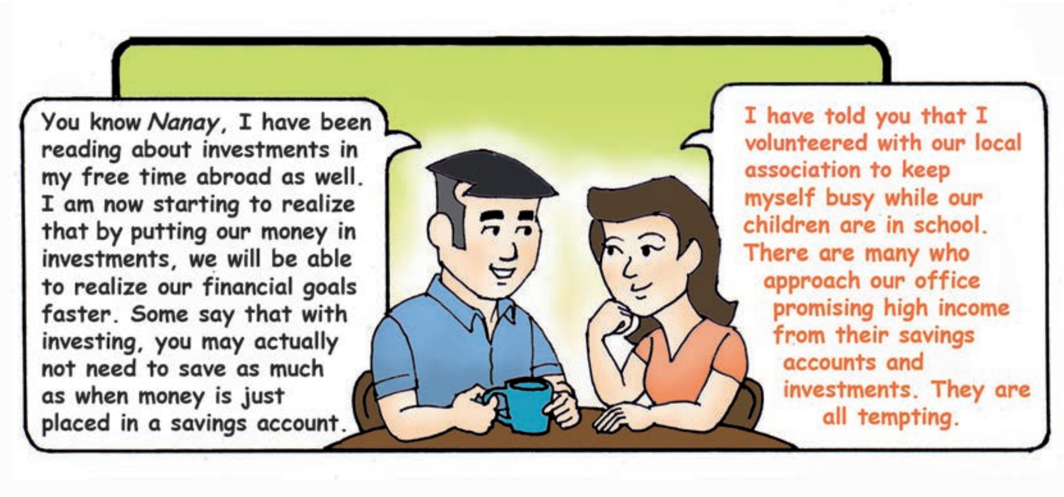
# CHAPTER 6

It is just two weeks before *Mang* Domeng flies back to the Middle East. As they enter their house, *Aling* Lorna says, "*Tatay*, I've been thinking; when you come back, we should have accumulated some savings. Shouldn't we invest it? When I watch the morning TV shows and read magazines, I always come across topics on investing."




*Mang* Domeng proudly professes, "My rule is that if something sounds interesting to me but I don't know a thing about it, I will first ask regulators or an expert about it.  We should ask the Bangko Sentral ng Pilipinas and Securities and Exchange Commission."

*Aling* Lorna exclaims, "You are right, *Tatay.* And since some of those approaching the association talk of bundled insurance, maybe we should also call the Insurance Commission.

"I remember what Harry said about Ponzi schemes and pyramiding scams," remarks *Aling* Lorna. "If we are not careful with our hard-earned money, we might end up also as victim," she adds.

"Yes," exclaims *Mang* Domeng, "do you remember what happened to Lydia, our next door neighbor, and her relatives? They put a lot of their own money and even borrowed more to put into this investment that was allegedly paying 10% per month, net of taxes. That's like earning 120% a year. But what company can also survive paying 120% a year in equivalent interest?"

"That's right, *Tatay*," says *Aling* Lorna. "Not long after the Ponzi scheme collapsed and the operator went missing in action, Lydia's house had also been abandoned. It seems like no one lives in their house anymore. The rumor is that they, too, went into hiding from their creditors and probably fled to the province."

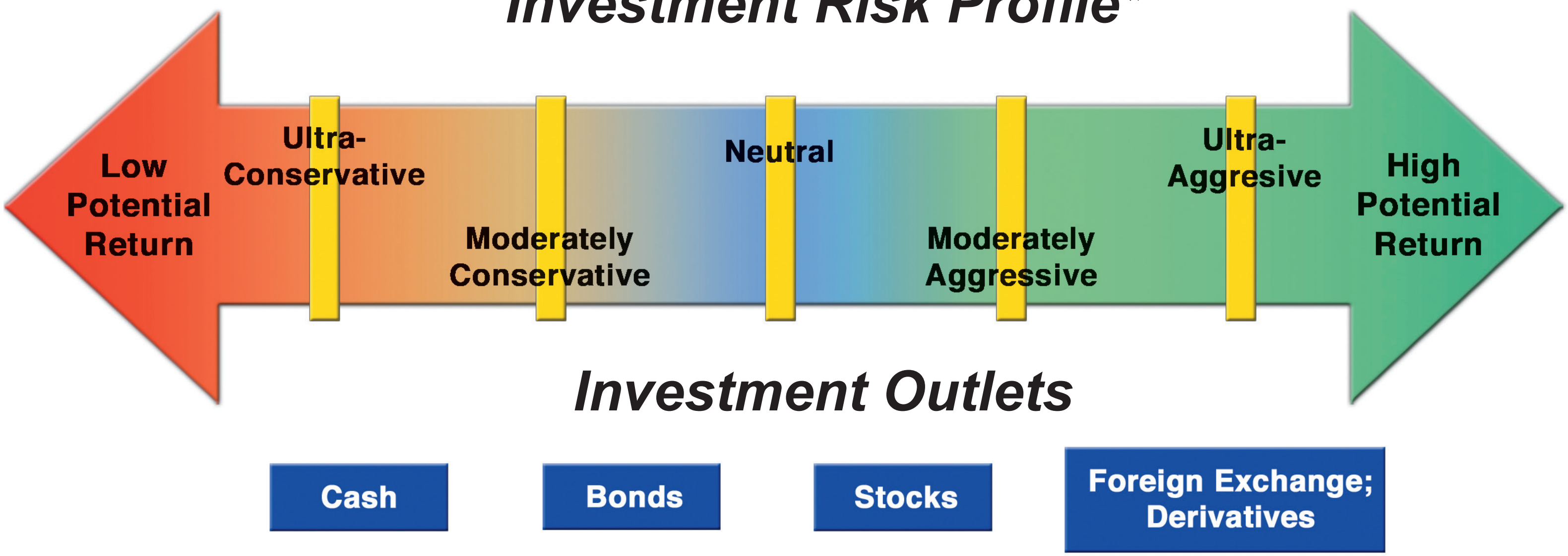
## Financial Expert's Corner

*There are many places to put your money from under your pillow or inside a bamboo post to complex investment instruments and even a business. Figure 8 gives you broad categories of where to put money given your risk profile.*

*Risk profile as used in Figure 8 refers to the losses you are willing to take on your money. And the unbreakable rule in investing applies here, namely: the higher the risk, the higher the potential investment return; the lower the risk, the lower the potential investment return. Please note the word "potential" as there is no place where you can put your money where the investment return and even principal repayment are fully guaranteed.*

## Figure 8

### *Investment Risk Profile**

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# Cash or Near Cash

Eager to find out more about investing, *Aling* Lorna visits their bank. She once more engages the branch manager in a little discussion, this time about investing. The bank branch manager was more than willing to discuss the basics of investing starting with the simplest - cash or near cash products.


Ed, the bank branch manager, replies, "*Aling* Lorna, we have to find out what you need your money for. If it is just for your family's daily needs and to maintain a fund for emergencies, you will need to put your money in liquid accounts. Basically, any place you can put your money that allows for quick withdrawal or conversion to cash with minimal transaction cost and without loss of principal is considered a cash or near cash account. Such accounts are classified as liquid. These include:

- Savings accounts with banks, cooperatives, savings and loans associations and other similar government-regulated institutions
- Checking accounts with banks
- Time deposits with banks, cooperatives, savings and loan associations and other similar institutions
- Special deposit accounts (SDAs)
- Special savings accounts (SSAs)

"And what do you mean by marketable?", asks *Aling* Lorna.

Ed replies, "Marketability refers to an account's quality of being easily sold and converted to cash but not necessarily without loss of principal and/or significant transaction cost".

Years of experience have taught Ed to also caution his clients about potential risks. Thus, Ed adds, "Please note that not all of the cash or near cash accounts are covered by deposit insurance. The Philippine Deposit Insurance Corporation (PDIC) insures only the following accounts:

- Savings
- Special Savings
- Demand/Checking
- Negotiable Order of Withdrawal (NOW)
- Negotiable/Non-negotiable Certificate of Time Deposits"


Again with utmost concern for his client, Ed explains that there is a difference between special savings accounts and special deposit accounts. He says, "Special savings accounts are deposit liabilities of banks. Special deposit accounts or SDAs are placements made indirectly with the Bangko Sentral ng Pilipinas exclusively through Investment Management Accounts or IMAs of banks' Trust Departments. Only special savings accounts of banks are covered by the PDIC. Since SDAs are not deposit liabilities of banks, they are not covered by the PDIC. The Bangko Sentral ng Pilipinas guarantees payment of the interest and repayment of the principal of SDAs."

**Did You Know?**

*By BSP regulation, IMAs must be opened with the Trust Department of a bank at a minimum amount of Php1 million. Because of this regulation, placements in SDAs must also be a minimum of Php1 million. Moreover, SDAs must be held up to maturity. As of this writing, the longest SDA tenor is 30 days.*

## Financial Expert's Corner

*For long-term time deposits, some banks would sometimes let the depositor shoulder the documentary stamp taxes if the depositor pre-terminates the long-term time deposit within the first year of placement. If the pre-termination is done after the first year of placement, banks may opt to pay for the documentary stamp taxes.*

*The interest rate on peso time deposits is subject to the final withholding tax on interest income of twenty percent (20%).*

*Banks also sell short-term commercial papers and Treasury Bills (T-bills), both of which have maximum original tenors of one year. Short-term commercial papers are issued by companies usually to fund their short-term working capital requirements. T-bills are borrowings of the National Treasury. T-bills differ from Treasury notes or T-notes. The latter would have original tenors in excess of one year. Sometimes, T-notes can be considered near cash if the remaining life of the note is one year or less.*

*Since a bank merely acts as a re-seller of short-term commercial papers, T-bills and T-notes, it does not guarantee the repayment of interest on such securities or of principal. The investor, in effect, will have no recourse to the bank should a credit event occur (i.e., such securities fail to pay interest and/or principal). Of course, government securities, which include T-bills and T-notes, have a very low risk of encountering a credit event. Still, the investor will have no recourse to the bank should a credit event occur. The investor will have to run after the actual issuer of the paper, bill or note for the interest and/or principal due him.*

*A short-term commercial paper will have to be studied well because it is the credit worthiness of the issuer and not the selling bank that will determine* *the relative certainty of interest income from and principal repayment by the paper. This study should include any credit ratings given by independent rating agencies on the issuer in general and the paper in particular. Needless to say, commercial papers, whether short- or long-term, also need to be registered with the Securities and Exchange Commission.*

*Short-term commercial papers and T-bills are not covered by the PDIC as well.*

# Bonds

To give his client a more complete picture, Ed also talks about bonds to *Aling* Lorna.

"You know *Aling* Lorna," Ed says, "you can also buy bonds with your money."

Ed says, "In their simplest form, bonds are actually borrowings by companies and governments. In contrast to short-term commercial papers, bonds have maturities of over one year when they are originally issued. Bonds are securities registered with the Securities and Exchange Commission and sold to the public. Bonds would normally pay interest first and periodically over the life of the bond and repay the principal upon maturity."

Ed apologizes to *Aling* Lorna for the following technical discussion, "However, there are also zero-coupon bonds wherein there are no interest payments. Zero-coupon bonds are sold for an amount lower than their face or maturity value. The difference between the amount invested by the bond holder and the bond's face value represents the interest to the bondholder. The thing with zero-coupon bonds is that the coupon or interest stated for them is the effective interest rate earned by the bondholder. The interest earnings on a regular bond would only equate to the stated coupon rate if such interest earnings were re-invested at the same stated coupon rate by the bondholder. Bondholders will effectively earn the interest rate quoted on regular bonds if each interest collection is also made to earn the same quoted interest rate up to the maturity of the bond. So if the bondholder merely spends his interest earnings or reinvests them at a rate lower than the quoted bond interest rate, he will earn a lower effective rate."

## Financial Expert's Corner

*Since bonds are securities sold to the public, they need to be registered with the Securities and Exchange Commission. However, by law, the securities issued by banks and the government are exempt from registration with the Securities and Exchange Commission.*

*Bonds can be bought and sold electronically through the Philippine Dealing and Exchange system or PDEx. As such, bondholders can more easily make capital gains or losses by trading bonds.*

*The actual investment instrument should indicate whether it enjoys any tax exemption afforded by law.*

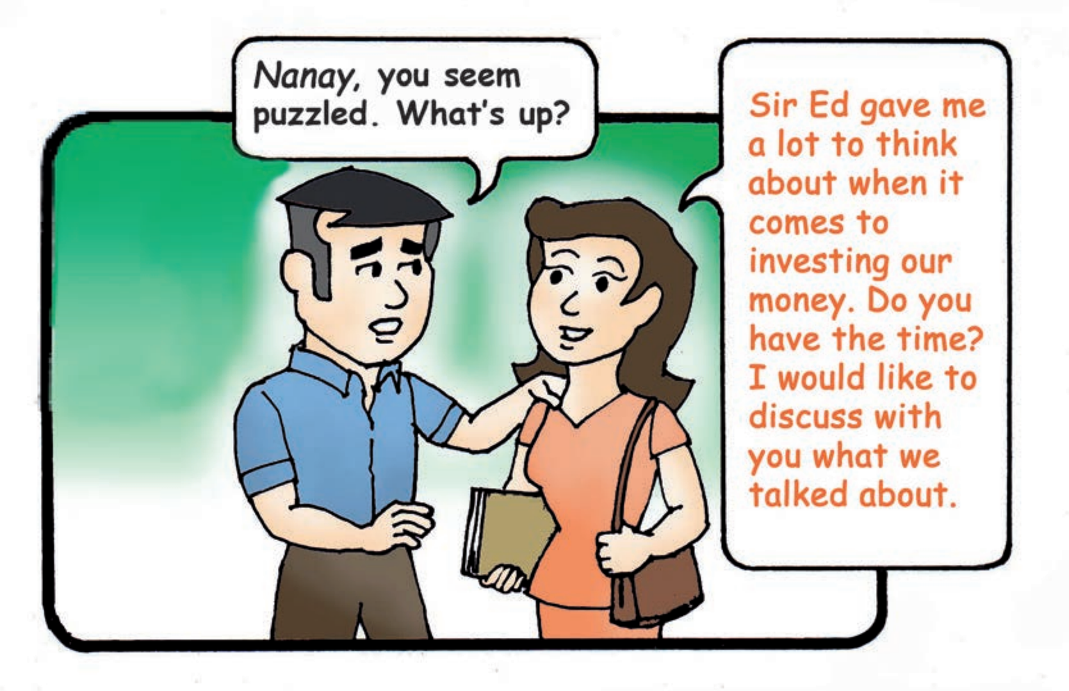
"Wow," exclaims *Aling* Lorna, "that is a lot to digest in just one sitting. Sir Ed, I hope you don't mind if I first discuss the matter with my husband before I invest with you."

Ed replies, "That's no problem *Aling* Lorna. Take all the time you need. And please take home the handouts we discussed."

Taking all the materials and sample computations that she covered with her bank branch manager, *Aling* Lorna thanks Ed and heads back home.

# Stocks

*Mang* Domeng notices a bewildered look on *Aling* Lorna's face as she enters the house after visiting the bank.




"Well, *Nanay*", says *Mang* Domeng, "I too have been busy doing research while you were away. Did you know that we can also potentially make money by buying stocks? I learned that stocks have been traded in the Philippines since the founding of the Manila Stock Exchange in 1927.  Then 38 years later, the Makati Stock Exchange opened for business.  In 1972, Presidential Decree 167 mandated the automatic listing of securities in all stock exchanges.  In 1987, the Manila and Makati Stock Exchange adopted a common set of index stocks.  In 1994, these stock exchanges were officially unified under the Philippine Stock Exchange."


After breakfast the next morning, *Mang* Domeng asks *Aling* Lorna if she is already up to discussing stocks.  *Mang* Domeng promises to keep it short and simple. *Aling* Lorna, after making *Mang* Domeng repeat his promise of limiting the discussion to the level of a person with no background in stock investing, finally agrees.

*Mang* Domeng explains that stocks simply represent ownership in companies. Investing in stocks," says *Mang* Domeng, "is like investing in land." Drawing on a piece of paper, *Mang* Domeng writes out the following table:

| | Land | Stocks |
|---|---|---|
| Income | Rental income | Cash dividends |
| One-time gains | Money made from selling land at a price higher than cost | Money made from selling stocks at a price higher than cost |
| Guarantees on income and return of principal | Tenant promises to pay rent and return land upon termination of rental agreement | No promises on cash dividend payments and return of entire principal upon the sale of stocks |
| Return of invested capital | When land is sold. However, value to be returned will depend on selling price, which in turn is dependent on prevailing market conditiom | When stocks are sold. However, value to be returned will depend on selling price, which in turn is dependent on prevailing market condition |

"You see, *Nanay*, although they are not exactly the same, investing in land is very similar to investing in stocks." *Aling* Lorna then exclaims, "Oh, so now I get it! Thanks, *Tatay.*"

"But *Nanay*," *Mang* Domeng adds, "investing in stocks is not as easy as investing in land. You will need to buy stocks through a stockbroker licensed and registered with the Securities and Exchange Commission and Philippine Stock Exchange. And without the proper expertise, a person can lose big with stocks[7]."

## Financial Expert's Corner

*Under the hands of experts, stocks can prove to be good long-term investments in the country. For the five-year period ending in 2012, the Philippine Stock Exchange (PSE), as represented by the PSE Index (PSEi) posted an annual compounded return of 9.9%. This is much higher than the 4.3% annual compounded yield of the one-year T-bill rate for the same five-year period ending in 2012.*[8]

*There is an indirect way of investing and this is through pooled funds. Among the pooled funds in the country are mutual funds and unit investment trust funds. Pooled funds gather funds of the investing public and put them in a fund that approximates their investment objectives and risk preference. Such funds are handled by professional fund managers, many of whom are able to outperform the PSEi through active trading strategies.*

*Mutual funds invested in local equities generated a 5-year annual compounded return as of the end of 2012 of 13% while equity-invested unit investment trust funds produced a 5-year annual compounded return of 16% also as of 2012. Stocks are not covered by the PDIC.*

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[7] *Presently, there is no need to hold on to actual stock certificates since stock ownership is now on book entry system or what they call scripless.*

[8] *Returns were imputed from data sourced from the Philippine Stock Exchange, Bangko Sentral ng Pilipinas, Philippine Investment Funds Association and Trust Officers' Association of the Philippines.*

# Foreign Exchange, Derivatives

It is the following Friday and *Mang* Domeng is going through their family budget meticulously. He suddenly realizes that the volatile Peso-to-US Dollar exchange rate is adding a lot of uncertainty to their budgeting. For example, as the Peso appreciates, *Mang* Domeng would need to work harder to fund their Peso-denominated expenses, which comprise the bulk of their budget.

*Mang* Domeng decides to visit their bank branch manager to ask for some advice.

Upon reaching the bank, Ed, the branch manager with his sixth sense was already waiting to greet him. “Good morning, *Mang* Domeng,” Ed says gleefully while motioning to *Mang* Domeng to have a seat, “How may I be of service to you today?”

*Mang* Domeng looks at Ed intently and asks, “Ed, as you know, I am an OFW earning in US dollars. Lately, the value of peso has been changing versus the US dollar. The effect on us is that we need to make continuous and sometimes large adjustments to our family budget. Does your bank have a solution for this?”

Ed tells *Mang* Domeng that their bank has tools to manage the movements of foreign exchange. He says that the bank is authorized by the Bangko Sentral ng Pilipinas to sell derivative products that could help smoothen out the movements in the exchange rate. Ed also talks to *Mang* Domeng about foreign exchange trading.

But Ed is also quick to point out that foreign exchange trading and derivatives are very complex financial products, which may also be risky investments in themselves. To put it simply, Ed says, “*Mang* Domeng, it would probably best for you to convert immediately to Pesos that portion of your earnings that is meant to be spent in the Philippines. The balance that you will keep in US dollars should be spent on items that require that currency as well. This way, you minimize the currency risk on your money.”

## Financial Expert's Corner

*The advent of globalization and high-speed Internet connection has also ushered in cross-border investing and, with it, global currency trading.*

*Foreign exchange or FX trading is not for the weak of heart. Since trades remain open overnight, investment positions can be magnified or lost in the blink of an eye. Trading is done largely through FX brokers who may or may not be regulated in their home country.*

*Regulations will vary from one country to another. There is currently no local regulatory body overseeing FX trading.*

*FX trading losses are not covered by the PDIC.*

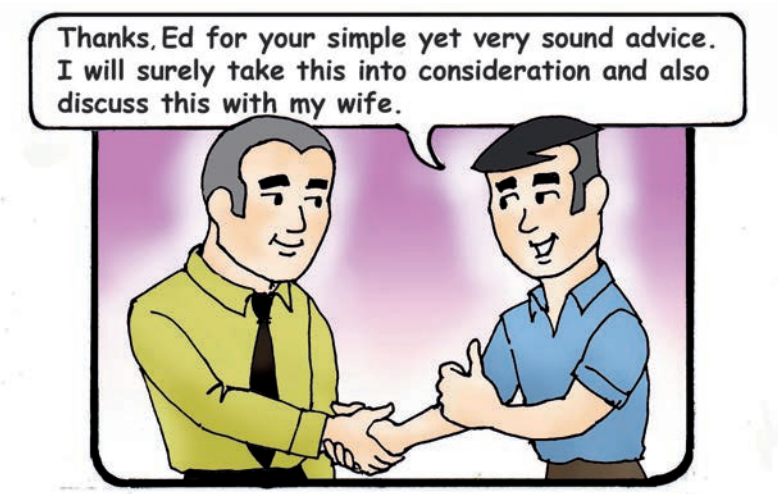
*Derivatives are fairly new securities being offered in the Philippines as banks are only now starting to get their derivatives license from the Bangko Sentral ng Pilipinas.*

*Derivatives are basically contracts between two parties that specify conditions under which payments are to be made between such parties. For example, a bank could offer a structured product that pays a higher than normal interest rate over a 90-day period provided that the price of gold falls within a certain price range at the end of the 90 days. If the price of gold falls on or outside of the target price range at the end of the 90-day period, the investor would be paid a lower than normal interest rate.*

*By their very nature, returns on derivatives are derived from other underlying securities, commodities, exchange rates or even stock market indexes. Pre-terminating a derivative can be very costly on the part of the investor as well, if it is even allowed.*

*Like FX trading, derivatives are also not covered by the PDIC.*

"And, *Mang* Domeng," Ed adds, "if part of your Pesos will be used for preparing for your retirement, watch out for the implementation of the Personal Equity Retirement Account or PERA law. Under the PERA law, money that is set aside for your retirement will enjoy tax exemption. You, as an OFW, will be allowed a maximum of Php200,000 a year in contributions to your PERA funds. In addition to being tax exempt, your yearly contributions will afford you a 5% tax credit. More importantly, when you reach the age of 55 and provided you would have contributed for five non-consecutive years to your PERA funds, you can withdraw your investments plus earnings tax-free."




## Financial Expert's Corner

*The Personal Equity and Retirement Account Law or PERA (Republic Act 9505) provides exemption of investments of PERA contributions from the final withholding tax on interest income of twenty percent (20%) and the one-half of one percent (1/2 of 1%) stock transaction tax. PERA also gives five percent (5%) tax credits on contributions. Individuals can make PERA contributions up to a maximum of Php100,000 a year for non-overseas Filipino workers (OFWs) and Php200,000 a year for OFWs. Contributions and earnings on an individual's PERA may be claimed tax-exempt at retirement provided the PERA contributor has reached the age of 55 years old and has made contributions to his PERA for five (5) non-consecutive years. For more on PERA, please see Annex G on page 150.*

# Other Places to Put Your Money

1. While there are many places to put money, the wise saver should remember that the cardinal rule in investing has never been broken: ***the higher the potential investment return, the higher the risk.***

2. Basically, any place you can put your money that allows for quick withdrawal or conversion to cash with minimal transaction cost and without loss of principal is considered as *cash* or *near cash* account.

3. In their simplest form, bonds are actually borrowings by companies and governments. Such borrowings take the form of securities sold to the public called *bonds*.

4. *Stocks* represent ownership in companies. Stock investors can earn (cash, stock) dividends from their investments as well as enjoy capital gains through price appreciation. Of course, stock prices can also decline due to factors both internal and external to companies represented by the stocks.

5. Foreign exchange or FX trading is not for the weak of heart. Since trades remain open overnight, investment positions can be magnified or lost, in the blink of an eye. Trading is done largely through FX brokers who may or may not be regulated in their home country. Regulations will vary from one country to another. There is currently no local regulatory body overseeing FX trading.

6. Derivatives are basically contracts between two parties that specify conditions under which payments are to be made between such parties.

7. FX trading and derivatives are not covered by deposit insurance.

8. PERA is a law that provides tax benefits for people who set aside and invest a maximum Php100,000 (Php200,000 for OFWs) a year towards their retirement. The tax benefits range from exemption for the 20% final withholding tax on interest income and stock transaction tax of □ of 1% to a 5% tax credit based on yearly savings towards retirement.

# Your Personal Notes