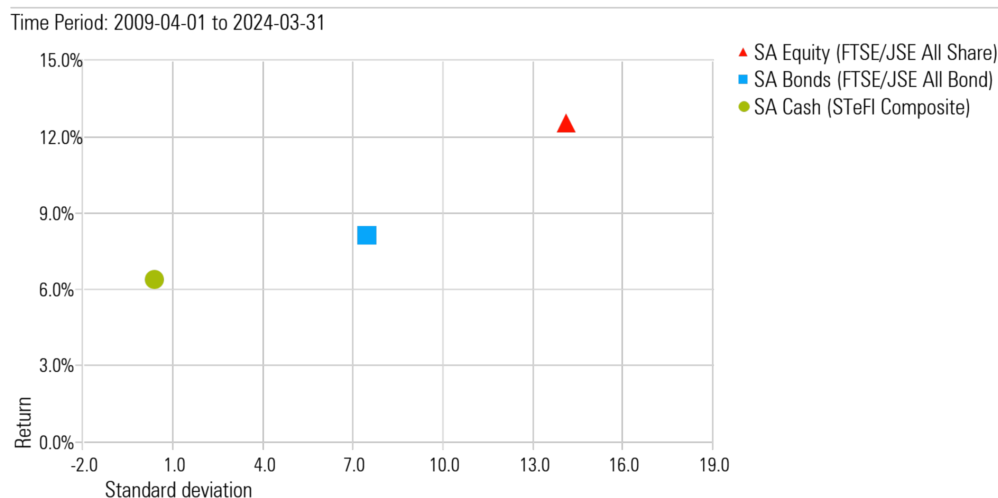

Source: Morningstar Direct as of 31 March 2024.

SA Equity, represented by the FTSE/JSE All Share Index ▲, has the highest return, of over 12%. Whereas SA Cash, represented by the SteFI Composite Index ●, has the lowest return of just over 6%. If we shift our focus to volatility, we can see that SA Equity ▲ has a much higher standard deviation than SA Bonds ■ and SA Cash ●, which means that SA Equities are the most volatile of the three asset classes over this time period.

Investments with more uncertain outlooks, like equities, are typically more volatile. That is because equity returns are based on a company's future profitability, which is difficult to predict. In uncertain market environments, investors tend to be especially pessimistic about how businesses will perform, which can result in steep market declines.

So, why would you want to invest in a more volatile investment? Because you are likely to be rewarded with a higher return over the long term.

Risk

Volatility and risk are terms often used interchangeably, although they are very different. Risk should be defined as "permanent capital loss" or the chance that you won't meet your financial goal.

For a retiree, one risk might be not taking on enough risk. By reducing your exposure to more volatile or "risky" assets such as equities, you could limit your portfolio's potential return over the long run. By remaining in cash for prolonged periods of time you run the risk of increasing your tax bill significantly (due to interest earned being fully taxable) or losing purchasing power due to the eroding effects of inflation.

Even though a more equity-centric portfolio will experience more volatility in uncertain market environments, your asset allocation might not be overly risky. If you're far away from retirement,

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you have time to ride out your portfolio's short-term volatility and take advantage of longer-term gains that equity markets tend to generate.

In closing

I hope that the terms discussed in this article make it easier to decode the next fund manager commentary that lands in your inbox. Of course, if you find yourself grappling with investment lingo, don't hesitate to reach out to your financial adviser who will be best placed to assist you.

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