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The Time Value Of Money Concept

Does Money Have to Generate Income? Why?

Why don't I keep my money under the mattress or locked in a safe at home? Because each pound not saved and kept as idle cash has a decreasing value. In other words, one pound today is worth less a year later. *But really does money have a value?* Yes, money has a value since prices usually increase, leading to a decrease in the purchasing power of money. This phenomenon is called **inflation**. A year ago, my brother and I had LE 1000 each. My brother decided to keep his money at home locked in a safe, while I deposited the money at a bank and received 10% interest on my account. Now, my initial amount has increased to LE 1100, while my brother still has the same amount of LE 1000. Given that the inflation rate in Egypt is 4%, by depositing my principal amount in the bank, I earned 10%, which is higher than the inflation rate. My brother did not earn at least an amount to mitigate the diminishing value of money caused by inflation. Furthermore my brother's opportunity cost was 10%, which is the interest forgone if he would have deposited his money in the bank. Therefore we should not keep our money idle but rather invest it to at least earn the rate of inflation.

What Are The Different Investment Channels, Where Can I invest My Money?

Return Varies According to Risk

Most individuals would like to choose investment alternatives that would result in the highest possible returns; but there is a very important concept that we must not forget, **risk**. For example the landlord has higher returns and risks than the farmer who is working for him. Why? The landlord is assuming the risk of being faced with drought resulting in low crop production and hence exposed to lower crop prices. On the other hand, his returns are greater, if harvesting conditions are good. The farmer however earns his wages regardless of crop productivity and price movements. Consequently, risk is directly related to returns. Hence, the higher the risk, the higher the expected returns and the opposite is true.

In fact, we must start the investment decision process by considering the risk tolerance we are willing to take before choosing among investment alternatives.

Therefore we have to differentiate between two distinct investment horizons, money versus capital market (short versus long term), in order to assess the available investment opportunities and accordingly the related return and risk profiles.

Money Market versus Capital Market

One alternative that you can invest in is **money market** instruments, which are usually investments with a time horizon less than one-year. Thus, investors tapping the money market are investors whose investment strategies are short term in nature, who highly value liquidity and safety more than higher returns. In other terms, investors in the money market want to re-coup their investment back in one year.

What are the main instruments traded in the money market? The safest and highly liquid financial asset in the money market is Treasury Bills issued by the government.

Government Instruments (T-Bills)

Treasury bills are more secure than bank deposits or any other investment alternatives, because the risk of the government being in default, not being able to re-pay interest or principal, is very remote, almost negligible compared to the risk of other borrowers.

How can I invest my money in government Treasury bills?

Treasury bills are marketable securities that are issued and guaranteed by the government, for the purpose of financing its budget. They are highly liquid and redeemable securities that are bought by financial institutions such as banks, mutual funds, insurance companies as well as individuals. In Egypt, there are three types of T-Bills i.e. 91 days, 182 days and 364days. The returns on T-Bills are usually lower than the returns on bank deposits because their risk is lower. Therefore, if I invest LE 1000 in T-Bills 91 days, I expect to receive 9%, which is lower than the 10% earned on bank deposits. This conforms to the risk/return tradeoff i.e. the risk and return of investing in bank deposits is higher than that of Treasury bills.

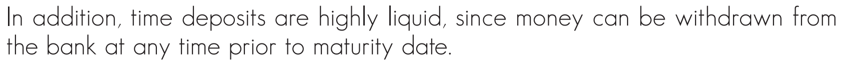
Treasury Bills versus Deposits

What is the difference between T-Bills and bank deposits? When you deposit money in a bank, you pay the initial amount and then at maturity date you receive the initial amount as well as the interest earned. On the other hand, you pay a lower amount when you purchase T-bills compared to their par value, which you will receive after a certain period i.e. 91 days. For example, I pay LE 990 today for T-Bills 91 days and later receive LE 1000 after three months.

Bidding for T-Bills

The method of offering Treasury bills to the market is through auctions. The entity or financial institution that pays more than the other entities will win the bid, which is the same process as any other auction in the market. But paying more today means that you will receive less tomorrow. For example the financial institution will certainly obtain the bid if it pays LE 980 rather than its competitor which is willing to pay only LE 970. However, the former institution will receive on maturity date LE 20 rather than what the later would have received (LE 30).

Bank Deposits Another short-term and safe investment tool is deposits in commercial banks. Bank deposits are less safe than treasury bills since banks can go bankrupt. In practice, you earn interest on the savings that you deposit in the bank. This interest depends on the maturity date, which is the date when your account is due. On maturity date you can either withdraw your principal amount plus the interest earned or renew your deposit for another period. Banks offer clients time deposit with different maturities such as one month, three months, six months and less than one year. The advantage of time deposits is that the bank guarantees repayments.



In addition, time deposits are highly liquid, since money can be withdrawn from the bank at any time prior to maturity date.

Then, what is the level of risk that I take when I save my money in the bank? You take the risk that the bank can be bankrupt. However, it should be pointed out that banking operations are well regulated by the Central Bank of Egypt, which provides protection to depositors. Therefore bank deposits are considerably a safe way to invest your savings. Yet one should expect a lower rate of return on bank deposits than treasury bills due to their lower risk.

Commercial Paper Another short-term investment tool is commercial paper, which is issued by well established companies such as IBM, Procter & Gamble etc. in order to finance their short-term or working capital requirements. Commercial paper is highly liquid and is traded on the secondary market. There are currently no commercial paper traded in Egypt.

The Capital Market

The second alternative that you can invest your money in is the capital market, which is a long-term investment above one-year. Hence investors tapping the capital market must have a long-term investment horizon and liquidity is not their main objective but rather higher returns. Investors in this category are willing to take a higher risk since they expect higher returns.

What are the main securities traded on the capital market? The capital market is a market where fixed income (bonds) and equity (common and preferred stocks) are traded.

The Stock Exchange

Where does capital market transactions occur? They take place on the stock exchange, which is an organized market, governed by specific rules and regulations. At this marketplace, one can buy and sell stocks and bonds. To clarify it more, the stock exchange is like any other market where goods or services are bought and sold. However buying and selling is not allowed directly by investors but rather through their agents i.e. brokers.

What Is The Role of The Broker And What Is The Cycle of Any Transaction?

Investors cannot buy or sell securities themselves but must seek the services of brokers. Brokers charge commission fees for their service, which are agreed upon in advance with their clients. The Capital Market Authority is the regulatory body authorized to grant brokerage licenses in Egypt. Apart from executing orders and providing research to their clients, brokers ensure professionalism and market integrity in the capital market.

The Cycle of Any Transaction

Client wants to buy or sell a stock or a bond

↓

Consult and contact the brokerage firm

↓

Formulate order, specify price, quantity and type of security to be purchased or sold

↓

The brokerage firm contacts its floor broker, and gives him the buy/sell order
At Time T

↓

Order is processed through the Stock Exchange
At Time T

↓

Misr clearing, settlement and depository handles the clearing and settlement of shares and bonds
At Time T, T+1, T+2

↓

Brokerage firm receives the transcripts of ownership or the physical shares themselves
At Time T+3

↓

Brokerage firm gives the bookkeeper of the client the physical shares or the transcript of ownership

With respect to the most active stocks traded without price limits, (34 stocks as per end of November 2005), clearing and settlement take place on T+2. While physical shares' clearing and settlement take place on T+4.

The Debt Market

What are the basics of the debt market? Investing in the debt market means buying government or corporate bonds. Corporate bonds are riskier than government bonds, which are guaranteed by the government. Bondholders are lenders not shareholders of the company. Lenders or bondholders do not assume the high risk that shareholders do. Meaning if the company goes bankrupt, lenders get paid their money back prior to shareholders, if there is money left. Furthermore, bondholders not only get paid first in case of bankruptcy but they also assume a lower risk. This is because bondholders are paid a fixed interest on their money, irrespective of the company's results. However if the company experiences a very profitable year, bondholders can not benefit from this profitability. Thus, the bondholder's return is lower compared to their lower risk.

Investing in the Debt Market

How can I invest in debt instruments? You can invest in the debt market by purchasing bonds. A bond is a promissory note issued by a corporation or by the government, which entitles the bondholder to interest payments for a specified numbers of years. In addition, on maturity date, the company pays the principal amount to the bondholder. For example if a bondholder buys a bond at a par value of LE 1000 that promises to pay 12% interest rate for five years, then the bondholder earns LE 120 annually for five years plus the initial principal amount (LE 1000) at the end of the fifth year. If the company's performance is exceptionally good during the second year, the bondholder does not enjoy extra benefits but is only entitled to the fixed coupon payment LE 120 plus par value of the bond on maturity date. In Egypt, there are 27 government bonds (treasury and housing) and 27 corporate bonds (fixed and floating rate) as of end of June 2003.

Different Coupon payments on Bonds

Bonds earn coupons annually, semi-annually or quarterly. Assume a bond with a par value of LE 1000, pays a 10% interest semi annually, rather than annually, you will receive LE50 twice a year or every six-months. But if the same bond, pays interest on a quarterly basis, you will receive LE 25 four times a year or every three-months.

What Is The Difference Between Fixed And Floating Rate Bonds?

Fixed rate bonds are bonds that pay a fixed interest, which is predetermined in advance, prior to the bond offering. *So, if you buy a bond with a fixed rate, how much will you earn?*

You will earn both current yield on the bond as well as yield to maturity, in case of fixed interest bonds, which is the rate of return earned if the bond is kept till maturity.

We have first to define certain bond terminology, the **par value or the face value** of the bond that the company issues it at, which is always at LE 100 or LE 1000

per bond. The bond promises the bondholder a **fixed interest or coupon payment** such as 10% annually till maturity. On the other hand the **current value or market price** of the bond is the price at which you buy the bond at the secondary market. The **current yield** on bond is the interest paid on the bond divided by its market price, which is the same concept as dividend yield. For example a bond that pays 10% coupon interest rate and is traded at LE 98 will have a current yield be 10.2%. As for **the yield to maturity,** it is the rate of return that you expect to earn if you buy a bond at a specific price from the secondary market and held it till maturity. The yield to maturity (YTM) is calculated by the following formula:

$$MP=\Sigma\ c/(1+YTM)^{t}\ +PV/(1+YTM)^{n}.$$

Where MP is the market price, PV is the par value, C is the coupon, n are the number of years.

If the market price of the bond is exactly the same as its par value, the rate of the return earned on the bond or its yield to maturity will be equal to the coupon interest. If the market value of the bond is higher than its par value, the yield to maturity on the bond will be lower than the coupon interest and vice versa. Thus there is an inverse relationship between the bond price and the yield to maturity. The following numerical examples illustrate the above-mentioned relationship.

Case one:

a. If MP= LE 950
b. PV=LE 1000
c. C=10% (annual interest)
d. N=5 years
e. Then the YTM is 11.36%

The yield to maturity is higher than the coupon interest, since the market price on the bond is lower than its par value.

Case two:

a. If the MP=LE 1050
b. PV=LE 1000
c. C = 10% (annual interest)
d. N=5 years
e. Then YTM is 8.72%

The yield to maturity is lower than the coupon interest, since the market price on the bond was higher than its par value.

Case three:

a. If the MP=LE 1000
b. PV=LE 1000
c. C = 10% (annual interest)
d. N=5 years
e. Then YTM is 10%

The yield to maturity is equal to the coupon interest, since the market price is equal to the par value.

From the above analysis, it can be noted that the yield to maturity and bond prices has an inverse relationship, which is the reason behind active bond trading. Some investors buy bonds at their par value and sell them when their market prices exceed their par value. On the other hand, other bondholders are willing to buy those high priced bonds as they earn a higher yield to maturity than the current coupon rate. Therefore investing in bonds necessitates that bondholders follow closely the price and yield to maturity relationship. This information can be found in the daily and monthly reports published by Cairo & Alexandria Stock Exchanges, Reuters, Bloomberg and some local and foreign brokerage firms that cover the bond market in Egypt.

What are Floating rate bonds? Floating rate bonds pay interest that is not fixed but is rather adjusted according to a benchmark like the Treasury Bills rate, Central Bank of Egypt discount rate or LIBOR rate. Companies usually issue floating rate bonds when future interest rates cannot be easily predicted. Due to volatile fluctuations in international interest rates in the late 80's and 90's, international firms prefer issuing floating rate bonds rather than fixed rate ones.

In terms of floating bonds, the interest will be set as a benchmark such as 0.5% margin over the T-Bills rate 91 days. If the T-Bills 91 days earns 8.82%, then the floating rate coupon rate will be 9.32%. If the benchmark is set at 3% below discount rate, the floating bond rate will be equal to 9% if the discount rate is 12%.

The Equity Market

What does the term equity mean? Equity securities are shares or stocks acquired by the investor, when he/she buys stocks of a specific company. Therefore, when you buy a stock of a company, you become an owner in this company. For example well-established or newly listed firms will face a period when they need extra funds but do not have enough retained earnings or have access to bank funding or bond funding. As a result these firms tap the stock market for equity funding. In other words, they raise capital by offering ownership in their company to existing or new shareholders.

Different Equity Securities

Are all stocks similar in type? There are two different types of stocks traded in the market: **Common and preferred**. Both common and preferred stockholders are owners in the company.

Common stocks are riskier than preferred stocks, since they do not guarantee dividend payments. Preferred stockholders are promised a fixed periodic dividend that must be paid before payment of any dividends to the owners of common stocks. It is the preference in dividend distribution that makes common stockholders the true risk takers with respect to receipt of periodic returns. Consequently preferred stockholders are not normally given the right to vote. Furthermore preferred stockholders are usually given preference over common stockholders in the liquidation of assets as a result of an organization's bankruptcy.

On the other hand, common stocks can earn higher dividends than the preferred ones, during successful years. In addition, common stocks grant their owners voting rights in the General Assembly Meeting.

In Egypt, preferred shares have a peculiar nature since they are entitled to earn the same dividends as to common shareholders. In other words, they have no preference in dividend distribution. Also preferred stocks enjoy double voting rights compared to common stocks. It is worth mentioning that by the end of June 2003, the number of listed preferred shares was 14 compared to 1121 listed common shares.

Why Would One Invest In Common Stock although Preferred Stock Seems A Safer And More Guaranteed Investment?

Dividends & Capital Gains

Investors choose investing in common stock despite the safer preferred stocks due to the higher expected gain from common stock i.e. dividends or/and capital gains. Common stockholders expect to earn a return by receiving dividends i.e. periodic distribution of earnings (dividend yield) or/and by realizing gains through increases in share prices i.e. capital gain.

Do companies distribute dividends every year? No, not necessarily, because companies earn profits during some years and in other years incur losses. Therefore, dividends paid out to common stockholders is a function of several factors including the company's overall profitability, investment requirements, market conditions as well as its internal dividend policy.

Accordingly the rate of return on common stock is calculated using the following formula:

$$k_e = d_1/P+g$$

k_e is the cost of equity or the rate of return expected by investors if they invest in stock

d_1 is the dividends to be earned next year

P is the market price of the stock

d_1/ P is dividend yield

g is the growth rate or capital appreciation or difference between price today and price next year.

Assuming:

- The market price of the stock is P = LE 52
- The dividend paid last year was d_0 = LE 4
- The growth rate or g = 6%
- Dividends next year is d_1 or LE4 + (LE4*0.06) = LE 4.24
- Rate of return on equity is k_e = 4.24 / 52 + 0.06 = 14.15%

Methods Used by Firms to Raise Funds

In the above-mentioned discussion, we tackled investment alternatives from the point of view of investors. However there are two sides to the coin, not only investors but also the companies issuing the various investment instruments. Hence in this part we will explain briefly the various methods that firms use to raise funds.

The Money Market

Companies can raise funds through the money market, by borrowing money from banks. Around 70% of the offered loans by commercial banks in Egypt are short-term loans for one year or less.

An important issue about bank loans is that interest on loans is tax deductible. In other words, interest on the money borrowed from banks is tax exempt. For example if the company is borrowing at 12% and the tax rate is 40%, then the cost of debt after tax will be 7.2% rather than 12% since the firm does not pay taxes on its interest charges. Therefore borrowing from banks will lower the cost of debt for the firm.

Also companies can borrow long-term loans and in this case they pay a higher interest due to the longer period. In Egypt there is very few financial institutions that can lend firms on a long-term basis.

Borrowing money from banks is not always the solution to meet the company's needs since there are limits on the amounts of money that companies can borrow. Banks will not continue lending a company unless its debt ratios as well as coverage ratios are satisfactory. If the company's debt ratios are too high and its coverage

ratios are low, banks will be reluctant to lend the company and charge very high interest rates resulting in the complete wipe out of the benefits from tax exemption that the company enjoys from more debt.

In addition, the majority of available loans in Egypt is short term, which is not suitable for financing long term fixed assets. Finally companies relying solely on bank loans must pay the fixed charges i.e. interest on debt as well as the debt repayment till maturity. The higher the debt funding in the company's capital structure, the more liable the firm is to default on payment of the interest or principal leading to its bankruptcy.

The Debt Market

Companies can also raise long term funds by issuing bonds. There are several benefits of raising funds through bonds. First the cost of issuing bonds is usually lower that the cost of funds borrowed from banks. Furthermore bonds can have longer maturities such as 5 years, 7 years, 10 years or more which suits better the finance of long-term assets. In addition, the borrower or the company issuing bonds is exempted from paying taxes on interest, same as borrowing loans. Moreover the issuing company has to pay interest or coupon on bonds annually but the face value or initial amount on debt is paid at the maturity date. In case of loans, the borrowing firm has to repay a portion of the loan amount on an annual basis and not at the end of the loan agreement.

By law companies cannot issue bonds unless they are rated by an independent rating agency, which assigns a rating to the credit riskiness of the company. In Egypt, there are some companies that are licensed by the Capital Market Authority to rate bonds such as Nile Rating, Moody's, Standard & Poor's and Fitch IBCA etc.

The Equity Market

Another tool that can be used by companies to raise funds is to offer ownership rights to investors by selling them common or preferred stock. The shares of the company can be offered for sale to potential investors either in the stock exchange, if the company is listed on the stock exchange or Over the Counter (OTC) if the company is not listed on the stock exchange. The advantage of equity funding is that investors become owners who are willing to assume the risk of the company. The cost of preferred stock is equal to the dividend paid on preferred stock divided by its market price. If a preferred stock is traded at LE 80 and it pays LE 12 dividends, then the cost of preferred stock is 15%.

Preferred and common stock does not benefit from tax exemption as debt. Hence the cost of equity for the firm will be always higher than the cost of debt. The cost of common stock is the interest rate or rate of return earned by investors on common stock or

$$k_e = d_1/P+g.$$

Why do companies get listed on the stock exchange?

On a worldwide basis, it is prestigious to get listed on the stock exchange. Listed companies gain high visibility and can easily have access to equity funding. Most stock exchanges have stringent listing rules (profitable companies, good earnings prospects, strong industry, qualifications of management, amount of capital etc.) to maintain the quality of the listed companies. In Egypt, the Stock Exchange had in place new listing rules effective 1 August 2002.

The majority of companies, which seek listing on CASE, do so merely to enjoy tax benefits. By law listed companies are tax exempted a certain percent (three months deposit rate set by the Central Bank of Egypt) on the paid up portion of their capital. Due to this advantage, many companies get listed on CASE despite their negligible trading. Currently there are over 700 companies listed on CASE. The 100 most active companies account for the bulk of trading i.e. more than 80% of the volume and value traded and 90% of the number of transactions of the total market.

It should be pointed out that there are four listing schedules on CASE:

There is Official schedules (1) and (2) and Unofficial schedules (1) and (2). All companies listed on these four schedules are traded on the stock exchange and enjoy tax benefits.

Should I know in which schedule each company is listed? Yes, since the listing requirements are different, knowing the schedule in which the company is listed will help you in evaluating your risk exposure. For example, companies listed on the Official schedule (1) must have 30% as free float and three years financial statements whereas companies listed on Unofficial (2) has no minimum requirement for free float and only one year financial statements. Therefore, companies listed on the Unofficial Schedule (2) are more risky than Official Schedule (1).

Why Do Prices Fluctuate?

I do not understand why do prices of stocks keep changing? You have to think of stocks like any other commodity in the market. The prices of commodities fluctuate based on their supply and demand relationship. For example if the demand for tomatoes is lower than the supply, this will cause the prices of tomatoes to go down. The same applies to share prices.

It should be pointed out that there are two approaches to security analysis to determine prices. The first approach or **Fundamental Analysis** begins with the

assertion that the true value of any financial asset is equal to the present value of all its cash flows. Thus the price of the stock is equal to its future dividends (cash flows) discounted back to the present using the dividend discount model. $P = d1/(k-g)$. P is the market price of the stock, d1 is the expected future dividends, k is the discount rate and g is the growth rate. Once the true value of the common stock is determined, it is compared to the current market price of the stock in order to see if the stock is fairly priced or not. If the intrinsic or true value is higher than current market price, the stock is undervalued and should be bought and vice versa. Fundamental analysts believe that misplacing will be eventually corrected if there is an efficient market. Thus prices of undervalued stocks will show unusual appreciation and prices of overvalued stocks will show unusual depreciation.

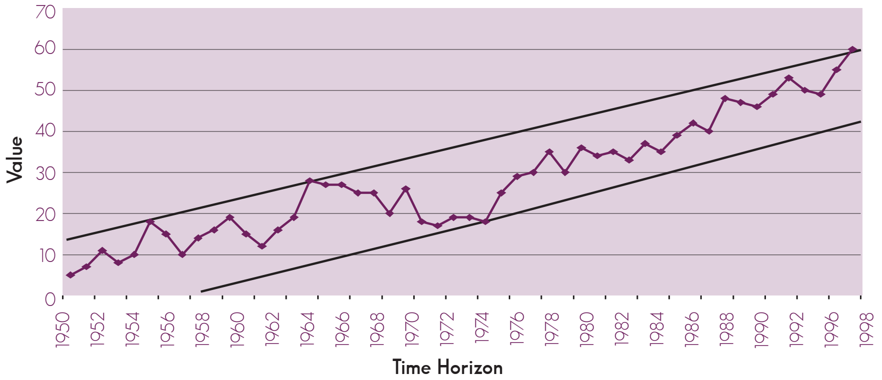
In order to forecast the security's true value, fundamental analysts forecast future levels of the economy's Gross Domestic Product, inflation, discount rate etc. Therefore if the economy is in a recession, stock prices will go down but if the economy is booming, prices of stocks will go up. World and national events affect stock prices such as the Gulf War, which had a negative impact on many stock exchanges. Furthermore analysts forecast future sales and earnings for a number of industries or sectors. If a company is in a growing industry such as high tech, we expect this to have a positive impact on its price and vice versa. Finally analysts forecast expected returns on specific stocks. The most important factor that influences the price of a stock is its company specific factors or its overall performance. If the company's cash flows are higher and its growth potential is strong, its price will appreciate and vice versa.

In the above approach, analysts are first concerned in making forecasts for the economy, industries and finally for individual companies. This is a **top down approach**. Other analysts begin with estimates of the prospects for companies, then build to estimates of the prospects for industries and ultimately the economy which is a **bottom up approach.** Using either method, the fundamentalists are concerned with identifying **which stocks are mispriced** in order to buy or sell them.

The second approach or **Technical Analysis** involves the study of stock market prices in an attempt to predict future price movements. Initially past prices are examined in order to identify recurring trends or patterns in price movements. This matching of emerging trends or patterns with past ones is done in the belief that these trends or patterns repeat themselves. Technicians attempt to predict short-term price movements and thus make recommendations concerning **the timing of the purchases and sales of either specific stocks or the market as a whole.**

Therefore price fluctuations is an expected and normal phenomenon in the stock market. According to Fama's random walk theory, stock prices follow a random walk so it is difficult to predict prices as they change according to events that could be company specific, industry related or economy related.

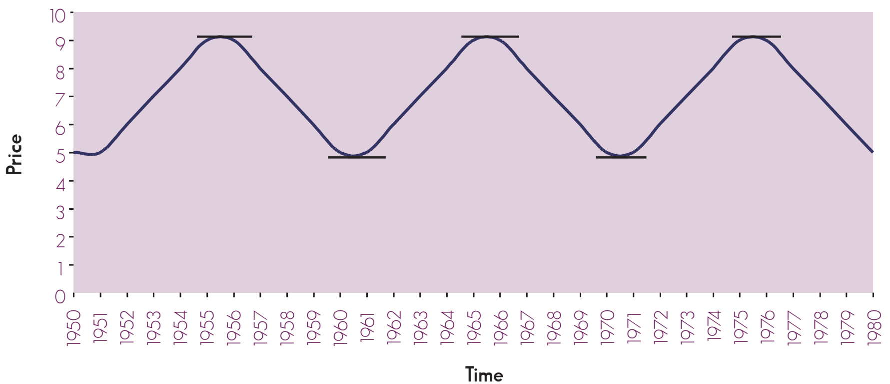
Stock Price Movements



The graph above shows that the long-term direction of stock prices, despite high and low fluctuations, will be upward, due to inflation.

Usually stock markets follow cycles, like the economy that tend to be upward sometimes and downwards at other times. Recent studies have shown that very high stock prices (bull market) are followed by very low prices (bear markets). To move from a bear market to a bull market, it takes 1 to 2 years in developed markets and 3 years or more in emerging markets.

Economic Cycle



It should be mentioned these charts are for illustrative purposes only and do not represent future performance of the stock market.

Which Stock/ Sector to Buy? Portfolio Selection

It is very difficult to choose among various stocks and bonds, how can I start? First you have to ask yourself a vital question, do you want to invest in the stock market? If the answer is yes, then you have chosen the highest risk/return investment tool. Second do you want to invest directly in the stock market? If yes is the answer, there are various things you must do. How much money will you be willing to invest in the stock market? Knowing that the stock market is the most risky investment vehicle, it is not advisable to put 100% of your money in stocks. Rather diversify your risk by allocating your wealth among various investments including bonds, money market instruments, stocks, real estate etc. However you could put more weight on stocks e.g. 60%, dependent on your risk tolerance. Furthermore you have to choose a reputable brokerage firm that provides you with quality research. Brokers not only execute investors buy or sell orders but they must advise their clients since they follow closely market directions and companies' financial performance. Therefore you should ask your broker to provide you with their in-house research concerning the stock market, the various sectors and companies you are interested to invest in. Though the brokers' research is one of the sources that could help you in making an investment decision, it is advisable not to base your decision on your broker's research only. You should therefore try to gather as much information as possible from other venues. They include published financial statements of the companies, auditors' reports, industry or sector reports, economy reports, publications by the stock exchange etc. You could also seek the advice of investment consultants or advisors.

Portfolio Diversification An important factor that you must consider when you are deciding on the sector and company you want to invest in is that you must choose more than one company and one sector. In other words you should invest in at least 8 to 10 companies and four to five sectors, in order to diversify your portfolio risk. Diversifying your portfolio risk occurs when you buy **at random** several stocks from different sectors. Portfolio diversification will virtually eliminate the non-systematic risk (company specific risk) and limit your risk only to market related or systematic risk.

In all the above steps, the investor should be very clear that research is a very vital process prior to the stock/industry choice and portfolio selection. This is because the investor is investing directly in the stock market and his/her investment strategy will determine his/her risks and returns.

Invest Indirectly in The Stock Market via Mutual Funds

Mutual Funds

If I do not have the pre-requisite knowledge and technical expertise about the capital market, can I still invest in the stock market? If you do not know a lot about the stock market and cannot analyze financial reports, you can still invest **indirectly** in the capital market through mutual funds. You can buy investment certificates issued by the different mutual funds operating in the market. Thus an investor, who is not well informed about stocks or bonds and is not capable of following the market, has the opportunity to invest in the stock market via the mutual funds venue or portfolio management firms.

The importance of investing through mutual funds is that they have expert and professional management that can take better and well-informed investment decisions. Furthermore mutual funds pool large amounts of money from thousands of small investors and then re-invest these amounts in different investments i.e. money market instruments, bonds and stocks. Through their portfolio diversification, they are able to minimize risk exposure for the holders of their fund. In addition, mutual funds provide high liquidity to small investors that can easily redeem their money back any day at lower transaction costs. Another benefit is that investors use the services of brokers and wait for their shares/bonds to be sold to collect their money, which takes longer time especially if the market is down or the securities are infrequently traded. Finally mutual funds are particularly advantageous for those willing to invest very small amounts of money starting from LE 500.

Open and Close Ended Funds: What is the difference between an open and close ended fund? **Open funds** are funds with an unlimited number of shares where investors can buy or sell (redeem) shares whenever they want. The Net Asset Value of the fund is calculated on a daily or weekly basis. It is equal to the market value of the outstanding shares of the fund less the fund's current liabilities divided by the number of outstanding shares of the fund. On the other hand, **Close funds** have a fixed number of shares and are traded on the stock exchange. Their price is determined like ordinary shares i.e. based on the supply and demand of the shares of the fund. In Egypt we have 18 open funds and 2 close funds.

Different Types of Funds

You must differentiate between the different types of funds, in the market, before making a choice among them. First, there are **income funds**, which include highly liquid securities such as money market instruments, deposit in banks, treasury bills in order to generate current income. These funds usually distribute dividends on a stable basis. On the other hand there are **growth funds** which invest mainly in common stocks, in order to achieve high returns over the long term. Another type is **income/growth** funds whose objective is to achieve a mix between the two strategies of growth and income. These funds invest in a wide variety of money market instruments, bonds, preferred and common shares so that they take advantage of long term trends.

In order to choose among the various mutual funds operating on the market, the investor have to collect enough information on the nature of funds, their investment strategies, management fees, management experience etc. The decision to invest in growth or income funds will be affected by the investor's time frame, investment objectives, risk tolerance and expected returns.

Portfolio Management Companies

For larger amounts of money, usually above LE100, 000, you can make use of portfolio management companies which are better suited to handle the investor's particular needs. The investment strategies, the risk exposure, portfolio selection and composition of each investor can be agreed upon individually in order to satisfy individual objectives. In other words, the investor decides on the investment strategy, investment tools and the level of risk/return together with the assistance and advice of his/her portfolio manager. If circumstances in the market change, the investor can review his/her portfolio to modify his/her objectives.

Never forget few things: what is your individual investment goal? Are you satisfied with the present results? How are your investments doing in line with the market? Always view things in relative terms. If the stock market fell by 10%, while your portfolio only dropped by 4%, this means that your portfolio is doing better than the market, however, in absolute terms it dropped by 4%. If you find yourself unhappy with the current results, you can always change your goals and the portfolio mix with your portfolio manager or change the portfolio manager all together.

How Can I Build My Investment Strategy?

Now that you have a better idea about various investment alternatives, you can build your own strategy. First, you have to identify your needs. What are your expenses, what is the level of your income, how much do you have set-aside for emergencies? Then you are able to decide how much money you can spare. Defining your investment objectives is crucial. You have to clearly define what you really want, in terms of the amount of wealth that you can invest, the risk you are willing to take, your expected returns and their frequency of occurrence. Then you will allocate your wealth on the different investment instruments (money market or /and capital market instruments) according to your investment objectives. Investing directly in the capital market requires that the investor construct his/her own portfolio (stock and industry selection) so as to diversify his/her risk. Meaning that the investor aims at maximizing his/her returns for a given level of risk. Diversifying your portfolio will enhance your returns and help reduce your overall investment risk.

On the other hand, investors might choose to indirectly invest in the capital market via mutual funds or/and portfolio management firms, if they do not have the technical expertise to invest directly.

Evaluating the risk that you are willing to assume is the most crucial part in building your investment strategy, since whichever investment instrument you choose, it will always be your risk. As a matter of fact, identifying the right mix is a key factor to successful investing, since stocks and bonds often react differently to economic and market situations.

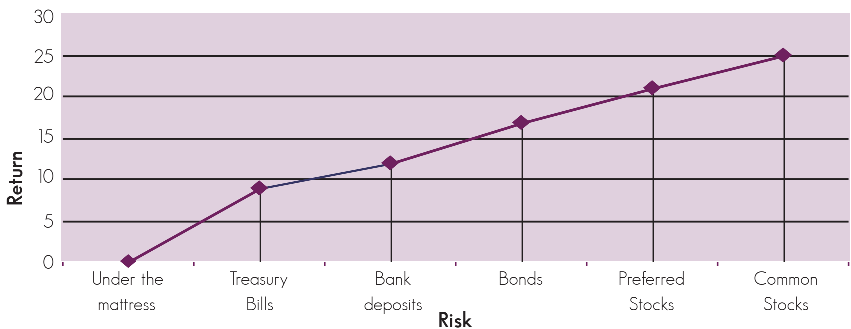
Based on each investor's investment objectives, strategies, time framework, risk tolerance and required returns, one of the following three distinct strategies can be adopted:

a. **A short-term strategy**, one year or less, relies on a stable current income, capital preservation and liquidity, while maintaining a small portion in stocks for growth potential. A short-term strategy would allocate 50% on money market instruments, 40% on bonds and 10% on equities.
b. **A medium-term strategy,** one to three years, relies on a balanced approach emphasizing equities and bonds more than current income. A medium-term strategy would allocate 40% on equities, 30% on bonds and 30% on money market instruments.
c. A long-term strategy, three to five years, emphasizes mainly growth potential and higher returns. A long-term strategy would allocate 70% on equities, 20% on bonds and 10% on money market instruments.

The above strategies are for illustration purposes only.

In short, invest your time before you invest your money. Time is the most precious resource that you have, therefore, invest your time in the most efficient and effective manner by learning, knowing, studying and understanding more about capital market and investment fundamentals. Time spent in pursuing knowledge will yield the highest returns. Always bear in mind that it will be your choice and your risk. Investing in the capital market is a long-term investment perspective for a period of 1 to 3 years.

Investment Alternatives



It is clear from the graph above that the higher the risk, the higher the returns. Placing your money under the mattress will yield a zero return, since you are not willing to assume any risk, except may be the risk of having your house stolen. Treasury Bills will generate the lowest returns since they are the least risky investments. Deposits in banks will yield a higher return than Treasury Bills, since placing your money in a bank is riskier than buying government instruments. Bonds are riskier and thus will yield a higher return than bank deposits. Corporate bonds are riskier than governmental bonds so they will earn a higher return. Preferred stocks will yield a higher return than bonds since they are riskier than bonds. Finally, common stock is the riskiest of all other instruments therefore their return is the highest.

Follow Up Your Own Portfolio

The evaluation of your portfolio is a continuous and important task, where you have to appraise your portfolio either on a monthly, quarterly or annual basis. Furthermore brokerage firms, mutual fund management and portfolio management companies send their customers' regular reports on the performance of the stock market in general as well as their individual investments. Other sources include Reuters and Bloomberg, as well as the stock exchange publications. The follow up on your portfolio is an essential process, since it helps you in assessing whether your achieved expected rate of return matching your risk profile. If this is not the case and you are not satisfied with the achieved returns, you can always make the necessary adjustments.

In the follow up process, the following tips should be considered:

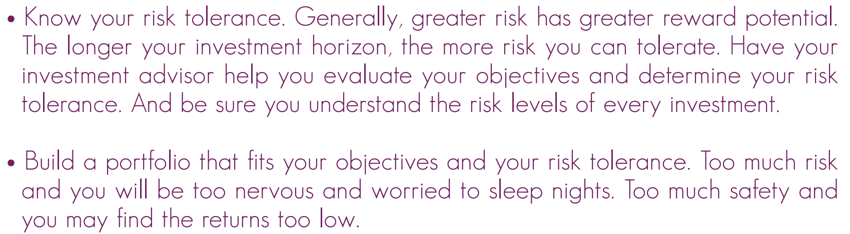
- Develop a plan and stick to it. Alter your asset allocation or selected fund or portfolio manager based on changes in your personal situation or investment strategy, not because of some short term market fluctuations.

- Let your intelligence not your emotions make your decisions for you. Do not panic and blindly follow others. Understand that you will make mistakes and take losses since you are investing in the capital market, even the best investors do. It is never a win-win situation.

- Do not let your emotions be ruled by today's performance. Do not be pressured into an investment that you do not understand or feel comfortable with.

- Define your investment objectives. Do you want growth, income or a combination of both? If you are unwilling to take any risk, you will be stuck with investments that have very low rates of return such as treasury bills or bank deposits.

- Investing in stocks to "get rich quick" has the worst returns. It is a long-term investment that yields returns on the long run.



- Know your risk tolerance. Generally, greater risk has greater reward potential. The longer your investment horizon, the more risk you can tolerate. Have your investment advisor help you evaluate your objectives and determine your risk tolerance. And be sure you understand the risk levels of every investment.

- Build a portfolio that fits your objectives and your risk tolerance. Too much risk and you will be too nervous and worried to sleep nights. Too much safety and you may find the returns too low.

In conclusion, whether you are a potential investor, current investor, experienced investor or just an interested reader about the capital market, we hope that this guide has provided you with the necessary and basic information concerning investment in financial assets. Furthermore, we trust that you found the subject interesting and you will learn more about it. We wish you good luck in your future investments.