Introduction to Module 4: Equity & Other Investments

Module Overview and Learning Outcomes

Te Wananga o Aotearoa

Module Overview

Introduction:

- Sharemarket investments are one of the main means by which individuals save for their future.
- The introduction of KiwiSaver has made sharemarket investments more common.
- Although many of us are KiwiSaver members or have signed up to some type of managed fund investment scheme, understanding of these investments is limited.
- Purpose of this Module is to demystify key concepts relating to sharemarkets so that tauira can learn how they can effectively participate in this type of investment.

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Resources

- The Module
- The Activity Workbook
- The Lesson Plan Workbook
- Assessment Handouts (2)

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Learning Hours

Lessons (five 3-hour lessons)	15 hours
Lesson Review & Assessments	75 hours
Activity Workbook (5 hours per week)	25 hours
Recommended Readings and Activities	25 hours
Support Workshops	10 hours
TOTAL	150 hours

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Learning Outcomes & Assessment Overview

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Assessments

- There are two assessments for this Module. We will look at these as we work through each section of the Module.
- Assessment 1: Sharemarkets and Investment Options:
  - A template-based assessment with a variety of types of tasks (e.g. True / false questions, short answer questions, identifying terminology.)
- Assessment 2: Business Purchase Case Study
  - A case study is given. Tauira answer questions about buying a business in relation to the case study. This includes basic business valuation calculations.

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Learning Outcomes for M4A1:

1. Demonstrate an understanding of how sharemarkets work and how an individual can participate in this type of investment.
2. Demonstrate an understanding of how managed fund investments operate and of key factors to consider when utilising this type of investment.
3. Demonstrate an understanding of a range of investment options and tools.
4. Demonstrate an understanding of general investment terminology and key concepts.

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Learning Outcomes for M4A2:

5. Identify and explain key considerations regarding private equity investment.
6. Conduct a basic valuation of a business for investment purposes.

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The L & N Learning Outcomes for CMM Module 4

By the end of this Module tauira will be able to:

- Locate and identify information of relevance in a case study and / or programme materials.
- Compare and evaluate information to identify missing or contradictory information.
- Evaluate the relevance of information to a particular situation.
- Write comprehensible sentences in response to questions and tasks.
- Write an example which demonstrates understanding of a concept.
- Demonstrate an understanding of terminology relating to private equity investment.

** Core Learning Outcome 6 (Conduct a basic valuation of a business for investment purposes) is also a numeracy learning outcome.*

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Module 4: Equity and Other Investments

Section 1: Introduction to the Sharemarket

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Section Contents

1. Introduction to the Sharemarket

1.1 The Sharemarket

1.2 Share Information and Terminology

1.3 Trading Shares and Tracking Performance

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Introduction

- Many people know somebody who has lost or made a lot of money on the sharemarket.
- Many people invest in shares without fully understanding what they are investing in and how the sharemarket works.
- Like any investment, sharemarket investments involve risk, but the risk faced by those who do not understand how the sharemarket works is generally much higher.

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1.1: Shares and Sharemarkets

- What is a share? A shareholder? A director? How many shares can a company have?
- What are dividends? How much is a shareholder paid?
- What are the pros and cons of investing in a company which pays high dividends?
- What is a sharemarket?
- The 3 markets of the NZX
- The role of a sharebroker – accredited by a stock exchange to trade on behalf of investors.
- Direct investing vs. Indirect investing.
- Stock market indices – price-weighted & market-weighted.

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1.2: Share Information & Terminology

- Finding information about shares is easy – e.g. www.nzx.com, the company's own website, sharechat (includes a shop containing detailed info for a number of companies), newspapers, etc.
- Understanding the Newspaper – what do terms such as 'buy', 'sell', 'Div CPS', 'PE Ratio' and 'Gross Yield %' mean?
- Terms related to a case study of Air New Zealand (pp 44 - 47)
- Other sharemarket terminology – e.g. ex dividend, cum dividend, bull market, bear market, etc.
- Using share information.

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1.3: Trading Shares & Tracking Performance

- The processes of buying and selling shares – page 56.
- Most banks now either work in partnership with a broking firm or have a broking firm as a subsidiary so they can offer share trading as part of their online services.
- The FIN and the CSN (p 59)
- Typical costs for buying shares – pp. 60 - 61.

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1.3: Trading Shares & Tracking Performance (cont.)

- Types of returns – capital growth and income.
  - Cash – interest income returns.
  - Bonds – mainly income returns, but may include capital gains if the bonds are traded.
  - Property – mix of capital growth and income.
  - Shares – usually more capital growth than income.

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Activities for Section 1

- Complete the 10 quiz questions on the hand out. Be prepared to explain your answers to the whole group.
- Discuss answers to Part One of M4A1
- Review the Delivery Strategies for Section 1

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Module 4: Equity and Other Investments

Section 2: Managed Funds

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Section Contents

2. Managed Funds
   2.1 About Managed Funds
   2.2 Investing in KiwiSaver
   2.3 Risk and Diversification
   2.4 Investment Statements and Taxes

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2.1: About Managed Funds

- What is a managed fund?
- Types of managed funds
  - Unit Trusts
  - Group Investment Funds (GIFs)
  - Superannuation Funds
  - Insurance Bonds (endowment and whole of life policies – Module 2).
- Why invest using a managed fund?- e.g. Diversification, knowledge, time.
- What do managed funds invest in? – types of funds (e.g. Balanced funds, sector funds, venture capital funds, etc.)
- Index funds vs active funds.

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2.1: About Managed Funds (cont.)

- Costs of investing
  - Annual management fees – often a flat rate
  - Activity fees – often charged as a %
  - Some funds charge one fee to cover both management and activity fees.
  - Other fees that may apply. E.g. Performance fees & upfront fees.
- Monitoring the Performance
  - Fund management companies send out reports at least once a year.
  - Fundsource (www.fundsource.co.nz) is a website dedicated to monitoring the performance of managed funds in New Zealand – refer p 85

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2.2: Investing in KiwiSaver

- List of providers given on www.kiwisaver.govt.nz
- 5 types of KiwiSaver schemes:
  - Cash funds
  - Conservative funds – (the default option) – about 80% fixed interest.
  - Balanced funds
  - Growth funds
  - Agressive funds
- Selecting a scheme and provider
  - Choose one which fits your risk profile
  - The Investment Statement outlines the type of investment in the scheme.
  - Check past performance – www.fundsource.co.nz
  - Providers are now required to report performance, fees etc in a standard format on their website.
  - KiwiSelect (refer pp 93-95)

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2.2: Investing in KiwiSaver (cont.)

- Taxation
  - Earnings are taxed and paid to the IRD by the scheme provider
  - Most schemes are PIEs – tax paid according to individual investors' income.
  - The Prescribed Investor Rate – compare rates on page 96 to the marginal personal tax rates on page 97.

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2.3 Risk and Diversification

- Types of risk – e.g. Capital risk, interest rate risk, currency risk.
- What is diversification?
- How much can be diversified away? – refer page 107.
- Asset allocation – the term used to describe how you spread your investments across different asset classes (and sub-asset classes).
- The risk / return ladder – from cash, to bonds, to property to shares. Refer to graph on page 114 re: Equity Returns
- Refer graph on page 116.
- Dollar Cost Averaging – reduces the risk of investing large amounts at the 'wrong time'.

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2.4: Investment Statements & Taxes

- An investment statement is a legal requirement for most investments.
- Using an investment advisor – What is an AFA and an RFA? Online register at www.business.govt.nz/fsp
- Required disclosure – what must an advisor tell you? p 125-130
- Taxation of Investments
  - A specialised area of tax – use an accountant or advisor.
  - Tax rates for various entitles – personal tax vs. Trusts and companies
  - NZ dividends usually come with imputation credits attached.
  - Managed funds – often take care of tax.
  - No capital gains tax on NZ company shares unless you are considered a 'trader'.

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2.4: Investment Statements & Taxes (cont.)

Overseas Investments and the Fair Dividend Rate

- Shares in companies outside of NZ and Australia may be taxed under the fair dividend rate.
- Each financial year you pay tax based on 5% of the average market value of overseas shares (excluding Australian shares), based on the *opening value* of your investment.
- Additional shares bought and held by the fund will contribute to next year's opening balance.
- If shares are bought and sold in the same year, the tax is based on the lowest of 5% of the price you paid for the shares or the actual profit made.
- Losses are not usually tax deductible.
- A number of exemptions apply.

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2.4: Investment Statements & Taxes (cont.)

- The following applies to individuals (not trusts): if you have foreign shares which cost you less than $50,000 ($100,000 for a couple) when you bought them (not their current value), you can opt to pay income tax on any income, such as dividends, that you receive. This only applies if you own less than 10% of the company.
- If your investments cost you over $50,000 when you purchased them, you are taxed as follows:
  - If your total return (including both capital gains increases plus dividends) is more than 5%, you are taxed using the Fair Dividend Rate method.
  - If your total return (including both capital gains increases plus dividends) is between 0% and 5%, you are taxed based on the actual total return. This is called the 'Comparative Method'.

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Activities for Section 2

- Complete the 12 quiz questions on the hand out. Be prepared to explain your answers to the whole group.
- Discuss answers to Part Two of M4A1.
- Review the Delivery Strategies for Section 2.

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Answer to Question 12

- If you personally purchase $80,000 worth of overseas shares (outside of Australia and New Zealand), how much tax would you pay in the following situation:
  - Your portfolio was worth $120,000 at the end of the financial year;
  - You received dividend income of $8,000 throughout the year; and
  - Your personal marginal tax rate is 33%
- Because the initial investment is over $50,000 AND the return on the investment was greater than 5% throughout the year (i.e. $48,000 / $80,000 = 60%) you are taxed using the fair dividend method.
- 5% of portfolio at start of year = $4,000
- 33% of $4,000 = $1,320 tax

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Module 4: Equity and Other Investments

Section 3:
Bonds, Derivatives and Other Investments

Te Wananga o Aotearoa

Section Contents

3. Bonds, Derivatives and Other Investments
   - 3.1 Bonds
   - 3.2 Derivatives
   - 3.3 Other Investments

Te Wananga o Aotearoa

3.1: Bonds

- When you buy a company's bonds, you are lending money.
- Usually pay a fixed rate of interest – the 'coupon'
- At 'maturity' you get your money back.
- Zero-coupon bonds.
- Senior bonds vs subordinated bonds (p 146)

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3.1: Bonds

- Bonds can be bought through a sharebroker or online.
- Bond information is available online
- The price of a bond moves up as interest rates fall and down as they increase – why?
- NZ Government bonds offered direct to public – Kiwi Bonds.
- Bonus Bonds – introduced by Government in 1970.
- Investment income is put into a prize pool.

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3.2: Derivatives

- A financial tool whose value depends on the value of something else – i.e. its value is *derived* from something else.

Key Terms:

- What is a '*long position*'?
- What is a '*short position*'?

- Can be used for hedging (fixing a price, off-setting a risk)
- Speculating – refer example on pp 157 and 158

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3.2: Derivatives (cont.)

- Introduction to Forwards:
  - a legally binding agreement to buy or sell a specific quantity and quality of a particular asset for a price agreed to today at a particular time in the future.
  - Not standardised and not traded on formal exchanges.
- Introduction to Futures:
  - Similar to a forward.
  - Standardised, normally traded on exchanges, do not usually specify an exact delivery date, usually 'closed out' before the end of the contrat and often used for speculating.

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3.2: Derivatives (cont.)

- Options
  - An option gives the buyer the right, but not the obligation, to buy or sell an asset at an agreed upon price on, or before, a certain date.
  - The strike price
  - Call options – buy if you think the price is going to rise above the strike price.
  - Put options – buy if you think the price is going to fall below the strike price.
  - If you sell (write) an option, your profits are limited to the amount you receive for the option, but the losses are potentially unlimited.
  - Options can be used for hedging and speculating.
  - Key info for tauira is on page 177
- Swaps

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3.3: Other Investments

- Term deposits
- Commodities – refer graph on page 189
- Currencies
- Collectables
- IPOs
- Wrap Accounts

The role of credit ratings:

- use to help determine which investments you will make.
- Based on an assessment of the entity's ability to pay their debts – do not say anything about price movements.
- Refer page 212

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Activities for Section 3

- Complete the 4 quiz questions on the hand out. Be prepared to explain your answers to the whole group.
- Complete Question 23 in Part Three of M4A1. Note down what page(s) you found the answers to each part of the question.
- Discuss answers to other questions in Part Three of M4A1.
- Complete Part Four of M4A1.
- Review the Delivery Strategies for Section 3.

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Module 4: Equity and Other Investments

Section 4: Equity Investment

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Section Contents

4. Equity Investment
   - 4.1 Introduction to Business Investment
   - 4.2 The Business Purchase Process
   - 4.3 Due Diligence & Understanding Data

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4.1: Introduction to Business Investment

- Advantages and disadvantages of buying a business as opposed to starting one.
- Discussion on purchasing a part of a business (not the entire business)
- Silent partners
- Is being in business right for you?
  - Evaluate the strength of the business idea – is there a gap in the market? Is it a superior product or service?
  - Evaluate your personal strengths and weaknesses (page 230)
  - What are key qualities and skills for business owners?

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4.2: The Business Purchase Process

- Buy a business by buying shares from a current owner.

The Suggested Process:

1. Arranging preliminary finance (& evaluating own position)
2. Finding a business for sale
3. Conducting due diligence – discussed in Section 4.3
4. Arranging formal finance
5. Checking legal agreements
6. Signing Contracts

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4.2: The Business Purchase Process (cont.)

Financing the Business:

- If purchasing a business, upfront costs are easily identifiable.
- Debt financing – usually need to contribute at least 30% yourself and provide security. Some other organisations shown on page 239.
- Equity financing
  - no loan to pay back.
  - Angel investors and venture capitalists (www.vcapital.co.nz).
- Business grants and assistance – page 242.
- Arrangements with suppliers – can provide enough time to earn the income needed to pay the invoice.
- Advance payments from customers – what situations may this be appropriate in? Do you need to offer a discount? (this may be a cheap source of finance).

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4.2: The Business Purchase Process (cont.)

Getting Good Advice

- Essential before committing to anything.
- Information to take – brief about business, financial statements, brief about your current personal situation.
- Types of advisers and assistance:
  - Accountants
  - Lawyers
  - Business consultants
  - Bank advisers
  - IRD
  - Business courses

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4.3: Due Diligence & Understanding Data

- The process of examining the state of the busines prior to purchase.
- Why is the business for sale? Some reasons are not of concern – others are. As long as you understand the implications of the reasons you can still purchase – just don't pay too much.
- Obtain a copy of the most recent financials and those from previous few years – if possible.
- What to look for:
  - Statement of Financial Performance (pp 255 – 257)
  - Statement of Financial Position (pp 259 – 262)
  - Is there a cashflow statement? Are bank statements available? (pp 263-264)
  - Other sources of financial information – GST returns, till receipts, inventory records

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4.3: Due Diligence & Understanding Data

- Other considerations
  - Industry information
  - Employees – will they stay?
  - Customers – are they likely to remain? Is there a list?
  - General considerations – e.g. Are leases transferable, does the business comply with legislation, what is the reputation like?
- SME considerations
  - Is the owner's salary included in the wages?
  - Are there additional non-essential expenses (e.g. FBT) or assets?
  - Are home assets included in the purchase price?
  - Restraint of trade clause
  - Is assistance from the vendor possible?

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Activities for Section 4

- Complete the 8 quiz questions on the hand out. Be prepared to explain your answers to the whole group.
- Discuss answers to Part One of M4A2.
- Review the Delivery Strategies for Section 4.

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Module 4: Equity and Other Investments

Section 5: Business Valuations

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Introduction

- When it comes to buying a business, it doesn't matter how well run a business is, or how profitable, how well-known, or how many customers it has – you can still end up paying too much.
- If you pay too much for your business it will take longer to earn back what you invested and much longer to make a profit.

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Section Contents

5. Business Valuations
   - 5.1 The Art of Valuation
   - 5.2 The Capitalisation Rate Method
   - 5.3 Other Valuation Methods

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5.1: The Art of Valuation

- No 100% accurate way to calculate what a business is worth as you are trying to predict the future performance of that business.
- A business can be valued by assessing its current profits, expected future profits and the value of its assets.
- When valuing a small business, you may need to adjust the financial statements in order to figure out true profit levels.
- If you are buying a non-controlling interest in a business, make sure you pay less than that % of the total value of the business.
- Goodwill: an accountancy term – refers to the difference between the purchase price of the business and the value of the net assets of the business.

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5.2: The Capitalisation Rate Method

- A 'Capitalisation Rate' – the rate of return you want to get out of the business. Can think of it like an interesst rate.
- The higher the rate, the lower the value.
- The link with the P/E Ratio helps show how many years it takes to 'earn' the price you pay for the business. Pp 285 and 287.
- Do not use a capitalisation rate below 20% - remember the risk / return ladder.
- Which profit figure?
  - Should reflect the contribution made by the current owner to get to current stage BUT do not pay more than future expected profits.
  - It is helpful to work out 2 values – 1 based on current profits and 1 based on expected profits.

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5.3: Other Valuation Methods

- Valuing based on Net Assets
  - If you were to sell everything the business owns and pay off outstanding debt, you are left with net assets.
  - Useful if you don't have cashflow or profit data.
  - Use market values, not book values, for assets.
- Valuing based on Sales
  - A basic method, often based on 'rules of thumb' for the industry.
- Valuing based on Cashflow
  - Apply the capitalisation rate method to future net cashflows to determine your future returns.
  - Use an extended version of the capitalisation rate method formula – e.g. On pp. 305-308.
  - Don't pay more than this value.

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Activities for Section 5

- Complete the 6 quiz questions on the hand out. Be prepared to explain your answers to the whole group.
- Discuss answers to Part Two of M4A1.
- Review the Delivery Strategies for Section 1

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